LLOYDS BANKING GROUP PLC – Q3 2016 INTERIM MANAGEMENT STATEMENT PRESENTATION

Wednesday 26 October 2016

António Horta-Osório, Group Chief Executive

Good morning everyone and thank you for joining us for our 2016 third quarter results presentation.

I am going to give you a short overview of the results and explain why I believe Lloyds is well positioned within the current macro environment, and George will then cover the financial results in more detail. After this we will take your questions.

Turning to slide 1 for those of you following the webcast presentation. In the first nine months of 2016 our differentiated business model has continued to deliver, with a robust underlying profit of £6.1 billion and a strong improvement in statutory profit before tax to £3.3 billion despite taking a further PPI provision following the FCA's additional consultation on the matter. The Group's capital generation also remains strong, with 60 basis points generated in the third quarter.

Our relentless focus on cost has allowed us to respond to the current market conditions, with the significant progress made in our Simplification programme continuing to drive lower operating costs. These efficiency savings have more than offset a marginal reduction in income and driven positive operating jaws.

Our credit quality remains strong. In the first nine months our net AQR was just 14 basis points and we continue to see no deterioration in the underlying lending portfolios, with these trends principally reflecting our low risk business model and the low interest rate environment.

With regards to PPI, the FCA's additional consultation paper has proposed a deadline for complaints of June 2019. Whilst the outcome is not yet finalised, we are taking a further provision of £1 billion to cover additional operating costs and redress.

Despite this and headwinds from the pension schemes, our capital generation remains strong as this was offset by gains in our gilts portfolio. We have therefore maintained our balance sheet strength with a CET1 ratio of 14.1 per cent, pre dividend or 13.4 per cent post, and a total capital ratio of 22.1 per cent.

We also remain focused on delivering on our targets to support people, businesses and communities as set out in our Helping Britain Prosper Plan. Over the last 12 months we have continued to increase net lending in each of our targeted customer segments. For instance, our SME lending growth continues to outperform the market at 4 per cent year-on-year, and UK Consumer Finance continues to grow strongly at 9 per cent, including growth of 23 per cent in motor finance.

Our differentiated, simple, low risk business model is delivering for our customers and shareholders, and as a result we are re-affirming our stated 2016 guidance.

The hard work undertaken in the last five years to transform and simplify the business has allowed the UK government to sell most of its stake in Lloyds, returning £17 billion, including dividends, on its original £20 billion investment. We welcome its recent decision to commence a new trading plan with the intention of selling its remaining 9 per cent stake over the next 12 months.

Looking at the UK economy, the outlook remains uncertain following the outcome of the EU referendum, however the strength of the recovery in recent years means the UK is well positioned faced into this situation.

Both households and corporates are now in a stronger financial position given the deleveraging that has occurred since 2009, as reflected in the reducing ratios of debt to GDP. Unemployment, now below 5 percent, is also at its lowest level in over 11 years.

Mortgage affordability has improved and is significantly better than the long term average, largely due to the low interest rate environment coupled with wage growth in recent years. House prices have increased, which combined with low mortgage growth, has led to much healthier LTVs. Our customers, on average, now have mortgage debt which is less than half the value of their homes.

Looking longer term, the UK has clear structural strengths that have allowed the economy to flourish in the past and which are likely to remain in place.

In terms of our business trends since the referendum, there has been no significant impact in any of our consumer markets. In the corporate sector we have seen some impact as businesses have deferred elements of their investment and borrowing, both pre and post referendum, given the uncertainty. However, the aggregate volume effect has been relatively limited.

Overall these early trends remain insufficient for us to be able to extrapolate the likely longer-term outlook. I am confident that the Group is well positioned to continue delivering for our customers and shareholders given the transformation of the Group in recent years and our distinct competitive advantages.

Our business model is built around being a simple, UK focused retail and commercial bank, which benefits from a multi-brand, multi-channel distribution platform and a market leading digital proposition. With a 21 per cent market share, we operate the UK's largest digital bank, serving 12.4 million online customers and 7.8 million mobile banking customers.

As you have heard me say many times before, one of the key differentiators of our business model is our rigorous cost management process and a cost culture that is fully embedded in the organisation.

Our cost discipline means that we have the lowest cost:income ratio among our UK peers and this cost advantage will be of particular importance as we face a more challenging income outlook across the sector.

In addition, our low risk approach, coupled with the improvement in the UK economy in recent years, has ensured that our credit quality has improved dramatically since 2010, with impaired loans now representing only 2 per cent of lending balances.

More recently we have not needed to make any material changes to our risk appetite following the referendum and this is testament to the low risk approach we have implemented.

Finally, our capital generation has been and continues to be strong. As a result we have seen a significant strengthening of our CET1 capital ratio, which has improved from 7.1 per cent in 2010 to 14.1 per cent pre dividend, or 13.4 per cent post, as at September 2016.

Given these competitive advantages we believe we are well positioned to continue delivering for both our customers and shareholders.

I would now like to pass the call over to George, who will run through the financials.

George Culmer, Chief Financial Officer

Thank you António and morning everyone.

As you have heard, underlying profit was £6.1 billion for the first nine months, with a marginal reduction in income offset by a 2 per cent improvement in operating costs giving positive operating jaws and a cost:income ratio of 47.7 per cent.

On credit, impairments increased to £449 million due to the expected lower releases and writebacks, with a gross AQR of 26 basis points which is in line with prior year. The net AQR was 14 basis points and we continue to expect the 2016 full year AQR to be less than 20 basis points.

For the year to date, the underlying return on required equity was a strong 13.6 per cent with the reduction on prior year primarily due to the movement in underlying profit and the impact of the banking surcharge tax.

Looking at income, net interest income of £8.6 billion was up by 1 per cent, driven by an improvement in the margin to 2.72 per cent, with lower deposit and funding costs continuing to more than offset lower asset pricing.

The margin in Q3 was 2.69 per cent and impacted by the base rate cut in August but yet to benefit from recently announced deposit rate changes. Looking forward, we continue to expect the full year NIM to be in line with our existing guidance of around 2.70 per cent.

Other income was £4.5 billion and down 2 per cent on prior year. The third quarter total of £1.4 billion is down on Q2 due mainly to Insurance, but up 4 per cent on Q3 last year. We now anticipate full year other income of around £6 billion.

Moving on to statutory profit, statutory profit before tax has increased by more than 50 per cent to £3.3 billion due to a reduction in below the line items.

Firstly, as you know, the Group took a £790 million charge in Q1 for the redemption of the ECNs and, following the Supreme Court ruling, there are no further charges for this item.

Market volatility and other items totalled £18 million. This includes a £484 million gain on sale of the Group's stake in Visa Europe, which largely offsets the fair value unwind charge of £156 million, amortisation of intangibles of £255 million, as well as negative insurance volatility of £157 million.

On restructuring, the £390 million charge mostly reflects the Simplification programme's severance costs relating to the accelerated role reductions, and also includes £97 million of costs for the Group's non-ring-fenced bank build.

On PPI, as António has already mentioned, the FCA's additional consultation paper has now proposed a complaints deadline of June 2019 and we have taken a provision of £1 billion in Q3 to cover for additional operational costs and redress.

Other conduct was £610 million for the year to date, with a Q3 charge of £150 million, £100 million of which relates to packaged bank accounts.

Finally, our tax charge was £1.2 billion, representing an effective rate of 36 per cent. This high rate reflects the revaluation of the Group's deferred tax assets following the corporation tax rate change, the banking surcharge and the deductibility of conduct provisions.

We continue to expect a medium term effective rate of around 27 per cent.

Finishing then with capital. As you have heard from António, the business remains well capitalised and continues to be strongly capital generative with a CET1 ratio of 14.1 per cent, pre dividend accrual.

In Q3 we have increased capital by around 60 basis points, comprising 50 basis points of underlying capital growth, a further 60 from market movements and 10 of other items, offset by around 60 basis points from conduct.

Within market movements the narrowing of AA corporate credit spreads moved the Group's defined benefit pension schemes into deficit and reduced capital by approximately 20 basis points.

Offsetting this, in the current low interest rate environment we have decided it is no longer appropriate to commit to holding gilts to maturity. We have therefore reclassified to available-for-sale the £20 billion of gilts within the liquidity portfolio that were previously classified as held-to-maturity. This action has benefitted capital by around 80 basis points which reflects the impact of the market movements in the year on the value of these gilts.

In terms of year to date capital growth, the Group has generated 110 basis points of capital, which comprises 160 basis points of underlying growth, 10 from other items including ECNs, offset by 80 basis points from conduct. Market movements in the year have been a positive 20 basis points, with the favourable held-to-maturity impact largely offsetting the market driven pensions and RWA movements.

For the full year we are reaffirming our guidance of around 160 basis points of capital generation, pre dividend.

Finally, TNAV of 54.9 pence per share is broadly flat on June, with underlying profit offset by conduct charges, tax and the interim dividend cash payment. The impact of market movements from pensions largely offsets the held-to-maturity reclassification benefit.

For the year to date, TNAV is up 2.6 pence per share, and up 5.5 pence after excluding dividend payments, primarily driven by strong profit growth and positive reserve movements.

So, in summary, while the UK faces uncertainty, the economy is well positioned given its structural strength and the recovery in recent years.

At Lloyds we have a clear strategy, a strong balance sheet and sustainable competitive advantages in our low risk and low cost business.

Our differentiated business model continues to deliver, with a significant improvement in profit and strong capital generation.

This confidence in the future means we are re-affirming our 2016 guidance and are well positioned to continue delivering for customers and shareholders.

That concludes today's presentation and we are now available to take your questions.

End of Presentations

Question and Answer Session

Question 1: Chris Manners, Morgan Stanley
Good morning George, good morning Antonio. Two questions if I may. First one was on the net interest margin outlook and if you could talk to us a little bit about the competitive environment you are seeing, what you are doing to offset the low rate environment maybe in terms of liability repricing and what the impact of this move in the gilt portfolio might be?

And the second one was on capital return. Obviously I suppose we have got a more constructive tone from the Bank of England. I saw your Pillar 2A's been cut by 10 basis points on the common equity tier one component. And obviously you had a big move there. On the gilt portfolio gain, are we really going to be able to pay down specials so we just finish the year at 13.0. Is that your sort of clear intention? Thanks very much.

Answer: George Culmer
Hi Chris, there were a number of things wrapped into that question there. Let me start with the gilts and I will come back to the competitive environment and all those sorts of things. To be clear, as we said in the presentation and in the press release, the reclassification of gilts are reviewed in terms of the low interest rate environment and as you know to hold HTM, you have to give a commitment if your intention is to hold these things to maturity. And that was no longer the case post Brexit vote, post base rate cut. I think it is consistent with what we are seeing and doing on the hedge etc. So our intention is not to hold these to maturity. So we have classified them as available-for-sale. So as to the capital benefit. Please be in no doubt that the capital benefit is as good as any other capital benefit and that goes towards our capital base and is available therefore for distribution or deployment as we see fit. So in terms of that, as we said in my Presentation, you know we reaffirm the guidance of 160 basis points. You can see as we started the year, where that will take us from 13 per cent up to a sort of 14.6 per cent. Our view on capital requirements has not changed. As you said, we have got some good news in terms of Pillar 2A coming down. We continue to see our requirement as 12+1. Our position on base dividend has not changed. Our position on potential for special dividend has not changed and the Board will consider that at the end of this year. And the impact of the gilts is part of that capital equation. This is not an inferior form of capital, it adds to our capital base. It has offset what has gone on in pensions. It has offset some of the market movements we saw in RWAs. So it is part of our capital calculation and will be part of our distribution deliberations that we will conduct at the end of the year.

So that is that bit there. In terms of it feeding back into NIM and all those sorts of things, again just to be absolutely crystal clear what we have done on gilts has no impact on future trajectory for NIMs, it is just a reclassification from, held-to-maturity to AFS, it does not introduce any macro volatilities or dilute NIM or anything like that.

In terms of NIM itself, again you see the 269bps, part of that is because we have flowed through some of the pricing impacts of any base rate cuts, and some of our response to that won't take effect until Q4, until actually moving some parts into the early part of next year. We remain very robust around the NIM that we have delivered and will continue to be able to deliver and that comes from: yes there are headwinds out there in terms of base rates and potentials for further base rate cuts, but the actions that we are taking in terms of managing customer balances, the actions that we are taking in terms of optimisation across retail, across commercial, the action we are doing on funding costs, and you will see as an example, on Monday this week we called in some of the crisis securities and about £2.4 billion of those which had a yield of 9-12 per cent. So those will be called and refinanced and give us a benefit as we go into next year. And some of that is, that we remain confident around the 270 and certainly while we will give formal guidance in terms of next year, when we come to the year end, as we look forward now, we feel pretty good about its potential and I think we will be hopeful of targeting, maintaining NIM around about that 270 level, so that is what we are targeting at the moment for next year.

Further question
Fantastic. That will be about 10 basis points ahead of consensus, so I think that is quite encouraging. So thank you.

Answer: António Horta-Osório

And in answer to your question about what we see in terms of competitors and outlook. As we thought at H1, I think the market as a whole has assumed that the risk premiums going forward will be different from the past. And if you adjust for swaps movement, margins in mortgages are up versus June this year which we thought would likely be the case. On the other hand, as you know, in terms of NIM in general and we said this at Q2, we have an abnormal influx of deposits following the Referendum vote and that is what, if you remember, made our loan to deposit ratio go down from 109 to 107 in June. We said we would go back to 109 and possibly a bit higher, given the lower level of rates. Well during Q3 we have a continued additional inflow of deposits and that is why our loan:deposit ratio is even lower at 106. That is an additional lever that we have in terms of managing the NIM which we intend to fully use as we go back towards the 110. And that together with TFS makes us comfortable now as George just said, that we will able to hold NIM at around the current levels for 2017.

Further question

So would you want to try and draw down as much TFS as you could, so £202 billion?

Answer: António Horta-Osório

We intend to draw TFS fully and that was what the Bank of England also asked us to do because as you know this was done to partly compensate the impact of lowering of base rates on banks, we intend to do it. And now we have drawn the complete plan on how to do it and that is why George has told you what our expectation is for next year on NIM. But the deposits are quite important as well, the additional influx of deposits which obviously gives us additional levers in terms of pruning the higher cost deposits, keeping the target loan:deposit ratio which we now think should be around 110, maybe slightly higher.

Chris Manners

Perfect, that is very clear. Thank you both.

Question 2: Joseph Dickerson, JEFFERIES

Hi, good morning gentleman. Chris actually asked most of my questions. But perhaps if you could quantify in Q3 any headwind that you had to the NIM from say the timing mismatch around deposit repricing? In other words, if the balance sheet was held static, what would have been the drag from the lagged effect of say liability repricing versus asset repricing?

And the second question that I had is, you have obviously been associated with certainly a major potential credit card portfolio out there in the press, and so I wanted to ask, without commenting on the specific deal, could you just go through what the hurdles you would require for any portfolio or business acquisition and also when it comes to funding, presumably and correct me if I am wrong, your funding costs would be de minimus given your liquidity position? Thanks guys.

Answer: George Culmer

Hi Joe, this is George here. First up, in terms of Q2 to 3 and impact of base rate cuts. It is not a huge impact, when you look at the two quarters I think we were 274bps in Q2. I think that is about 4 basis points from asset headwinds and within that there would just be a small element from repricing. I would have thought 1 or 2 too basically because of the timing. So a small number, a bit more to come, but going back partly to Chris's answer, around specifics, I would be confident with the actions we are taking to balance that in terms of the change in size and in terms of doing the liability management, that we would be able to offset and manage the book and deliver the type of NIMs we were talking about. So in terms of being precise, it is a small number, it is like a basis point or two basis points. A bit more to come but the reactive response is yet to come as well.

In terms of your second question, obviously we are not going to comment, but what I was going to say is shareholder value is absolutely pre-eminent in anything we do. And we are absolutely aware of entities that are out there and liabilities they may or may not have and we are not going to do anything that would threaten the potential of shareholder creation within this particular business, so please be in no doubt of that. Similarly you know where we are interested in terms of strategic growth. You have seen what we are delivering in Consumer Finance, which is an area we have targeted, that is an area we believe we are underweight and there are still good returns that can be made and that is an area where we are focused and we are targeted on. So that, you know that is the key.

Further question

George can I just ask more question on the funding side? In past quarters you have given us some of the costs of retail savings and fixed deposits. Is that something you are able to quantify for us this quarter? And also any change in the churn rate on the SVR book?

Answer: George Culmer

The SVR book is about 9 per cent and I think that is about where we were, so the Halifax result, well that 399 or now down to 374 following base rate cuts, that is £48.9 billion and that was £50.7 billion. So that is about 8-9 percent year on year attrition. In terms of savings costs and in terms of funding. So retail savings, we previously talked about a blended rate of about 94 basis points at Q2 and I think it was 106. That is down to 86 basis points at the end of Q3 and within that fixed is 197, fixed ISA 177. So they are down from about 208, 186 respectively in Q2. So you see the trajectory. I would also like to point out to the optimisation point, when you look at retail savings. Retail savings came into this year about £274 billion, they are now about £271 billion and we obviously prioritise core over our tactical brands. So in terms of optimisation and in terms of some of that flight to quality as well, which we saw around Brexit, commercial has grown from £135 billion up to about £143 billion. And the average cost of the commercial deposit, you have got to ensure LCR and that sort of thing, but it's around 40-50 basis points. So you can see the optimisation that is taking place there. And to Antonio's point made earlier, it is that ongoing process, you know we literally do go line by line in terms of cost of funds, which I can bring in that TFS and look where I can retire the more expensive elements and that is a critical part of managing the spread, delivering the NIM and talking about the types of NIM that we have just spoken about in the last question or so.

Joe Dickerson

Thanks very much.

<u>Question 3: Jonathan Pierce, EXANE BNP</u>

Morning. Thank you, can I just ask a couple of questions. The first one is back on the AFS reclassification. Can I ask what you have done with those bonds that have been reclassified that clearly weren't being hedged before I guess because they were being held to maturity. But have you now put a hedge in place such that there won't be any adverse movement in capital as yields potentially move back up? That would be the first question.

George Culmer

Do you want to give the second question as well, Jonathan, is that alright?

Further question

Yeah sure, it is supplementary to that one really before the second if that is okay. But your broad intention around these bonds, I mean are you thinking you will just sit on them and this is purely an accounting reclassification? Or is there an intention to maybe crystallise these gains in any reasonable size?

And then the second question is on the structural hedge. You told us at the Interims that you were reinvesting that short, as it were, as it matured, is that still your policy or are you starting to take advantage of some of the small move up in yields that we have seen in recent weeks?

Answer: George Culmer

Hi its George. So the second one first, so the structural hedge. No we continue not to reinvest. We were about £122 billion, I think we are down to about £110 billion now at Q3. So we continue to let that roll off. And part of that philosophy you also see in that action we have taken on the gilts. So just to your point, first, we do hedge gilts, the Bank runs a hedged balance sheet and when the gilts come in we do hedge them. Without making this an accounting lecture, when you move them into HTM, I actually have a surplus hedge which I can then actually net off against my structural hedge. I have a pay fix which I can net off against my receive fixed. But they were hedged when they moved to HTM, they remain hedged on an economic basis but from an accounting basis I can actually separate the two. When I move them back to AFS, I can basically bring that hedge back and precisely to your point, they will be hedged again against interest rate exposure so movement in interest rates I am agnostic to because they are hedged. What you do have and this is one of the reasons why you put things into HTM in the first place, you do have a second order impact which is basically the asset swap which is just the differentials in movement in gilts and swap prices. And that is a second order impact and that is part of why you put them into HTM, so you can actually avoid that. But it is very much second order. But they were hedged and now they are hedged again please be in no doubt about that.

In terms of our intentions. It is absolutely not our intention to hold to maturity. In the world we now live, when you see what we are doing on the structural hedge, we can't make that assertion, there have been some very small disposals of them. We will see where rates go and we will depend upon that. But as I say, what you are seeing and what we are doing is as you say consistent with what we have done with the hedge in terms of where we see long rates tying up shareholders money giving us the flexibility to act and respond to market movements.

Further question
Sorry, can I just ask, I will pretend I understood everything you just said on the AFS stuff, but in very simple terms, are you saying that now they are in AFS, there is a true accounting and capital hedge if rates start to move up? So there won't be any negative impact in Q4?

Answer: George Culmer
That is correct.

Jonathan Pierce
That is very clear, thank you for that, cheers.

Question 4: Jason Napier, UBS
Good morning. Jonathan has asked two of the questions that I had, but I am going to add another two I am afraid, also on the gilt portfolio shift. And I think I am right in believing that if they are not sold down, that the capital will attrite over time and I just wondered I think from the EBA data that you have got around an eight year residual life on the Portfolio. But I wonder whether that is the right way to think about the fade, if you were indeed to hold onto them?

And then a number of investors this morning have been posing the question as to what net interest income impact would be seen, if any, if the entire portfolio were churned in the market today? Thank you.

Answer: George Culmer
Hi Jason, yes you are absolutely right. There is about an eight year term on these. So you know about a fade of sort of 10 basis points, which in the scheme of running a Bank, it's noise and you will not see us amending any capital guidance because of that. That is the type of thing that I will absorb whilst sticking with previous commitments. So it is in the noise factor but it is over eight years or so.

Were we to sell £20 billion, what would the income dilution be? I don't have the number to hand. It would be a much smaller number than people might think simply because you have got to look at the net in terms of the gilt versus the swap that sits against that, because at that point I have physically sold them. You do have a redundant hedge at that point. So I don't have the number to hand, but you have to look at the net yield as opposed to the gross yield. So it would be a much smaller number, were we to hypothetically dispose of £20 billion of gilts.

Further question
Thank you. And then if I may, just as a cheeky follow-up. Can I just ask you to repeat or clarify what I think you said earlier that there is a hope that you might target 2.70 per cent of a net interest margin for next year as well? Did you say 2.70 per cent?

Answer: George Culmer
Yes we did. We will formally update guidance when we do our full year results, because as we stand today, as we look forward, we would certainly be hoping to hold NIM at around that 2.70 level as we go through next year.

Answer: António Horta-Osório
You know Jason, I mean we have been telling you repeatedly that we really think we have a competitive advantage in managing NIM because we do it as you know with whole balance sheet as a difference between the assets and liabilities. We make the decisions every week on all products and we do this at the top of the Bank. And on top of this we have a multi-brand strategy which I repeat I believe has been very helpful in terms of managing deposit costs in a low rate environment. And we have been telling you repeatedly over the last two to three years that we are hoping to hold margins for longer in spite of adverse headwinds and as we discussed before, and as George and I told you, after considering the TFS in its entirety and the additional deposits inflows that we got post the vote and kept getting in Q3, we think we will be able to hold it again lower, hold it steady, for longer. And this is a real competitive advantage that we think we have. And the base rate obviously hurts us, not good for retail and commercial banks as you know. But we are now confident that we are going to be able to hold it steady for longer and during 2017 as George just said.

Jason Napier
Thank you, that is very clear.

Question 5: Martin Leitgeb, GOLDMAN SACHS
Good morning. A few questions also from my side. The first one just to add on the NIM questions and NIM guidance from here. Could you just clarify or to the extent possible obviously what the kind of assumption we should be making in terms of the

progression from here in terms of average interest earning assets into 2017? Because looking at the number, the number has remained fairly stable in 2016 and then also before. And the reason I am asking it, obviously we have seen particularly on the mortgage side, some of your competitors lowering front book pricing, whereas Lloyds and the Halifax brand has remained fairly firm in terms of pricing. And I was wondering whether we should expect here some decrease in terms of volumes or mortgage balances or average interesting earning assets?

The second question was just the follow on from that, in terms of other income headwinds we are facing, given the expected economic slowdown into next year, how should we think about the other income progression into 2017 from here? Thank you.

Answer: George Culmer
So average interest earning assets, Martin, you are right, relatively stable. I always caveat this answer because it depends on market conditions and what competitors do and you know etc. and all those sorts of things. But at the moment as we look forward, I think relatively stable. You have seen the stability in Q3 and I would project that relative stability as we move forward in terms of interest earning assets.

Answer: António Horta-Osório
And Martin to give you some colour, between the segments, which is the way we manage this. You should continue to expect SMEs to grow around current levels. So we said in H1, our SME book which was growing in net terms by 5 per cent a year for the last four to five years, we expect it to be a little bit less between 3-4 per cent given that some investors pulled out in terms of investment decisions. It is growing at 4 per cent now year-on-year so you should expect to see SMEs growing at around the same rate. We have a commitment of having £2 billion of net lending growth between SMEs and mid-market corporates which we believe we will meet again this year and you should expect again next year. Mid-markets is growing 2 per cent year-on-year which is again gaining market share because the market overall is around zero and I would expect that to continue. Consumer finance should continue to grow around the same rate, 9 per cent net year-on-year as of now.

And on mortgages, to your precise question. I mean we are expecting within our NIM guidance that our mortgage book will continue to evolve around the current trend. So our open mortgage book is decreasing around the 1 per cent year-on-year. You should expect that same trend to continue. So these are the overall assumptions we have in the different segments, to give you some more colour of the total AIEAs.

Answer: George Culmer
And on other income, it's going to remain pretty tough. I think when you look at this year, we were hopeful this year we might come in slightly ahead of last year. We are now saying it's going to be around about the £6 billion mark. Q3 year to date is down a couple of percent on last year. I think as I said in the presentation, was led by insurance, a large portion of that actually by the way is simply market related in terms of swap rates which are used to discount returns on shareholder funds and shareholder backed assets. And so it's the economic impact on insurance which is the primary cause of that being down. But I think the outlook will stay tough in terms of other income and some of that's sort of structural and some of that I think will continue to be market impacted, things like swap rates on insurance.

Martin Leitgeb
Thank you very much. Very helpful.

<u>Question 6: Chintan Joshi, MEDIOBANCA</u>
Hi, good morning. I have two questions as well. Continuing on the AFS portfolio. I note one of your peers has a £40 billion AFS portfolio, so I take your comments on board that capital benefit is as good as any other. But nonetheless can I check following up on comments made earlier, what the net impact of the pension and gilt portfolio would be if you were to mark to market today, clearly some of those yields have come back? And also are there further gilt portfolios that you can reclassify or is this it?

And then the second question was on PPI. How have monthly reactive complaint trends developed in the quarter relative to the previous quarter? How much cost did you incur in the third quarter? I just want to get a sense of what the run rate is currently and if I should be cleaning up that run rate for any remediation costs or other costs that do not recur in the future? Thank you.

Answer: George Culmer
Okay, I will deal with PPI first and then I will come back to AFS. So PPI, cash spend in the first quarter of this year, we spent about £900 million, but what you saw in the first quarter of this year you had a lot of past book and remediation activity. What has happened is that I have moved through, I have moved out of remediation, out of past book review and I am really just coming back to my reactive. So in the first quarter of this year we spent best part of £900 million. Second quarter we spent round about £600 million. Q3 is down to about £400 million and I would expect that to continue to fall down, as I evolve through

this to just dealing with the reactives and you come down to below the £100 million a month. That is a very clear trajectory that we are on.

In terms of those reactives, we assumed about 10,000, we are running around Q3 at around 8,000. The monies we put up essentially assume about a flat 7.7-7.8 now to 2019. The mix has been slightly different in terms of the ones that we have seen. While the volume has been lower, there are things like Plevin re-complaints which have been much lower than expected that have a lower unit cost than others. But at the moment assumes around the 7,700 to 7,800 which is pretty close to where we are at the moment in terms of reactives.

In terms of market movement, AFS, pensions, those sorts of things. So if I start with pensions. So pension moved from as we said £430 million surplus to a £740 million deficit since the half year. Within that and perhaps I would say that, I do think, when you think we have got essentially got a £47 billion size scheme, that represents a pretty small relative movement and that reflects the very successful hedging that we have done over the last few years in terms of interest rate and in terms of inflation. What you can't do is fully hedge out the credit risk because as you know the discount rate which is a sterling index. I used to discount essentially all of my liabilities and in terms of my assets, whilst I have about 40 per cent in credit, there isn't enough sterling credit to go round so I have international credit so you get a basis mismatch there. But we do think in terms of how it has been managed, we have been able to offset most of those macro-economic impacts.

Since quarter end, difference in asset swap spreads, and in terms of credits have gone out a few basis points. If I was £700 million in deficit, I would probably claw back a few hundred million there I would have thought since the period end. In terms of impact on the gilts portfolio. Yes I would have come off a bit, but I would repeat the answer to Jonathan's question earlier. Those are hedged, so you know I have a swap that hedges those out. So in terms of a capital impact, I am absolutely hedged from an interest rate perspective. So there will be zero capital impact. There may be some asset swaps as I said, second order movement since the period end, but that is very much second order. So from an interest rate perspective, we are hedged. There is zero capital impact.

Further question
Thank you, can I have a cheeky follow-up on the NIM? If I think about the fourth quarter, your SVR repricing really hits in the fourth quarter on annualised run rate which means NIMs should be slightly lower? And then if I take your guidance of 2.70 per cent for next year, that actually implied that NIMs will be rising for the year. Am I reading that correctly?

Answer: George Culmer
You are reading it correctly, but again, be wary of being overly precise in terms of a basis point here and there. But when we get the benefits from actions on deposits and savings when they kick in, you know, and that takes time and notice periods and those sorts of things. But your broad understanding is correct.

Chintan Joshi
Thank you very much.

<u>Question 7: Andrew Coombs, Citi</u>
Good morning. If I could follow up on the interest margin please with a couple of questions. The first is, can you just confirm, did you say that your assumption of trying to maintain 2.70 per cent next year was based on stable front book mortgage pricing from here? So I just want to clarify that.

Answer: António Horta-Osório
No we did not say that Andrew, we did not say that.

Further question
So what is built into your assumption in terms of front book pricing from here?

Answer: António Horta-Osório
What we said was two different things. So when asked about the current environment, in the first question, when we were asked from Chris about how the current environment is, I told you that from June to today the net impact of mortgage margins taking into consideration swap movements, has been slightly up. So that's what happened until today. We are not assuming higher front book prices going forward. What we know and that's why we are comfortable to tell you that, is that after a thorough analysis of our balance sheet, which we do top down, considering all the assets and liabilities, the full use of TFS and the additional deposits inflows that continued through quarter three, we are comfortable that we will be able to continue to be able to

hold margins stable for longer. And that is why we gave you that perspective on NIM. So it's an overall perspective given all the levers that we have available and obviously there is market uncertainty, but we are comfortable enough that we tell you.

Further question
And on the instant access account, I think George, the last time you gave us the average blended rate on outstanding was in the first quarter, 0.5 per cent, perhaps you could update us where that is today?

And then also in terms of the trajectory going forward, following Chintan's question, I know you have announced to a number of your savers, plans to cut rates and I think a lot of those come through on 1 December, so is it a case that we will get the full benefit of that shown through in Q1, but thereafter really the ability to offset any asset margin pressure comes more from the TFS and wholesale funding as opposed to deposit rate cuts?

Answer: George Culmer
You are broadly right, it gets tougher as you approach the floors, but I still think there are some things we could do in terms of the fixed accounts, and as those actually flow through and we get the benefit from them. The instant access is down to you are right, it is down to 44 basis points at the end of Q3, but whilst it gets tougher, there is still ability to manage the spread and manage those liabilities further.

Answer : António Horta-Osório
Andrew if you look at the multi-brand strategy, if you look at the prices of Halifax deposits versus Lloyds deposits for example, you see that although we have been shrinking the difference between the cost of those depositors, there is still a significant difference and we intend to use it over time. So we have more levers again by the fact that we have a multi-brand strategy and we have higher cost Halifax deposits which we intend to absolutely use and the fact that we been having excess inflows as I was telling you, giving the additional lever that will enable us to do that and have a loan to deposit ratio target met at around 110 per cent.

Further question
Very clear. And final one on this, sorry to keep pushing. The outstanding FLS money that you have, would the assumption be that that would just roll into TFS and that you potentially would then take additional TFS on top?

Answer: George Culmer
Well I think as Antonio has said earlier, we will be a big user of TFS and the way we look at it, and this goes back to the comment Antonio made as to how the business is run, you know we have a source of funding. We will then look at all our sources of funding in terms of be they deposit, be they retail deposits, be they commercial deposit, be they wholesale funding, be they FLS and we will look to see what is the most advantageous mix for the Group. And we put everything on the table and assess the marginal cost. So that is how we run the bank.

Answer: António Horta-Osório
And when we look at the FLS Andrew, we these it as a low cost source of funding which we can repay at any moment. So total flexibility, so we like it and we don't have many mandatory maturities next year.

Andrew Coombs
Okay, thank you both.

<u>Question 8: Chris Cant, AUTONOMOUS</u>
Good morning all. I just wanted to follow-up on the margin guidance, thank you for that. I am just trying to reconcile it with what you said about not rolling the structural hedge and the fact that the volume there had shrunk £12 billion in the quarter I guess continues to come down next year, and you will have an adverse impact of the older positions, probably the more profitable positions rolling off first. So I just wanted to understand, when you are guiding margin to be flat next year, assuming you are not recommencing hedging which is obviously what you are suggesting as your assumption, how much of a drag is that actually creating to the top side? So how much of an offsetting benefit do you have to assume comes through from deposits because it would appear to be reasonably meaningful? That would be the first question.

Answer: George Culmer
Chris you are right and the numbers that we have given are very cognisant of rates and strategy with the hedge. But I mean there is a headwind that will run into the few hundreds of millions that we have to work to offset, but what I have referenced to you is not just Antonio's previous answer on what we can do on retail deposits and how we manage that, but also things like again, I think I mentioned this earlier, things like the call that we have just done in terms of this £2.4 billion of Tier 2 which is

anywhere between a 9 and 12 per cent coupon, that crisis funding rolls off. If you just do the maths on that in terms of refinancing you can see there is a significant pickup, or offset if you like. So we have factored that in. We continue to work hard, we will continue to work hard on the optimising mix and all those sorts of things. But yes we are all cognisant of that and it will continue to roll.

Further question

Thank you. If I could also ask on the outlook for other income, you guided to £6 billion for this year. If I look into next year, one of the things you have had as a sort of running sore there I suppose is the roll off of interchange fees. Has that now washed through entirely and should we expect £6 billion to be a base to grow from or would you expect on balance, the risk to be to the downside in 2017?

Answer: George Culmer

I think the interchange has fully flowed through, and though we have been very helpful to you on NIM, let's wait and see. As I said in response to an earlier question, OOI is tough and things will stay pretty tough. How that plays out in terms of precise financials, we will wait and see as we go through with some of our internal processes. But I think it will stay a tough environment.

Chris Cant

Okay, thank you.

Question 9: Raul Sinha, JP MORGAN

Morning Antonio, morning George. I think we have done the gilts to death, so I am just going to ask about the capital generation in Q4. I mean obviously the 50 basis points that is to come in Q4 is at the top end of your 150-200 basis point range. So I was just kind of wondering if there was anything large or specific that you want to call out in terms of the performance in Q4 on capital? I mean you usually get an insurance dividend as well. Is that why you think it will be at the top end of the usual range? That is my first one.

Answer: George Culmer

In terms of top end, I am just thinking, we're 110 and we are saying to 160, so 50 basis points. When you look at my underlying year to date, it has been sort of 1.6 per cent. You know we have done PPI, you know there are some things we always look at in terms of RWAs, insurance is out there. So there are always a number of moving parts, but I am feeling pretty good about the 160. In terms of underlying, I suppose you get things like levy come through in Q4 which is a slight seasonality which impacts earnings, but I am feeling pretty confident about the 160.

Further question

And then the tick-up in impairment in this quarter, I know it is from very low levels and you have reiterated your guidance which obviously is still well below sort of normalised levels. But I was just wondering if I can get some thoughts from you guys on what you are seeing in terms of asset quality for the SME and in particular for the unsecured sectors because they tend to be more sort of sensitive to the cycle?

Answer: George Culmer

What we said in the presentation was we're not seeing deterioration, the slight pickup is all to do with the recoveries and write-backs. I think we talked about the 25-26 basis point gross AQR which has been pretty constant. We did expect write-backs and recoveries to cease, it is good to see they continue, because of what that implies in terms of what you are providing, but we knew the quantum would reduce. But in terms of SME since Brexit, we actually wrote a whole load of early warning indicators which we take to Risk Committees etc. And there is nothing that we have seen in there in terms of the lead up to believe there is any deterioration in terms of the underlying trends in both the unsecured and the SME book.

Answer: António Horta-Osório

And you have to take into consideration as well, we have a low risk profile. So we have been telling you over the last few years that we were first worried about large corporates a few years ago in terms of margins versus returns. In terms of low covenants and therefore we have materially decreased our large corporate portfolio already a few years ago and then two years ago we were worried about London house prices if you recall and we were the first to reduce the loan to income value for high properties so we could reduce our market share in London which is now substantially lower than the rest of the book. Last year we told you about buy-to-let, the Regulator was worried, we have not increased our portfolio in buy-to-let, which is the only segment which is growing in mortgages and that plays into our risk and margin trade-off with volumes that we described previously. So we have a low-risk profile which we believe is absolutely the right one to have as the economic cycle was progressing. And therefore as George was saying, we didn't have to make any risk appetite changes when we went to risk

committee meetings in the last few months because we already have taken those actions in the past. And apart from that, looking at the different segments in the economy out there, we really do not see any sign of deterioration in our key target segments. So none in SMEs, mid markets or the core mortgages or on the consumer finance credit curves. We don't see signs. So the AQR is slightly higher, not because it comes from a low base, but basically because we have had less recoveries as George told you in the first quarter because the gross AQR is very much in line with the previous ones.

Further question
Sure thanks very much, that is really helpful. If I can just have one follow-up on all of the NIM discussion. I mean that £380 billion of deposits, I think you mentioned 87 basis points or 88 the last time we saw. I would have thought it was pretty difficult for you to reprice the whole book straight away in Q4 or Q1 even. And there would be a sort of staggered duration profile of the repricing that should actually give some kind of tail wind over your margin which is probably what is driving your confidence as you look forward. So is that a fair assessment or do you think it is kind of like a step change in Q4?

Answer: George Culmer
The first part of your question is correct, there is a staggered approach as you go through notice periods. So you are correct with the first part.

Further question
You are not saying there is going to be a step up and then again a sort of quarterly decline, you know. Because effectively, you have got one of the highest deposit costs among all the large UK banks and I would have thought that given the multi brand deposit cost you would have quite a long tail of deposit repricing still ahead of you?

Answer: António Horta-Osório
That is exactly right. We intend to use it as I said before, you are absolutely right.

Raul Sinha
Fantastic, thanks very much.

<u>**Question 10: Peter Toeman, HSBC**</u>
Morning. You very kindly gave us an exposition about the hedging of the gilts that had moved into the available for sale category. However I wonder if you could confirm that there are no other material interest rate mismatches anywhere else in the book, you know fixed rate, variable rate mismatches?

My other question was on the multi-brand strategy because true, Halifax has higher deposit cost than Lloyds but Lloyds have higher sort of mortgage costs or the front end mortgage rate at Lloyds is higher than the front end mortgage rate at Halifax and I wonder if it is possible to get some idea of the differentiation in volume growth that might be produced by these differences in pricing structure?

Answer: George Culmer
I will do the first one and have a think about the second one. First, within the Bank we do not run material interest rate mismatches. I know it gets a bit techy and complicated and in answer to Jonathan's question, when I buy a gilt, I will buy the asset swap to hedge out the interest rate risk and that is what happens. And if you hold available for sale from purchase, it is quite simple. Here I do that, I buy the gilt, I buy the swaps so I am hedged. Then actually when I designate as held-to-maturity, from an accounting perspective, I no longer need the hedge, I have still got it from an economic perspective and it enables me to actually move that hedge and I can net if off against my structural hedge which gives me some additional capacity and goes through net asset etc. But we don't run material interest rate risk within the Bank. So it is a difference between accounting and equity.

Further question
And all fixed rate mortgages are swapped?

Answer: George Culmer
That is correct.

Answer: António Horta-Osório
That is correct. And relating to your question on the different brands and Lloyds and Halifax, you are right when we discussed on the previous question. So we have higher cost deposits in Halifax than Lloyds and we have been shrinking that difference over time and we intend to continue to do it. So we use that difference which is an additional lever in terms of margin

management. And in terms of the mortgage book, we also adapt our mortgage price as you correctly said, to the different brands. I mean different brands have different customers who have different preferences. And that is why we have a multi-brand strategy. Because we believe that the different preferences enable us to fulfil customers' needs in a better way in terms of revenue versus costs. We have some additional costs of having different commercial approaches to customers, but we believe overall customers are more satisfied and we have better returns in terms of revenues minus costs of the strategy and I think that has been very clear. And for example in the way we have been managing NIM in the last few years.

Question 11: Rohith Chandra-Rajan, BARCLAYS CAPITAL

Hi, morning, I appreciate time is getting on, so very quick one from me please. Just on the other income. If I look at your £6 billion guidance for the year, it suggests a 4-5 per cent uplift in the fourth quarter, I was wondering George if you could quantify that discount rate impact on the insurance business in the third quarter and how much you expect to reverse based on where rates currently are in the fourth quarter? And if there is anything else that we should think about going into Q4 in terms of other income? That was it, thank you.

Answer: George Culmer

We do it on a smooth basis, so it doesn't come through automatically, but we were down about £50 million in the nine months, so probably if you extrapolate that forward in terms of a full year impact. So I think that is probably the best answer I can give to the question.

In terms of Q4, there is a seasonality of results. If you look at last year's you will recall we were about £1.3 billion of that order and I think we came back more strongly. Insurance tends to have a stronger final quarter. Some around seasonality, some of that is as you come and look and update assumptions and things like that. So Insurance tends to have a stronger fourth quarter and I think I would expect that again.

Further question

Because I guess Q3 last year was very negatively impacted by I guess capital markets in particular and then you had a bounce back in Q4. I guess we haven't quite had the same underlying performance in Q3 this year?

Answer: George Culmer

Yes it wasn't a big capital markets story last year. I think insurance again was a large part in terms of when you look at the difference between Q2 to Q3, up from 1.6 to 1.3, I think again insurance was the main lumpiness and that was around bulk annuities, so you know, £6 billion is I think the right number for the full year.

Further question

Okay and is there any bulk annuity pipeline that is visible at the moment?

Answer: George Culmer

Yes there is, not huge deals, but there is a pipeline, yes.

Rohith Chandra-Rajan

Alright, thank you.

End of Q&A