UBS EUROPEAN CONFERENCE WITH WILLIAM CHALMERS – PRESENTATION TRANSCRIPT
(amended in places to improve readability only)

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Jason Napier
Morning, everybody, and welcome to the UBS European Conference. It's my great pleasure to welcome William Chalmers, the CFO of Lloyds Banking Group, a great supporter of the conference. My name is Jason Napier. I run European financials research in the equity department here at UBS. William, thank you so much for joining us.

William Chalmers
Pleasure. Thank you for inviting me, Jason.

Jason Napier
So there's an awful lot going on in the world, and there's an awful lot going on in UK banking. Let's start with the elephant in the room perhaps. It's been two, two and a half weeks since we had the court judgment in the Court of Appeals. What have we learned? How's the thinking evolved over that time?

William Chalmers
Sure. Yeah, well thanks for the question, Jason, and, again, thanks for inviting me. As you say, we may as well get the big issue on the table in the first place. The Court of Appeals' ruling was an unexpected change in the law at the time, as you know. It moved the debate from a question as to commission fairness, which was the focus of the FCA inquiry into motor commissions, to a debate around the disclosure of commissions and, likewise, the informed consent on commissions. So in that sense, it's moved the debate along, as said, to a somewhat surprising and unexpected turn of events in terms of the interpretation of the law.

Now, what is very clear right now is that there are a lot of uncertainties in this topic. So three main buckets that come to mind. One is judicial uncertainties. Will the appeal be taken? If it is taken, what is the determination? Likewise, the Court of Appeals put the remedy in the hands of the lower court so nobody quite knows what a remedy might look like if one were to apply.

Second set of uncertainties, what type of factual circumstances might this Court of Appeals ruling apply to? So questions about customer vulnerability or, alternatively, sophistication. Questions about disclosure around documentation, questions around sales processes, these types of questions. What are the factual circumstances to which that ruling applies?

Third bucket of uncertainties, what will the FCA do? Will the FCA determine to make any changes to motor complaints, for example? Will it execute a stay of complaints?

So you can tell from those comments, Jason, the situation right now is replete with uncertainties. I've mentioned three buckets, there are probably others. And, realistically, that is going to take a while to play out. It's going to be with us for a few months yet, and we'll see how it plays out.

The position of the bank, as you know, remains that these are uncertainties that we're just going to have to deal with for the time being. We are determined, from a customer point of view, to stick with our customers, where we can. Pretty much the day after the ruling, we went out with a no commission and, therefore, compliant structure, which allowed us to stick with customers, which allowed us to continue to play our role, if you like. As we speak, we're now rolling out a compliant commission-based structure which, obviously, has disclosure and obviously has informed consent alongside of it, which, again, allows us to continue to play our role in the transportation sector and participate in what we consider to be a long-term profitable and attractive business.

Jason Napier
So we published a short note last week, where we just looked at the historic timelines of Supreme Court action. As you say, the Supreme Court needs to first decide if it's going to hear an appeal. But it looks like, on historic averages, a decision is an early 2026 event. Although, there have been calls for an expedited process. Lloyds and FirstRand are fairly unique in the sector, in having made provisions so far, for what was a narrow area of inquiry. How should we be informed by just how complex and uncertain this issue is, when we think about the potential for a need to revise those sorts of provisions?

William Chalmers
Well, you can tell from my comments Jason, there are a lot of uncertainties out there right now. I mentioned judicial. I mentioned the fact patterns that this ruling might apply to. I mentioned the FCA determinations or intervention or otherwise. There's three right there. They're all pretty major. And within that, there's a whole spectrum of uncertainties. So I think that's going to be with us for a little while.

You mentioned, Jason, that you thought a Court of Appeal ruling might come in 2026. I'm not so sure. It may come sooner than that. There is the potential, at least, for an appeal to be granted sometime in the not too distant future. If it is granted, it may come in an expedited format which, in turn, will allow us to reach a decision, potentially, around halfway through next year. Let's see. This is speculation right now, as are many things in connection with this issue. But I think if we are fortunate, if you like, we might have resolution somewhat ahead of the timetable that you're suggesting there.

In terms of where we go with respect to any provisioning, as you know, we've got £450 million provisioned right now for the FCA inquiry which, as I said, was around the fairness of commissions. This is a new and, as said, unexpected legal development, which is around disclosure of and informed consent to commissions, a slightly different point. We, from our perspective at least, remain very committed to our capital distribution commitments and objectives. We're sitting on, as you know, a very healthy capital position. It's a very capital generative bank. We'll keep the motor situation under review, recognising those uncertainties, and any provisioning that might be required as a result of them, Jason, is going to take a while to play out.

Jason Napier
Very good, and certainly I think we're all in agreement that earlier resolution is better than delayed, for sure. Turning to issues more pertinent to today's banking environment, the budget. We've had yields move up, quite a lot of talk in the market around why that is, and what that implies. As far as the bank itself is concerned, how do you see the consequences of the budget for the firm?

William Chalmers
Yeah, it's interesting, when we look at the budget, it was focused, as everybody knows, on education, on housing, on health. And all of that makes sense, but it probably had a bit less immediate growth impetus than we might've expected. It's good to see that there weren't any targeted impact upon banks. That is to say, no bank tax in there. There were some relatively minor product implications, e.g. in pensions, but on the whole not terribly meaningful. So all of that is good to see. I think, when we look at the budget, it is likely, we think, to provide a near-term fiscal impetus. That is to say, the increased levels of spend probably will raise growth profile a little bit above what we've previously expected.

You've commented there upon the rates picture in particular, Jason. We have seen a period of volatility post budget in rates. Let's see where it settles. It was the case, before the budget, that, actually, rates were settling a little bit below our expectations. As you know, we're expecting rates to settle around three and a half percent by 2026, and the market was coming in inside of that. I think, then, in the speculation post budget, they've moved in the other direction. Right now, it's not terribly far from where we would expect rates to settle. Maybe it's a little bit above. I think as long as rates don't, if you like, quell or hinder economic activity, then, overall, from our P&L perspective, that is probably a net benefit. A modest net benefit but, nonetheless, it'll come through the benefits to the refinancing of the structural hedge. And as said, may provide a bit of a macro stimulus to the economy in the context of 2025 and beyond as the fiscal stimulus comes through.

One further point, when we look at the particular measures within the budget, we've seen the NIC increase, that'll impact us, just as it will impact all businesses going forward. We think that's probably about a £100 million full year run rate NIC impact from what we've seen.

Jason Napier
So the reloading of the hedge at better yields is fairly easy for us to think about. Does it do much to impact the forward on mortgage spreads, do you think? So net-net, it's a marginal positive, as you say. Do we need lower rates in order to get the right balance between asset and liability spreads in the way that you model out to the future?

William Chalmers
Well, maybe just take a step back in terms of what we've seen. We've seen mortgage spreads actually be pretty stable over the course of this year, so we've seen about 70 basis points, typically, in terms of completion spreads. It was a touch above that in the course of quarter three. I do think, as your question implies, Jason, that those mortgage spreads are somewhat couched in the overall margin environment. So, as you know, we're seeing margin environment right now that is 295 basis points. We're seeing it strengthen, as we speak. That's an expectation for the remainder of this year. It's an expectation for 2025, and it's an expectation, in a ramped up way, for 2026. So that margin environment is improving.

Now, within that, what happens to the mix between mortgage and liability spreads I think is in a sense of slightly lesser importance. What you're measuring more is just the overall spread that the business is achieving. As said, what we really need for mortgage spreads is a period of swap stability. When we get a period of swap stability, we'll see them settle maybe a touch above where we are right now. That's traditionally been our expectation. But on the other hand, if we're seeing an overall spread of the type that we're seeing today, and certainly heading in the direction that we're seeing today, we'll be happy with that.

Jason Napier
Certainly. We think that the UK domestic sector will probably produce the best NII growth in Europe over the next two or three years. The hedge being a particular driver of that. If we were to just take a step back, because I appreciate it's the day job to get the aggregate right captured on both sides. If you were looking to a generalist PM type conversation, who was convinced that mid single-digit NII growth over the next few years is what the system ought to do, in what environment does that not happen now, given the base case we have around macro?

William Chalmers
Well, I might just start your question at a slightly earlier point, Jason, and say what environment does it happen? So where are we right now? As said, we've seen an improvement in the margin over the course of quarter three versus quarter two. A couple of basis points, 293 going to 295. That is also matched by an improvement in NII of around £70/75 million or so, Q2 into Q3. As I said at our Q3 results, we expect that to continue, looking forward. It may be that it's slightly slower in the course of Q4, largely because of non-banking net interest income developments, but that's just a temporary factor, and it won't be terribly significant. It does put us on a trajectory, both for rising NIM and rising net interest income in 2025, and then stepping up the pace further in respect of 2026. So I expect a pretty good picture for net interest income in 2025, and then a better picture in respect to 2026.

Now, what's going on behind that? And I'll come to your question in just a second, Jason. What's going on behind that is basically three main factors. So we're seeing the headwind of mortgage refinancing, if you like. Mortgages are coming off at 110 basis points in quarter three. They're being refinanced back on at around 70 basis points. So you've got a 40 basis point mortgage headwind there. That continues into 2025, and more or less exhausts itself by the first half of 2026. And then you've got deposits as a headwind. We are seeing slowing churn in deposits. That is to say slowing migration from non-interest bearing to interest bearing, and within interest bearing to fixed term. So that is slowing down, for sure, in Q3, but it is also being somewhat augmented by base rate cuts. Every time you've got a base rate cut, you've got a lag in terms of repricing of deposits. We expect three base rate cuts in 2025, and so that is going to be a factor. But, again, it is somewhat mitigated by a slowing pattern of churn, consistent with a falling rates environment.

Now, those are the headwinds. They are offset, more than offset, by the strength of the structural hedge, as it comes in and refinances, which, as you know, is £242 billion of balances. Currently, earning 1.8 per cent on a yield basis, refinancing into, let's say, 3.5-4 per cent. That is a very powerful tailwind. It's certainly in place for 2025. It picks up even further in 2026. And we've put numbers behind that before, Jason, as you know. As we said, we expect that structural hedge to deliver growth in contribution of greater than £700 million in 2024. Growth of significantly greater than that £700 million again in 2025. And then materially greater than that in 2026. So there is a ramping up of the structural hedge contribution, which, as said, more than outweighs those headwinds that I mentioned, in the form of mortgages and deposits.

Now, that is augmented by average interest earning asset growth. We do expect decent loan growth over the course of next year, off the back of the macro that we talked about a second ago. So that's also building the NII picture. And, overall, it leads us to feel comfortable with respectable growth next year, and then growth in NII that picks up further in 2026.

You asked what might present the counter case, if you like, Jason, what might go wrong, I suppose. One relatively extreme point that one might make there is, if we had a sudden collapse in rates, if we're back to the zero rate type environment that we experienced before COVID, I suppose, where we see a very flat curve, that's a tougher environment for banks, no question about it. And it puts pressure on, basically, the system on the asset and liability side. We saw a little bit of that in the course of the 2010 to roughly 2020 period. So that's one. I think that is unlikely, based upon everything that we see right now. And in any case, it's always a relative game. So Lloyds, as a scale player in all the major markets, would expect to fare better than others, particularly with its business focus in Retail and Commercial. So it's not an environment that we would welcome, frankly, but we would still expect to compete very, very strongly in that type of environment.

I think that's the main one, Jason. There are other scenarios which are tougher from a bank perspective, a deteriorating macro might be a further example. That's less about spreads, clearly, but it's more about total returns that we might expect to see. In fact, in that type of environment, as you know, historically, spreads tend to go up. But it's just that you're in a slightly less welcome impairment environment. So probably those two I would highlight.

Jason Napier
That's helpful, thank you. We published a sector piece yesterday. We think the bank sector will do 25 per cent in the next 12 months, and that may be the last 25. We've had a five-year bull run. But the base case for that is that, as you say, 12 months from now, the curve is upward sloping and the rate cuts are done, says the curve. The curve changes its mind every couple of days. It feels like, at that point, deposit mix will have stabilised, margins will be rising, default risks will be lower, loan growth will be coming through. It all feels like a sector that shouldn't be trading at seven times. And Lloyds is obviously at a small discount to that now.

William Chalmers
I won't obviously comment on valuation, that's really for the room to determine. But there's no question those trends that you've just described, Jason, in terms of spreads, in terms of loan growth, in terms of income, it's happening as we speak. We saw it in Q3, we're seeing it again in Q4. We expect to see it in 2025, and then growing in 2026. So I don't have any question about that. We've talked a bit about the structural hedge, and maybe I'll make one more comment there. The structural hedge, in many respects, is a legacy of previous years, right? Let's not forget that. The structural hedge, in its earning capacity of 1.8 per cent, is effectively a function of where rates were over the course of the last three or four years, not a function of where rates are today. So where rates are today is a much better reflection of the enduring earnings power at the bank.

Jason Napier
One of the other things that Lloyds has been more vocal on, and I believe invested more in, is diversification of the business, your other operating income line. The £750 million you're looking to add this year, that's 10 per cent of group PPP. It's a big number, and you're looking to double that over the next two years. It feels like, as much as in February, we'll look at your 2025 guidance. Very quickly, we're going to move on to 2026. The hedge is doing better. You've promised much more on OOI. In terms of building blocks for that, the past investment that you've put in, is there much that you can add to reassure investors that that 2026 number will come through? Given that if it does, I think consensus is probably 10 per cent too low for 2026. And that's not far into the future anymore.

William Chalmers
No, I think, with every day that we get closer to 2026, our confidence in the 2026 outcomes builds, for sure. You asked about OOI generally, Jason, and you asked about strategic initiatives, revenues, as part of that. Maybe to pause on the first point, OOI, as you know, it's been a good story. We're up 9 per cent year to date, year on year. It's pretty good performance. We expect that to continue over the course of the next couple of years. So we've seen robust OOI growth, and we, again, expect that to be a pattern going forward. Now, what's behind that? I think a couple of things, really. One is a bit of a resumption of activity, supported, obviously, by a relatively stable macro that we've seen. That's coming out of COVID. We've probably taken advantage of the catch-up period post-COVID. But, again, it's supported by reasonably robust macro circumstances.

And then it's obviously driven by strategic initiatives, as your question highlighted there, Jason. What are we seeing in that area? We have two main commitments out there. One is £0.7 billion of incremental revenues with respect to 2024. We're well on track deliver those. We'll give you more commentary at the year end. The second is the £1.5 billion of incremental revenues in 2026, as per your comments, Jason, of which we think about 50 per cent are going to be OOI. We expect about 50 per cent to be OOI. And, again, we feel very comfortable with respect to those commitments, on the basis of what we're delivering so far, and what we see in the pipeline, if you like, for the year or so ahead.

I think what's good about that is that (a) it's growth, (b) it's diversified, I'll come back to that in just a second, and (c) it's capital light, effectively. So all three of those things feel pretty good, in terms of the strategic transformation of the business. And just commenting briefly on each of them, the growth point I've just commented on, i.e. 9 per cent, year on year, year to date, we'd expect a pattern to that end in a similar spirit. The diversification, we're seeing it come through Retail, for example. We're seeing it come in the context of Mass Affluent. We're seeing it come in the context of transportation. In Commercial, C&I revenues for example, up 30 per cent versus H1'21. And a consistent pattern of, if you like, productivity out of the strategic investments that we've made. IP&I, we've seen significant growth in GI, GI Q3 year-on-year net income after claims, or net of claims, is up 19 per cent. AUA, in terms of workplace, up 10 per cent in half one. So a good diversified set of earnings streams coming through there.

And then, again, the capital light point, often enough in a commercial area, for example, these are ancillary revenues that we're seeing develop in a pretty capital light way. Likewise, insurance, as you know, is a relatively capital efficient business for us, quite an attractive earnings stream. And so, again, the development of OOI is critical to the transformation of the business. It's good for us because it's growth, it's diversified, and it's capital light, and we expect to see more of it.

Jason Napier
Thank you. So with five or six minutes left on the clock, are there any questions from the audience?

Very good. William, you mentioned the expectations around average interest earning asset growth in the next couple of years. I think, for investors, the margin of safety in a stock that's growing is always higher than one in which it's not. That's why the OOI thing is important. But loan growth is afforded real status when you look at a bank. What are the signs you're seeing now? And what do you think the cases are for a proper acceleration in growth? Perhaps the budget is a place to think about where we might see more spend on things like infrastructure.

William Chalmers
The picture of growth, as you say, has been pretty good, actually, over the course of recent periods for us. So you'll have seen lending growth up £4.6 billion in the course of Q3, which is good to see. The confidence that we have in AIEAs being greater than £450 billion this year is very clear, consistent with our commitments. It's off the back, again, of two things, really. It's a relatively solid macro, and alongside of that, strategic delivery, whether that's in mortgages, personal loans, and so forth. So those two, I think, are giving us some benefits in terms of the growth pattern.

Highlights that one might mention, mortgages up £3.2 billion over the course of Q3. 21.5 per cent market share, not a bad outcome, particularly when it's consistent with margins, as I said earlier on, they're in excess of 70 basis points. Personal loans up £0.6 billion, cards up £0.1 billion. So an overall pattern within Retail that feels pretty robust, actually, for us in terms of loan growth.

Probably a slightly more nuanced Commercial Banking picture. So what have we seen there? We've seen, within C&I, growth in lending, basically chasing things like infrastructure, for sure, but also with an ancillary revenue spirit in mind. That is to say, we're not chasing lending for lending’s sake in C&I. We're rather doing it because of a holistic approach to clients, which is a mantra that is held quite strongly within the bank. And then, at the same time, within SME, we've seen a picture which is continued paying back of government-based lending from the COVID period, with relatively muted underlying demand. So within SME, at least, we are seeing it slightly quieter from a loan perspective.

Now, looking forward, I think the budget may help, in the sense that the uncertainties, if you like, have now been removed, and so people can figure out how they want to invest going forward. As said, we think the budget is probably a modest fiscal stimulus going forward, which in turn may inspire capital formation and investment and the like. And we should be a big beneficiary of that. But it'll be relatively modest, I think, in terms of the impetus that is given. More importantly, I think, is the way in which we hope to stand out from that, by continuing with our market share gains, by continuing with performance in terms of strategic initiatives. And by continuing to promote the type of growth that you've seen in the course of Q3, over the course of 2025 and beyond.

Jason Napier
The strategic plan calls for a cost income ratio below 50 per cent in 2026. I think the market is higher than that. You've just confirmed that NI is going to cost £100 million. Could you talk a little bit about how you characterise the state of investment in the business. I don't think Lloyds are viewed as a company that's got fat in the Opex, and I just wonder whether it's about strategic spend being above normal, and how you think about landing that objective as you come into 2026?

William Chalmers
Your question, Jason, is essentially around costs and how we're managing efficiency. As you know, efficiency is a closely held strategy within Lloyds. It has been for a while. It certainly has been since I got here, but it's also been for a number of years before I got here. And that commitment is unchanged and the resolution, or rather resolve, to meet our commitments is very high. That's very strong, Jason. We've got a commitment for £9.4 billion out there this year. That includes the Bank of England Levy, and we'll meet that commitment. Likewise, we've got a commitment for £1.2 billion of gross cost saves. We'll meet that commitment. So we continue to be very strong adherents to what we've said publicly, and that includes also the less than 50 per cent cost income ratio in respect to 2026.

There's a couple of factors in that cost income ratio, Jason as you know. One is the income side of things, where you've made a few comments there on where you think the market is versus our expectations. So that's one side of the cost income equation. And then our cost commitment to efficiency, as said, remains resolute.

What are we delivering there, and how much of that is investment driven, if you like? I think there's probably three main buckets that I would highlight. One is our BAU efficiency approach, which is around things like matrix management, it's around organisational design, it's around third party supplier management, these types of things. Which are, I suppose, in some sense at least, lasting components of Antonio's strategy that continue to this day.

The second is investment driven, often technology-based commitments that we have. And that's all part of the strategic transformation that we have pursued, investing part of that £3 billion over three years, £4 billion over five years, that we've talked publicly about. Where's that headed? It's headed towards digitisation, automation of back office processing, for example, automation of customer service. It's headed towards rationalisation of data centres. It's headed towards decommissioning of legacy technology. These types of things that can make a real difference to the cost base on a lasting basis going forward. So that's the second bucket.

And then, a third bucket, which entails both efficient management and a degree of added investment is around property optimisation. So whether that is head office, whether it is branch rationalisation, or the like, that's a third bucket of cost savings that we expect to deliver, and indeed are delivering, pretty much as we speak.

Now, what that leads to, Jason, is a BAU cost pattern and an investment cost pattern that, I suppose, delivers on the cost base in the way that you see in 2023 to 2024 i.e. a rising cost base. But it is also a pattern that once depreciation catches up, allows us to deliver a flatter cost base going into 2026. Because at that point, the benefits of your investment start to come through. That includes all the three buckets that I've described. It also includes a little bit of excess severance that we're taking on board last year, this year, next year, in order to deliver lasting cost efficiencies. Which, again, then just start to deliver that flatter cost base in 2026. Combined with the income, it delivers operational leverage. And as you know, it's operational leverage that gets us to a cost income ratio below 50 per cent, together with our ROE greater than 15 per cent, and our capital delivery greater than 200 basis points. That's the story.

Jason Napier
Thank you. And that brings us perfectly to time. So thank you, William, for joining us today.

William Chalmers
Pleasure. Thank you, Jason. Thank you.

Jason Napier
Thanks, everyone.

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FORWARD LOOKING STATEMENTS

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