LLOYDS BANKING GROUP PLC – Q1 2024 IMS – SELLSIDE ROUNDTABLE TRANSCRIPT
(amended in places to improve readability only)

Monday 29 April 2024 – 4.00pm

LBG:
William Chalmers, Chief Financial Officer

William Chalmers
Good afternoon to everybody. Thanks very much for taking the time to join us this afternoon. We have about an hour of Q&A ahead of us, so I'll leave the agenda open to whatever is of greatest interest to you. But maybe a couple of words to kick off. You heard our results last Wednesday, so I shan't repeat. Safe to say, as you saw, I hope, we've seen continued progress on strategic ambitions, number one, we've seen robust financial performance in line with expectations, number two, and we are reaffirming our guidance and confidence in respect of 2024, and indeed our 2026 commitments, number three. So, over to you on the line for whichever questions are of greatest interest.

Question and Answer Session

Question 1 – Aman Rakkar, Barclays Capital
Hello. I had a question on rate sensitivity, actually. I was just looking at your disclosed rate sensitivity at 4Q'23, and I guess the initial observation is that your rate sensitivity has come down quite a lot, even in the last year. If I compare it versus the end of '22, your rate sensitivity has come down quite meaningfully. And I guess within that there's two parts to it, there's the hedge maturing element to it, and the remainder I guess, which is principally the managed margin. If I assume that the hedge maturity element is broadly unchanged year-on-year, such that you are repricing 40 billion per annum, there or thereabouts, in similar fashion on this rate sensitivity now, as you were a year ago, the residual component is down quite a lot, right?

So, the bit that I think is sensitive to base rates from here, the impact on your NII is down quite a lot, versus what we will have observed historically. So, I guess, my first observation is, is that the right observation? Your sensitivity to base rates from here, even in your illustrative 50 basis points down scenario, it's a lot lower than it was a year ago, is that the right observation, first of all?

And secondly, I guess I'm going to ask a question that we asked you 18 months ago actually. You helpfully and kindly broke down your rate sensitivity between the various constituent parts, between asset and liability repricing delay, movements in the structural hedge, and managed margin. I was wondering if in light of a lower rate sensitivity from here on in, could you update us on that, on how to think about the breakdown there? And look, just to put that into context, the reason for that is, people like me, and I suspect a lot of other analysts on the call, we like to model your hedge separately to your rate sensitive balance sheet. So, that's kind of what I'm looking to break apart here. Thank you.

William Chalmers
Sure. Thanks Aman. First of all, in terms of comparison with a year ago, I don't think it's changed too much. I don't have the number at hand from a year ago, but it may be that we are now showing disclosures for rates downwards as opposed to rates upwards. In fact, we're now showing them in both directions. There may be a bit of that in there, Aman. But putting that point to one side, in terms of the rate sensitivity, I'll talk for the moment about the downwards reduction of 25 basis points, because that seems to be the, I guess the order of the day, given where we are. As you know, our sensitivity on the rate reduction of 25 basis points, about 150 million pounds, that is composed of a number of the elements that you just took us through there, Aman, in your question. But in terms of the cost of that £150 million, where does it come from?

About a third of it is coming from repricing lags, as you know, we need to give customers notice before we are able to reprice the product. So, about a third from there. About a third from hedge maturities, getting a lower yield. So, roughly a third from there. Then just under a third from pass on effect. So, that's broadly the spread, there is also some effect from a slightly lower yield from buffers that we have on the hedge too, so that makes up a small proportion. But of the order of about 10 per cent. So, that gives you a decent split, I hope, for the sensitivity in respect of rates down. A couple of other points to make on that Aman. One is, as you know, what we're looking at there is the very literal rate sensitivity to a downwards 25 basis point shock, there's a lot of other stuff that could go on within the business at the same time.

So, while you've got the structural hedge, which is refinancing in a lesser yield environment, if you like, you've also probably got less churn in terms of deposits, which should make up for some of that. You've also got us, and I think all of our competitors looking at their margin in the round, so some potentially offsetting asset margin impacts in that, including most obviously

mortgages. And then, you've also got activity benefits, that is to say off the back of rate cuts you might see more activity which in turn stimulates income opportunities. So, it is likely, Aman, that a rates reduction is negative in terms of the interest rate sensitivity, but it may not be as negative as our sensitivity of around 150 million implies, for the reasons that I just mentioned. The final point, Aman, which is to say, that if you look at our greater than 290 basis points margin guidance for the year, we've got three rate reductions embedded in that margin guidance. So, this sensitivity, if you like, is for rates shock above and beyond what we already have embedded into our margin guidance, which is worth bearing in mind.

Aman Rakkar
Okay. Can I just ask one quick follow up there then?

William Chalmers
Sure.

Aman Rakkar
So, that breakdown is really helpful, thank you very much. I guess the third of repricing lags, I guess you'd expect that to reverse its course in year two? That's a temporary thing that I'd imagine not to be a drag after 12 months. The hedge maturity is fair, but we typically might look at that separately. I guess the remaining 50 million, 25 basis points reduction in base rate, the idea that it only takes 50 million out of NII on a sustainable basis excluding the hedge, it's actually just a very, very low number. Again, am I making an incorrect observation there? Have I made a logical misstep at all?

William Chalmers
I might just ask you to repeat that last point, Aman. But before you do, just to give you some idea of what carries on in year two for that same 25 basis points reduction, which I think was your first question. The repricing lags obviously do not carry on because you've given notice and that's that. The pass on pressure does carry on, but obviously in the same proportion. The hedge maturities, that's where it increases clearly, because you've got increasing maturities coming due in that lower rate environment. So, that effect does continue, and indeed it expands actually, over the course of year two, simply because you've got more maturities that are refinancing on lower yields. And then, finally, the buffer impact carries on year after year, but at the same quantum. Now, I didn't catch the last of your points there, Aman, which, if you wouldn't mind, could you repeat for me?

Aman Rakkar
Yeah, it's just the remaining 50, right? The bit that’s not the repricing lag, not the hedge component, I understand that compounds through the three years, the bit you're left with is ultimately your sensitivity to base rate on an enduring basis, and that is 50 million. It's just a very, very low number.

William Chalmers
Yeah, I think the answer to that, Aman, and it came up actually when rates were going up in the cycle before the cycle that we may be on now. It's just because you are really just talking about that proportion of balances, which are effectively not in the hedge book. And so, we saw that in the context of rates going up, and we’ll see in the parallel effect in the context of rates going down. So, that's the explanation.

Aman Rakkar
Okay. Thank you so much.

William Chalmers
Thanks very much, Aman.

Question 2 – Raul Sinha, JPMorgan
Hi, afternoon William, thanks very much for doing this call, we do appreciate it. So, if I can perhaps get your thoughts firstly on this non-NII performance, which is obviously quite good in the quarter, but I was hoping you might be able to give us perhaps an update on where you think you are at in terms of the 750 million strategic growth initiatives? So, given the growth that we've seen so far in Other Income, how much of your targeted 750 million you've already achieved? I guess related to that, I was wondering if you might be able to comment, it sounds to me like the 750 million target has got some associated funding costs that are booked in the NII line. So, I was just wondering if you could talk to us about that overall quantum of 750 million, how much should we think about structural increase in funding costs related to the initiatives that you are putting in for growth over the plan horizon? Thank you.

William Chalmers
Yeah. Thanks very much for those questions, Raul. So just to comment briefly on OOI, as you know, we have OOI in quarter one at around 1.34 billion, that was up 7 per cent year-on-year up, I think it was 4 per cent, quarter on quarter. That was in essence coming from the various different business areas, in particular retail and commercial, but actually also, if you strip out bulks within IP&I, some growth within IP&I too. So overall, that was the pattern during the course of the quarter. As said on Wednesday, I'd expect that to continue to grow during the course of the year, I'll be hesitant before using the word growth too much, but nonetheless continue to grow for the course of the year. That in turn is going to contribute to our achievement of the 700 million benefits off the back of strategic initiatives. You asked the question, Raul, around how much of that 700 million has been achieved, but the answer is as of the end of last year, about 500 million.

How much of that is in OOI? We haven't actually split that out to any precise level, but you might split it out roughly 50/50, something like that. I think that's the commitment that we gave for our 2026 commitments of 1.5 billion. It wouldn't be terribly far wrong for '24, perhaps a bit more tilted towards net interest income, simply because we've seen a rate cycle going up during that time. So, a bit of a tilt towards net interest income, that point notwithstanding a reasonable split between the two. In terms of non-banking net interest income, which as you rightly point out, Raul, is in support of delivering OOI. We gave the guidance on Wednesday around the expectation for that non-banking net interest income to be overall around 450 to 500 given OOI growth expectations.

We didn't give any comment beyond that, Raul, other than to say that as we expect OOI to grow, we should also expect non-banking net interest income to grow modestly, off the back of the growth component, less so off the back of the refinancing component. So, I shan't give anything much more precise than that at this point, Raul. It's safe to say, if you look at the pattern of non-banking net interest income increases, if you like, over the course of the last couple of years, and you bear in mind the comments that we've made, that 50 per cent of that is around interest refinancing, if you like, in a high yielding environment, or higher funding cost environment, and 50 per cent is off the back of growth, that gives you something to work with on what you might expect going forward.

Sorry to not have been much more helpful than that, but hopefully that gives you a basis on which to analyse the forecast. Just while I've got the microphone, the slight lull between Aman and Raul's question there has allowed me to look back on the rate sensitivity for last year, which I think was closer to 200 from memory, judging by the numbers that I have here. The reason why that was higher, I believe it was because of floors in the context of rate reductions. Where, as you know, you can't reduce rates on given products below a certain level, and so as a result, when rates go down, you've got a one-sided outcome from a cost point of view. That's why the rate sensitivity was higher last year versus this year, the fundamental drivers have not changed.

Question 3 – Alvaro Serrano, Morgan Stanley
Hi William, good afternoon. It's just kind of a follow-up possibly to the previous question and to some of the debate during the call. Obviously, non-banking NII is a drag and we've spent half of the call trying to guess if the NIM was going to bottom in Q2 or was going to be flat. If we think about the NII in absolute terms, combining both banking and non-banking, and think about volume growth, I got the impression that you were very measured in the results call talking about NIM improvements during the year, very back-end loaded. Are we going to see the NII grow in absolute terms in the back end of the year? Will that NIM turnaround, be enough to offset any growth in non-banking? And when I think about 2026, consensus is still not factoring in the targets that you laid out, is NII the main biggest difference you think or Other Income? Thanks.

William Chalmers
Yeah, thanks, Alvaro. A couple of questions there. NII and its composition and how does it fare through the year and then looking forward to 2026. Couple of things, couple of points perhaps to make there.

The drivers in our margin, first of all, might be worth commenting further on. As you know, we've got a margin expectation during the course of this year for greater than 290. We have seen a slowdown in the rate of margin attrition in Q1, whereby it went down, as you know, from 298 in Q4 to 295 in Q1, which is good to see. We do expect that margin erosion to carry on a little bit further into this year.

And the reason for that, as you know, Alvaro, forgive me for this, but I'll just underline one or two points. The reason for that is, one, continued churn. We do expect PCA balances to have a slightly tougher journey in Q2, in part because of the bank holiday timing benefits, but partly because we expect churn to continue, albeit at a slowing pace.

Likewise, within savings, savings migration between instant access and fixed term, it doesn't stop as of Q1, it carries on a little bit further. And then we also saw BCB, as we term SME, in essence NIBCA balances, non-interest bearing current account balances migrating a little bit in quarter four and again in quarter one. So that deposit churn we do expect to continue in quarter one.

The second point, and this might differentiate us versus others a little bit, is that we have a mortgage refinancing headwind, as you know. And that mortgage refinancing headwind is not yet in balance, to be clear. That plays itself out during the course of the remainder of this year and continues into 2025. So that's a point that's worth bearing in mind.

Then on the flip side, we have the hedge, which, as you know, is going to deliver a further 700 million of income this year, but itself is stronger in quarter three and quarter four than it is in quarter two. So that's worth just bearing in mind as you think about how the margin plays out.

What I think that means is that we do expect the margin to drift down a little bit looking forward. We haven't called out precisely the quarter in which it turns, but we do expect it to have a positive direction by year end, and precisely when is going to depend upon customer behaviour, number one, rates number two, competitive pricing pressures, number three. But again, just bear in mind the distinctions in our book versus maybe some others.

Relevant to your point around NII, we have called out the AIEA benefit, if you like, over the year, growth over the year versus the quarter one 449 position. We have stuck with our greater than 450 position. And I made a couple of comments last Wednesday that overall, quarter one was looking pretty constructive on that front. I don't want to overstate that, but it was looking perhaps a touch better than we had thought. That is likely to have an effect, as you point out, Alvaro, in terms of the overall net interest income balance within the year.

And I'd make two points. One is I shan't call precisely when net interest income will turn, but I think the premise of your question is not unreasonable. That is to say because of the AIEA benefits, you might expect net interest income to turn a little bit ahead of when the margin turns. So that type of sequence I think is not unreasonable, but I'm not going to call out exactly the quarter at which that takes place.

Alvaro Serrano
And that should more than compensate for the non-banking, the non-banking is not going to get in the way of that, it's not mature enough?

William Chalmers
No. Well, let me take a step back, Alvaro. There are three components to net interest income, as you know, non-banking net interest income, AEIAs, and margin. Non-banking net interest income over the course of the year, that fits the definition that I described on Wednesday and we gave you some hopefully pretty precise guidance in respect of that. You'll make your own assumptions about how far and how fast AIEAs progress and you'll also make your own assumption about where rates go, customer behaviours, churn, and the like. That's really for you to take a view on rather than me to tell you. But that combination, as said, should lead to net interest income turning a touch before the margin turns, but I'm not going to call out precisely when it turns within the quarters of the year. So again, hopefully that is helpful.

One component, just by way of illustration, I suppose, in the AIEA dynamic is we talked a little bit about mortgage asset growth on Wednesday. That's one component that, if you like, improves over the course of the year. We've seen it improve in the course of the quarter one. And that should, pan out a little bit further during the course of the remainder of this year.

Secondly, Alvaro, you asked about 2026. I shan't comment on consensus clearly in 2026. But as we look at 2026, we remain confident in our greater than 15 per cent RoTE number one, and as you know that is not dependent upon us reducing our CET1 target to 13 per cent, number two.

What are the drivers of that RoTE expectation? I went through them on Wednesday, so I'll probably spare you all from going through them now, otherwise you might hang up. But nonetheless, it is, overall, a complement of drivers within the organic business, on the income line, drivers because of the strategic initiatives, on the income line, drivers because of the structural hedge, on the income line. And then that all benefiting from a degree of operational leverage within the business as investments flatten out and as costs flatten out. To be clear, this will continue to be an investment oriented business, but nonetheless, that operational leverage should tick up versus what you're seeing this year, for example. And that, in turn, off the back of a higher tangible asset value, drives a higher RoTE for the business. And again, we have confidence in greater than 15 per cent.

I suspect that there may open questions around any one of our lines, but I shan't comment specifically and again I shan't comment on consensus.

Alvaro Serrano
Thanks, William.

William Chalmers
Thanks, Alvaro.

Question 4 – Edward Firth, KBW
Afternoon, William, thanks for these questions. Yeah, I suppose a slightly different topic really. I'm looking at IFRS 9 provisioning and how we should think about that going forward. Because I guess in the past, one of the key drivers we've always looked at is NPL coverage, which I guess is stage three in the new world.

And if I look at that now, you're down below 40 per cent now. Back in 2019, you were above 50 per cent, which I guess is quite a surprise given the interest rate environment. Logically, one would imagine in a higher interest rate environment, you'd need more coverage. And I guess some of that is mixed, but is that something you look at? I suppose, my first question is, is that a relevant dynamic now? Is it just a model output? That would be one question.

The other one is how does that sensitivity work? So I think the changes you made this time were there was quite a big change in house price expectations. Was that the biggest driver of the write back? Or can you give us any sense at all, I always thought unemployment was the big one in the past, but it looks like maybe house prices were more this time? So that would be really helpful to get some sense on.

And then the other thing is your 13 per cent RoTE target for this year, because I guess we've talked endlessly about the margin, but I guess it sounds like it's going to be there or thereabouts for this year. But you only made 13 per cent in Q1 with a 200 million write back in impairments. And I'm assuming you're not assuming further write backs. So I'm just trying to sense your level of confidence around that 13 per cent and what will do best and what would do worse as we go through the course of the rest of the year to ensure we get that. Is this going to be like a 12 and a half is 13? Or is this like you've got 14 in the bag, and you feel comfortable on the 13, does that make sense?

William Chalmers
It does, Ed. Yeah, thanks very much. I may need to ask you a little bit around the first question that you asked, but I'm going to give you some comments and then you can tell me whether or not it actually answers the question.

In respect to IFRS 9 provisioning, there's a kind of broad point there, which is around the ECL that we have now and then coverage, depending upon how you look at it, whether it's around the book as a whole, whether it's around stage two, stage three and so forth. But just to stop on the first for the moment, we've got ECL right now of around 4.1 billion. On a like-for-like basis, that is greater than we were at pre-pandemic. And the reason for that is, as you know, we had one or two very big, what were previously impairments coming out of the book at the year end last year, one in particular. When you strip that out on a like-for-like basis, as said, the ECL is actually higher now than it was pre-pandemic.

Secondly, as you know, the ECL is at circa 600 million above what it should be on a base case, and that's because of the weightings for our scenarios within the MES methodology, the IFRS 9 methodology. Whereas you know, we've got a particularly severe case which requires something like an 8.7 billion ECL and we take a 10 per cent dose of that in our overall probability weighted ECL. So we've got, in short, 600 million more provisions in our probability weighted ECL than we would expect to see necessarily in the context of our base case should it play out in that way, Ed. Hopefully that gives you some idea.

I think then when we look at the overall coverage levels across the book, we feel very comfortable in terms of the coverage levels. In fact, if anything, our empirical experience has been better than the coverage levels would suggest. And that's partly what you saw, you saw a little bit of that last year.

Moving on in respect to this year and the Q1 MES release, you asked the question around how much of that is HPI, how much of that is unemployment. I think just because HPI took a jump to 1.5 per cent up as it is today, from the 2.2 per cent down last year. That jump means that the MES that you saw of 192 million, about two thirds of that is from HPI and about one third of that is from the unemployment shifts. So that's roughly speaking the MES split, 192 million, about two thirds from HPI, one third from unemployment. And I said that's because of the jump from 2.2 per cent negative HPI up to 1.5 per cent positive HPI between Q4 to Q1, Ed. I'm just going to pause there briefly on the asset quality questions, Ed, to make sure I covered your questions.

Edward Firth
Yeah, I guess I suppose just related to that, if we see some of the indicators deteriorate, and I'm not going to hold you to what you will do, but just conceptually, is that 600 million available then, in your mind, to utilize if we were to see house prices head back south? Or is that the way we should think about that?

William Chalmers
Well, just an entry point to that question, Ed, the performance within the mortgage book has actually been improving for the last quarter, so we've seen NTAs and flows to default actually improving in the last quarter. I say that just to give some context, if you like, for the question.

Our provisioning is done, just as you might imagine, in terms of asset class by asset class. So, the impact upon the overall ECL would really depend upon where the economic outlook went to, so if you saw, this sounds like a bit of an anomaly, but if you saw an environment where the HPI, or rather the mortgage provisioning was needing to increase, but at the same time the outlook was improving, you'd see some offsetting impact there in terms of the overall ECL required. If, on the other hand, you saw, let's say asset performance in mortgages deteriorating at the same time as the outlook deteriorated, you'd obviously expect, because of IFRS 9 methodology, you'd expect ECL to follow that pattern.

So, it really depends upon what happens to the outlook, Ed, in terms of where that excess of 600 million that I pointed out goes, the difference in particular between your downside cases and your base case.

Edward Firth
Okay. Perfect. Thanks.

William Chalmers
So then just moving on in respect of your second question, you asked about returns for the remainder of this year. As you know, we stick with our guidance of circa 13 per cent and we reaffirmed that on Wednesday.

What are the moving pieces within that? You're going to see some benefits, if you like, play out over the course of the year in the context of the income lines that we discussed earlier on. We talked a bit there with Alvaro around the net interest income. You know our expectations around other operating income, we expect it to grow over the course of the year. So that's the income picture.

Then moving through into costs, as you know, we had a couple of lumpy items in Q1 costs, in particular, the change in the Bank of England levy, and then secondly some front-loading of severance costs. Those are not going to play out every quarter by their nature so you get a slightly different shape to the cost line over the course of the year.

And then as you saw also within our P&L this quarter, we saw some volatility. And that volatility, in turn, was a cost to the RoE within the quarter that we would not expect to reoccur over the course of the year. As you know, we don't forecast volatility because it really just depends upon the ebbs and flows the markets take. So taking all of those puts and takes, if you like, Ed over the course of the year, that's what gives us confidence in the circa 13 per cent, which again, we continue to stand behind.

Edward Firth
So t sounds like it’s the Q1 costs?

William Chalmers
I would say it's all three really, Ed. I think it's a bit on the income, it's a bit on the costs and it's a bit on the non-recurring nature of volatility.

Edward Firth
Perfect. Okay, thanks so much.

William Chalmers
Thanks, Ed.

Question 5 – Chris Cant, Autonomous
Thanks for taking my questions. I just had a couple of niggly ones, please, to help us fill out our models.

So firstly, in terms of the operating lease depreciation print, obviously that's bounced around quite a bit over the last couple of years and has increased quite meaningfully versus where we would've been in 2022. A big part of that being gains coming down. Were there any sort of sale gains within that q1 figure? And how much in a normal year should we now be thinking about sale gains being?

I mean, if I go back historically, when the portfolio was much smaller, you were averaging about 54 million a year for a number of years pre 2019 when used car prices started to provide some benefits. So are you thinking about sort of 70 million a year of gains in a typical year? That would be the first question, please, just to help us understand the dynamics.

And then on the non-banking NII, sorry to labour this point, but just in terms of what you did tell us the other day about sequential expansion of that going through the year landing at a sort of 450, 500 type level, does that mean we should be then thinking about a 550 type level for next year in terms of the exit run rate for that line item?

Conscious that you indicated on the call when I asked you about this that as we get into 2025, the rates component should start to drop out of driving that number higher, but obviously you're telling us I think that you're expecting continued expansion as we go through the course of this year. So should we be expecting that number to be at the 550 level ish for 2025, allowing for a bit more other income growth? Thank you.

William Chalmers
Yeah. Thanks, Chris. Two questions there: operating lease depreciation, number one, non-banking net interest income, number two.

In terms of operating lease depreciation, just a couple of points to put it in context. As you know, we saw a pretty extraordinary environment in the car market during the course of '21 and '22, and it's just worth saying that the benefit from accumulated depreciation profit on sales during those years was around a billion pounds. So it's just worth bearing in mind, if you like. The P&L benefited, and thereby stakeholders benefited to the tune of around a billion pounds during those years because of the, I would say unusual developments in the context of the used car market.

So that was the abnormality if you like. What we've seen since then is a reversion to something like normality in terms of used car price performance augmented by growth within the overall fleet, and then clearly by a bit of electric vehicle volatility from time to time as part of that. But the main characteristics for the last two quarters I think have been normalisation; in fact more than two quarters, more like three, or maybe even four; normalization of the used car price market, number one; and number two, growth in the core businesses, particularly since the acquisition of Tusker, number two. So that's the context.

You asked around the expectation for operating lease depreciation going forward. We had a charge in Q1 of 283 million. That was a relatively normal charge, but then you need just to build that a touch over the course of the year in conjunction with our other operating income benefits, because we expect the transportation business to continue to grow. And so, you should expect a little bit of growth on top of that 283 million that we saw in Q1 as we go through the year because the other operating income line within transportation is growing.

You asked about gains on sale and referenced the historical number there of 70 million, Chris. To be honest with you, I'm not sure whether we've actually disclosed it at quite such a particular level. But nonetheless, just to give you some, I suppose further context around it, we think the gains are going to be a touch lower than that going forward. I'd be surprised if they were much more than around 50 million on a run rate basis going forward. But having said that, when you model the operating lease depreciation line, just bear in mind these other moving pieces that I've just highlighted, because they're going to be pretty important in terms of determining the direction.

Non-banking net interest income, Chris, as you say, we gave guidance to 450 to 500 in the call on Wednesday, and I think in part, Chris, that is because we recognize that it is not necessarily an easy thing for you to model. We talked also there about the increase in NBNII over the course of '23 and '24 as being driven by roughly 50 per cent growth, 50 per cent rates led and I said that as we go forward, the interest rate refinancing piece of that, the funding cost piece of that should complete over the course of next year. And then of course as rates fall, it will start to reduce NBNII.

We haven't guided particularly to exactly what that will be, but as I said in the call on Wednesday, there are a bunch of underlying assets there. Some of them are financed over three, three and a half years; some of them are financed overnight. So quite a lot of variation in terms of the terms and therefore the interest rate sensitivity of the funding costs.

I think when we look next year, it is going to be mainly about the growth component over the course of the year. I shan't be too precise about saying much more than that on NBNII because it is linked to OOI. So if you take a very strong view of other operating income expectations because activity is strong, because hopefully the products and services that we're offering are increasingly capable of delivering customer needs, then in turn you should expect OOI to strengthen off the back of that, and in turn you should expect a slightly higher number for non-banking net interest income. And conversely, if you think it's the other way around, it'll be the other way around. But I would link it to your perceptions on the OOI line, Chris, and then build into that the rates versus growth points that I made.

Chris Cant
Thank you. If I could ask one quick, follow up as well just in terms of lumpy items. In response to Ed's question, you talked about expecting revenue strength, and obviously we've talked about other income growth and expectation that the NII will at some point turn around. Are you expecting any lumpy items within other income this year which would be contributing to the delivery of the 13 per cent, please? Thank you.

William Chalmers
In short, Chris, I think the answer is no. We do expect progress frankly in terms of our key areas within OOI. Some of those are about expanding the capabilities and about customer activity if you like e.g. in retail, likewise in commercial. Some of those are a bit more locked in in some areas, e.g. the unwind of the contractual service margin within insurance, pensions and investments, for example, alongside strength in other areas under their purview, like general insurance. Some of those might show a bit of return from last year. So for example, the Business Growth Fund, was impacted a little bit negatively last year in our central line items, that's our equities businesses, that shouldn't happen again this year.

But I wouldn't describe that as particularly significant, Chris. So overall, the short answer to your question is no. Nothing expected to be particularly lumpy.

You made the comment there around NII turning around at some point. I hope that through the combination of my comments on average interest earning assets and margins that it's more than at some point.

Chris Cant
Got it. Thank you.

William Chalmers
Thanks, Chris.

Question 6 – Aman Rakkar, Barclays Capital
Thanks for the follow up, William. I just wanted to pick up on something you mentioned on the call last week actually. I think you referred to the mortgage margin headwind running its course in '26. And I've processed that subsequently as this is substantially done H1 of '25, but there's the vintage of five-year mortgages on higher spreads that's coming off in '26.

You've been really, really helpful in sequencing the kind of maturing spread on mortgages. I wondered just for our models, just to make sure we're kind of in and around the right place, could you help us size those maturities and the kind of spread that they're coming off on so we can take a view on the impact on your NIM in '26, please?

William Chalmers
Couple of points, Aman, which I'm afraid probably won't be quite as helpful as you'd like them to be, but just to give you a bit more context on the point. Mortgage headwinds, as you know, we talked about it a little bit in the call during the course of Wednesday. I think we have maturities around 128 and we were refinancing at around 65 or so. And on that basis, you've got right there I guess about a 60 basis point headwind from the refinancing of mortgages.

As you know, that's a reasonably healthy volume right now, because we wrote quite a lot of business in the preceding two years, three years, five years when fixed rates were being written on more favourable terms. That is going to continue to play through '24, it is going to play into '25, and then there is a little bit of that stuff, as you just pointed out really, five-year rate stuff that continues to play out into '26. But the key point from a margin perspective is, as you say, the volumes of that are playing themselves out, number one; alongside of that, the churn has pretty much stopped over the course of this year as is our base case expectation, number two; and then of course the hedge is playing into the margin, number three, and all of that alongside what we believe is a growing business across the various different business areas. So that's the context for it.

Aman, I'm just being very direct about it, I suppose, I'm not going to give you volumes of mortgages this year, next year or the year after, but hopefully that gives you a sense as to the moving pieces within the overall margin. Again, as you can tell from our comments about the back end of this year, our base case is very much that the factors that are influencing and driving the margin are trending to the positive by the back end of this year, and there's nothing that we know that should, if you like, reverse that trend during the course of '25. So the factors, very much the benefits, if you like, of the tailwinds, the extent to which they outweigh the headwinds, those factors should continue to play through next year.

Aman Rakkar
Okay. Thank you so much.

William Chalmers
Thanks, Aman.

Question 7 – Jonathan Pierce, Numis
Hi William. Thanks for the questions. I've got two. One is back on this RoTE target this year. Consensus is 150, 200 basis points below the 13 per cent, the standout lines, I suppose are remediation and possibly impairment. At no point this year have you caveated that 13 per cent with, "It depends on what happens in September post at least the first stage of the FCA motor market review."

I guess also this year you have had a bit of a benefit to the RoTE from the TNAV being a little bit held back by moves in the yield curve. But the question is, how confident are you that you can hit that 13 per cent even if there does need to be a little bit of a top-up to the motor market cost? And do you think you would still be hitting that 13 per cent if the TNAV hadn't been held back a little bit by the move in yield curve?

The second question is on the NIM. At full year I seem to remember the message being maybe a little bit more confident than it sounds now that we'd see a gentle decline in Q1 and Q2, and then hopefully at least a gentle incline in Q3 and Q4, and we kind of finished the year at a not particularly different level to Q4 of last year. It seems like that message has softened a bit. Do correct me if I'm wrong there, but it'd be helpful to know if you think by the end of this year we are getting the margin back up towards the sort of level we saw in Q4 of last year. Thanks a lot.

William Chalmers
Thanks, Jonathan. I'll maybe just take the second question first and then come back to the first.

But on the second question, is there any softening or otherwise of the tone around NIM? No is the answer. There's nothing from my words at least that are intended to soften the confidence or direction that I've given you on the NIM, Jonathan. So I'd be happy to take any further questions on that. But I hope that's clear. And I thought it was worth just dealing with that issue first.

The RoTE, in terms of the expectation for the course of the year, as I said, very much remains circa 13 per cent. What's happened over the course of the year that wasn't entirely anticipated, I think volatility is one item, I think to a degree at least the Bank of England levy being in place, that it is another item. Those are two. I think in addition to that, you might see the MES benefits also from the 192 million that we took during the course of quarter one.

I think very roughly, Jonathan, those play themselves out against each other over the course of the year. And so when we are looking forward, naturally we wouldn't expect any further MES benefits over the course of the year, but our guidance in terms of the asset quality ratio has clearly strengthened in terms of the confidence with which we're able to say less than 30 basis points.

I don't mean strengthen in terms of us giving you a different number. I just mean strengthen in terms of the confidence of below 30 basis points has clearly increased off the back of the 192 million MES benefit. Whilst at the same time, our assets, if anything, have probably strengthened a little bit versus where they were at the end of quarter four. Witness the mortgage margin point that I made in my comments earlier on. Those are the elements playing out there.

You asked specifically about the remediation charge, Jonathan. As you know, we took a 450 remediation charge in quarter four. Just to give you a bit of a mark to market on that, so far in quarter one we've spent eight million of it, so I wouldn't expect us necessarily to see that 450 million running out during the course of the year on motor to be clear. We await to see what it is the FCA says in September and I can't categorically say one thing or the other about what they're going to come out with, but as said, we await to see what the FCA says. If that changes our scenarios, we'll clearly have to consider what that means for our remediation charge, but it's our expectation if you like that 450 is pretty well provisioned against a range of weighted scenarios as we discussed at the full year.

Jonathan, you asked on TNAV and would our confidence around the 13 per cent be the same if we hadn't had a marginal benefit from TNAV because of rates going up in quarter one versus quarter four. No, again, not really, our confidence around circa 13 per cent remains today as it was before. You are right to point out that we've got a little benefit from TNAV, but it's not an awful lot to be honest. I mean, if I had to think about where we expected TNAV to be at the end of '24 in February 22nd versus where we expect TNAV to be today at the end of '24, it's not hugely different. We expected it to be up somewhere between 5 to 10 per cent. I still expect it to be up somewhere between 5 to 10 per cent.

Jonathan Pierce
That's helpful. Thanks for that. And sorry, can I just add one on the end here in regards to TNAV, you mentioned again on the call the other day that over the next couple of years you'd expect to see some TNAV tailwinds from the pension fund surplus. Now, the pension fund surplus has gone down quite a long way since the rate cycle turned. I think the aggregate now since the start of '22 is about 3.6 billion, so it's about 5p of TNAV. Can you give us a sense how much of that you are building in to your 2026 TNAV number coming back? Obviously rates aren't going back to where they were, but is there a couple of pennies of TNAV benefit from that as well? I suspect very few of us actually model it.

William Chalmers
I don't think it'll be as much as a couple of pennies, Jonathan. I don't have that right in front of me, but just to give you some steer on that, I suppose there is some benefit to be clear in our expectation for pension surplus over the course of the next three years, '24, '25, '26. I'm not sure it's as much as a couple of pennies.

Jonathan Pierce
Okay, brilliant. Thanks William.

Question 8 – Jason Napier, UBS
Hi William. Thank you for taking my question. I only have one and I'm effectively throwing myself at your mercy and hoping you can rescue a very conceptual question and that is in the way that you've seen product pricing evolve through the rate cycles of the past, how realistic is it to hope that the tailwinds of hedge gains will fall to shareholders rather than being absorbed in more aggressive pricing? And what I'm wondering is whether an expansion of, for example, the mortgage market, the amount of business that can be done, is that the key driver of where the pricing holds up? I'm just wondering how you think about that sort of thing when you devise three year forward plans? Thank you.

William Chalmers
It's a great question, Jason. And I'll give an answer to it and you can tell me whether or not it's addressing the concerns, but it's obviously something that we think about at a strategic level quite a lot in terms of the positioning of the company. It's also something that we think about in terms of our BAU pricing decisions within the company. First of all, in terms of product pricing, how does it respond over time? At least in my experience, it is pretty much what theoretically you might expect. If you wind the clock back, for example, to the years when liability margins are practically zero, you did indeed have thicker mortgage margins and that's the mortgage refinancing headwind at work for us today. We're back now to an environment where we have thicker liability margins, but now the asset margins are much thinner. There's definitely a holistic dynamic that is going on and underneath that holistic dynamic I think is an expectation or rather an industry structure point.

What type of margins are dictated by the competitive conditions within the industry at any given point in time? Added to that in a low interest rate period like the one that we saw between roughly 2012 to 2020, you are going to see low returns on equity. That's a necessary output as well. You've got a couple of things determining the outputs for margins as a whole. One, the interest rate environment that we're in, low rates typically equals lower RoTE and then the competitive conditions or competitive structure within the overall market, that's one point. Second point as said, asset and liability margins, they definitely play off against each other. Looking forward, we're in a position as you know from our forecast and from the market's forecast more importantly, we're in a position where rates are likely to be a little bit higher on a long-term basis. And off the back of that, that is very likely to sponsor stronger RoTE in the industry as a whole.

Now, where exactly that means margins settle, there have been, as you know, commentators from around the market, including the governor of the Bank of England, who think that bank margins are likely to be sustainably in excess of 300 basis points. This isn't just us saying this, I think this is a sector view which I wouldn't necessarily deviate from. That would be something like my base case. Let's see exactly where they settle, but greater than 300 basis points is supported by a range of analyses and a range of commentators. Your question there is off the back of that, how might competitive conditions if you like, play out with the hedge benefits to the benefit of sharper pricing if you like, rather than the benefit of shareholders? A couple of points on that, Jason. I think one is inevitably in a period of returns that are in excess cost of capital, to an extent at least you are going to see some sharing of benefits. Inevitably you are, and that's probably the way it should be too.

Customers are going to get some benefit off the back of sharper pricing, shareholders are going to get some benefit off the back of better returns, so there is definitely going to be a match there. The one final point that I would make is that bear in mind that we're all in separate positions with our hedge. Some of the new guys who are arguably setting pricing, are some of the guys that don't have big built-up hedges that are likely to benefit going forward. So the extent to which they're able to offset our hedge returns by sharper pricing are themselves somewhat impeded by the fact that they are not benefiting from those hedges that the incumbents are and that's a very different financial or balance sheet structure, which in turn is likely to produce different pricing responses and in turn different returns to the different business models.

Jason Napier
That was really, really helpful, thank you. Just as a follow-up to that, I take what you're saying about headwinds and mortgages enduring perhaps a little longer than we've heard from a couple of the peers. My sense is that's because you did a lot of market share when COVID took place, you were better equipped to deal with demand at a time when margins were wider. But perhaps in general terms, would you say that you're able to participate across the product range without endangering back book margins? You don't have those pockets of earning customers to protect from a margin perspective anymore?

William Chalmers
I think increasingly that's right, Jason. In response to the first part of your question, yes, I think it is exactly right that we did write a lot of volume during the COVID period in particular, we found ourselves in a position where we were able to respond to customer needs. I think others had a harder time servicing than us, both at the front end and perhaps beyond that and as a result, pricing in the context of relatively modest supply into quite a strong market reflected itself in margins and we were a beneficiary of that. Obviously, that's playing out now and so you get a headwind effect from the mortgage book. But having said that, it's a bit like one of these questions, would you rather have earned the money even though you have a headwind on day two or not have earned the money in the first place? And for us that's an easy question to answer.

On the second part of your question around the back books. The back books are coming down at quite a rate, so right now for example, we have an SVR back book, semi variable rate back book, of around 30 billion just a shade over 30 billion, I think it's 33 to be precise. We saw that come down quite a lot during the course of quarter one, which was what was responsible for the 1.6 billion mortgage book headwind that we saw in quarter one, it was that refinancing of that SVR book. If you look at the quarter one attrition on that 33 billion, it's a touch over 20 per cent. We plan for that over the course of this year. We plan for continued attrition in the context of our SVR book and so it is an increasingly diminishing part of our overall book and therefore an increasingly small part of our overall pricing strategy, Jason. It is safe to say that we've got bigger, more important objectives than protecting the SVR book as we stand today.

Jason Napier
That's very helpful. Thank you so much.

William Chalmers
Thank you. I think we've got time for about one more if that's all right, we'll perhaps just open it up for that last question and for any that are remaining, I'm sure the team in IR would be very happy to take them.

Question 9 – Andrew Coombs, Citi
Thank you. The first one on motor finance, Barclays have elected to appeal the FOS case, I think there's a debate as to whether you appeal it as well. They've made it clear that it is an appeal against that specific case, they're continuing to support the FCA's review into historic motor finance arrangements. Do you think there are any implications from an appeal of that case or if you were to appeal your own case, do you think it could influence the FCA's decision? That's my first question.

Second question is non-NII. If I look at Q1 now versus Q1 '22, when you came out with your strategic plan, it's running about 160 million higher for the quarter. I know you've got Embark and Tusker in there, but when you originally flagged the 700 million strategic revenue benefit by 2024 from some of the organic exercises, how much of that do you think is already in that Q1 run rate as well? My question is, should we think that the non-NII is going to continue to run around 160 above where it was in '22 per quarter, or is there room for even more upside potential as you deliver on some of those investment opportunities?

William Chalmers
Thanks Andrew. Just in relation to the first question on motor, we obviously observed what Barclays did, we have not done the same as you know. We wanted to keep an eye on what they've done and keep it under review. In terms of what impact it will have, one point that I think is interesting is it will run its course pretty much in parallel with the FCA review and I'm not sure the timing's going to be terribly different. And so it's hard to make a call that it will influence the FCA's judgment because I think the progress of the two may well be contemporaneous. I think from our perspective at least we have decided not, for the moment at least, to

intervene, but we'll keep our options under review and if the facts change then we will take another look at that decision and reconsider.

But at the moment, at least really what we're focused on, Andrew, is trying to do everything we can to help the FCA conduct an impartial review and get clarity for the industry. To be clear, they're looking for misconduct and customer loss, we don't believe that it is there, we believe that we've complied with the regulation at all applicable times. And so for us right now, this is about getting through it, about helping the FCA and about getting to an outcome that is conducive to the successful motor finance industry, which is where we think the FCA is as well. It's just a question of navigating its way to that path, not to downplay it or to simplify it, but I think we believe that is the journey that they're on. Hopefully that's helpful in respect to the motor point, Andrew.

On NBNII, it's an interesting question. A couple of points I would make really. One is when we set out in 2022, we did not expect rates to go up to the level that they have gone up to. And so a lot of the inflation within NBNII as I said, has been rates driven. Therefore, that's responsible for a chunk of the increase. As we look forward, that rates driven component I mentioned earlier on is going to level off first clearly, but then come down as rates come down, that element at least exhausts itself. One then has to take a view on the volume of activity and it's the volume of activity that will play the greater role in determining where NBNII goes to going forward. But as said, I think NBNII overall, it's probably a touch higher now than we had expected it to be back in 2022, and that's simply driven by the fact that rates are a touch higher now than we expected them to be at that time.

Andrew Coombs
Thank you very much.

William Chalmers
Thank you, Andrew. Thanks for the question. I think we'll call it a day there just to say thanks very much indeed to everybody for your continued interest and indeed your questions. We'll obviously be around both in the IR team and more generally to answer any further questions that come up. And once again, thanks a lot for your time.

End

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