Lloyds Banking Group plc – Interim Results 2010

The Plaisterers Hall, London – Wednesday 4 August 2010

Eric Daniels – Group Chief Executive

Good morning, and thanks very much for coming. We do appreciate your flexibility in accommodating a slightly different time than usual. What I would like to do is to start out this morning by briefly reviewing the highlights of our performance in the first half, and put them into the context of the longer term development of the Group.

Tim will provide you as always with the texture and detail behind the numbers. We will then go to the usual question and answer session.

In my presentation, I am going to focus on two key areas. First, an overview of the results we achieved in the first half, and I will comment on the significant progress that we have made across the Group during that period.

We are very pleased to be announcing our return to profitability, which comes just one year after acquisition. This reflects the hard work of our over 100,000 employees, who strive to serve our customers and deliver for our shareholders.

I will also talk about how we will operate over the next several years, and how we intend to build out our profit model.

I will then address our longer term prospects. We believe that we can build industry leading efficiency and effectiveness. That will allow us to add greater value to our customers, and will support high quality growth over the next several years.

Let me begin by reviewing the first half highlights. At the Prelims, we shared with you the great progress that we're making, and particularly the strong momentum we had in the core businesses.

I am delighted that we have advanced the organisation on all fronts and on a combined basis we are reporting a Group profit of £1.6 billion £1.3 billion on a statutory basis

All of the key line items in the Profit and Loss statement are showing positive momentum and excellent results, with income up 5 per cent, costs down 5 per cent and impairments down by 51 per cent.

What is especially pleasing is that we have seen very good levels of profitable growth and strong new business flows in our customer relationship franchises.

We have made excellent progress on the integration programme. We achieved a savings run-rate of £1.1 billion at the end of June, and we're highly confident of meeting our 2011 target.

We have continued to reduce the size of our balance sheet, with a further reduction of £23 billion of non-relationship assets in the first half.

We have improved our funding and liquidity position. We reduced our reliance on the wholesale funding markets by £32 billion since acquisition and have repaid £33 billion in central bank funding.

And we have further strengthened our capital, with core tier one rising to 9 per cent, up from 8.1 per cent at the start of the year. This remains well ahead of regulatory requirements, and meets the stress tests.

Overall, I am delighted with our performance in this last half. We are building momentum on all the key line items and we have a strengthening platform from which to drive future growth.

The operating divisions had a very good half and I wanted to touch on a few points that demonstrate the real strength of these businesses.

Helen and her team in the Retail Bank to an excellent half, delivering a profit of £2.5 billion. Income grew strongly, costs were well controlled and we saw a good improvement in the asset quality ratio. We were very pleased with the growth in Retail customer deposits, which were up some £6.6 billion for the half. Equally important is the growth in sales volumes, which reflects our success in attracting new customers and building deeper relationships with existing customers.

Turning now to the Wholesale Bank, under Truett's leadership, we saw a return to profitability, with a substantial reduction in the level of impairments. Impairments fell by 69 per cent, reflecting the rigorous risk management approach and prudent provisioning that we applied to the problem portfolios.

We opened up another 60,000 new commercial banking accounts and committed £24 billion of gross lending to commercial and corporate accounts, demonstrating our support for customers in these critical sectors of the UK economy.

The Wealth & International business reported a loss of £1.6 billion, reflecting the increased impairment charges in the International units. Impairments rose by 52 per cent in comparison to the same period in prior year, but were down by 15 per cent on the second half of 2009. This is in line with our guidance. The majority of the increase related to Ireland, as a result of the continued deterioration in that country's economy. I was very pleased with the performance of the Wealth units, which we have identified as a growth opportunity for the Group. We opened up 13,000 new private banking relationships in the UK, and customer deposits rose by £1.3 billion across the division.

Turning now to Insurance, Archie and his team delivered a profit of £469 million in the first half.

Our focus has been on driving profitable business, rather than sheer volumes. Total income was down 10 per cent, with lower sales but improved ongoing internal rates of return, which rose to over 15 per cent. The team has made good progress on the integration, and costs are down 15 per cent.

We have launched a single bancassurance proposition across the Group, and we continue to believe this represents a significant growth opportunity as we help our customers meet their life, pensions and investment needs.

We have also continued our capital efficiency programme and the division upstreamed a further £2 billion of core tier 1 capital to the Group; which will go some way toward mitigating the potential impact of Basel III.

The Integration programme remains a key focus throughout the Group, and it is critical to underpinning our drive to become a leader in terms of efficiency and effectiveness. This is one of the largest and most complex integrations ever undertaken in the UK, and so far we are proceeding letter perfect.

The synergies stack up well when compared to other financial services integrations, both in terms of the percentage reduction of the addressable cost base as well as realisation cost.

We are delivering synergies from four main initiatives.

On organisational design, we have removed the obvious duplication created by the merger and we have put in place a matrix, with 8 layers and 8 spans. In this category, we have already achieved the majority of the savings expected.

In systems and processes, the priority for the first 18 months has been on the development and testing of a common set of IT platforms and aligning our processes. Over the next 12 months we will begin roll-out and we expect to see major benefits coming through. This is also critical to our positioning the organisation to better serve our customers.

Property has provided a good flow of benefits and we are on track to exit 1.4 million square feet by year end.

We are on track to achieve the £2 billion target at the end of 2011.

We previously set out detailed guidance and I thought it would be helpful to summarise our current performance against that set of metrics.

In terms of revenue growth, we delivered 5 per cent in the first half, and this represents 8 per cent real growth if we take out the impact of the liability management gains.

Our margin increased to 208 basis points, somewhat ahead of guidance, and we expect to see a further modest increase in the second half.

Our cost income ratio improved by 440 basis points, to 43.5 per cent, well ahead of guidance.

The integration programme as I mentioned, is going well.

Impairments improved by 38 per cent against the second half of 2009. This is a better performance than had been expected, and represents the success of the divisions in actioning the portfolios.

Our balance sheet reduction programme is firmly on track, with an £83 billion reduction already achieved against our target of £200 billion over the five years.

I am pleased that for the first half, we are performing in line with, or better than, guidance. Given the progress we have already achieved thus far, I will set out new guidance for the coming periods later in the presentation.

That covers off the last half. Let me now turn to the longer term prospects for the Group, and why we believe we are very well positioned to deliver sustainable growth over the coming years.

Our economic outlook remains cautious but we believe a gradual recovery is the most likely outcome. We have factored this into our business plans. We have taken a conservative view and reduced our forecast for 2010 back to 1.3 per cent. However, that now looks on the low side given the data released for the second quarter. We are assuming a steady pick-up beyond 2010.

We expect to see residential and commercial property prices rising modestly over the next couple of years. Our forecasts are below consensus and we are not dependant on a faster recovery for our growth story.

We continue to anticipate that company failures and unemployment will peak this year.

Our financial outlook is based on a range of economic and regulatory scenarios, and having thoroughly stressed all of our portfolios, we remain confident of our capital position and our growth prospects.

I won't go through all the points on this slide but it is clear that the industry faces a period of significant change. There will be more stringent regulatory requirements, particularly affecting both capital and liquidity. There will be challenges to the shape of banks through the reviews that are being launched, looking at both the types of business conducted and the competitiveness of the market. At the same time, consumer expectations are rising with regulators leading the move to changed standards across the industry.

We continue to believe that the industry remains highly competitive, with relatively few barriers to entry, and that UK consumers receive good value, as has been evidenced by independent research. The new environment will be challenging for all financial institutions, and we are actively engaging on these issues to try and achieve an appropriately balanced outcome.

We have always believed that our strategy of focussing on customer value is the right one, and the best way to deliver value for our shareholders. But with the heightened regulatory backdrop, the strategy will serve us especially well as it addresses many of the issues currently under discussion. So, with that backdrop, let me now describe how we think about the phasing of the development of the Group going forward.

On acquisition, our first priority was to establish control over the enlarged Group, and address the immediate issues regarding capital and funding, and put in place a risk framework.

During 2010, we will continue to make progress against these areas but we are evolving our focus toward the elements of the profit model which we expect to drive our future financial performance.

Our return to profitability in the first half is evidence that we are on the right track. Each one of the line items is moving in the right direction; we are growing our top line, driving positive operating leverage and reducing our impairments. We would expect to see continued improvements in our profitability over the next several periods.

Our improved performance will be sustained over the longer-term by embedding our customer value strategy across the Group. Our objective will be to build industry leading efficiency and effectiveness. This will enable us to provide greater customer value, resulting in deeper relationships and the development of high quality market share.

We expect our strategy to drive strong and sustainable earnings growth, generate capital and deliver high returns. In many ways, we think our model is even more viable in the new environment. We believe successful banks in the future will combine cost and capital efficiency, with deep customer understanding to provide real value for customers. That leaves us very well positioned.

We are combining two highly efficient organisations and together, aided by the synergies, we will create an industry leader with the capacity to invest more in its customer propositions.

Our ongoing investment in data management and insight tools, will give us an unrivalled understanding of our customers' needs, helping us to build deeper relationships with them.

This will truly set us apart in terms of what we can offer to our customers. We will understand them better, we will offer them better products, better pricing and better service.

By providing better value to our customers, we will also provide better value to our shareholders. We will deliver strong, sustainable growth, with greater predictability and better returns.

This slide briefly sets out the measures we are driving into the business and reflects how we will report on our future progress. Our efficiency measures will include operating leverage, the cost income ratio, our investment levels and loss ratios.

In terms of growth, we are looking at target customer acquisition backed by measures of relationship depth. The enhanced customer value we will provide will be reflected in our satisfaction ratings, which we will measure through net promoter scores. This is a higher standard than normal satisfaction ratings, but we believe it is critical.

For shareholders, our performance will be measured in terms of return on equity, earnings per share and dividend capacity.

We will also measure our progress as an organisation against other stakeholder metrics, such as employee engagement and community involvement, and these are very important to us. It is by focussing on all these metrics that we will be able to ensure that we deliver on the growth potential of the new franchise.

I would now like to tell you how the Group will deliver against our strategy by providing updated guidance.

This slide sets out the financial performance we expect to achieve over the next several years.

We expect to deliver 6 to 7 per cent income growth per annum from our core businesses, through our focus on customer relationships.

We set the top-line growth objective as we expect to grow faster than the nominal rate of growth in GDP. We considered driving faster income growth but we believe that the range we have set out is consistent with the more conservative risk appetite that you would expect from Lloyds, and our desire for lower volatility through the cycle.

The rate of revenue growth across the Group will be partially offset, as we continue to run down our non-relationship assets and meet our state aid commitments.

We expect to see our margins return to above 2.5 per cent by 2014, more in line with our historical rates.

We expect to achieve market leading efficiency with a cost : income ratio of around 40 per cent, by delivering the integration savings and maintaining our focus on positive operating leverage. This will enable us to further invest to strengthen our customer proposition and to support future growth.

On impairments, we will continue to apply our more conservative approach to risk, which is underpinned by unparalleled customer insight. This should result in a portfolio that settles in at a consistent 50 to 60 basis points of impairments. We expect impairments to be moderately lower in the second half of the year, and will continue to improve thereafter.

We will continue to shrink the non-relationship part of our balance sheet, so that we can focus our capital on supporting customer relationships. That will allow us to reduce our capital intensity and support a loan to deposit ratio of under 140 per cent.

We are expecting our returns on equity to be over 15 per cent, in the medium to longer term. Given the regulatory uncertainty, we cannot be more specific on ROE's at this stage, but we expect that we will be in the top quartile of world-class banks. And we also expect to return to a more normal dividend policy in the future.

In finishing, let me summarise my three key messages.

First, we had a strong half and delivered £1.6 billion of profits.   We have greatly strengthened our balance sheet and funding position, and we have a strong profit trajectory.

Second, we are putting in place the building blocks for a strong business; control, profitability and growth.

Third, we are building the UK's most customer-focussed franchise. We have a growth strategy that will combine our skills in driving our efficiency and building deep customer relationships, in order to generate customer value. That in turn will drive shareholder value.

The positive trends that we have established and our plans, point to strong, sustainable and profitable growth in the future.

Thanks very much for listening. Let me now turn over to Tim to take you through the detail of the numbers.

Tim Tookey – Group Finance Director

This morning I am particularly pleased to be presenting a robust set of results which demonstrate the underlying momentum that we are delivering in our business. On top of that, I want to share with you some of our views on the future shape of the Group which will be supported by our increasing strength in the key disciplines of capital and funding.

In the first half, we have demonstrated that our core business is in good shape with a strong trading performance against the backdrop of a stabilising economy. The Group delivered resilient revenues, a strong cost performance and a significant reduction in impairments. In addition, we have continued to make excellent progress with the integration of HBOS.

All of this has contributed to the acceleration of the Group's return to profitability.

Looking now at our business performance in more detail.

We delivered good revenue growth of 5 per cent, driven by margin expansion, and excellent cost control with expenses down 5 per cent.

Impairment losses were half those of the same period last year and materially lower than the charges in the second half of 2009 and this is significantly ahead of our February guidance. The reductions principally come from our Wholesale and Retail divisions but all divisions are showing strong trends.

It's good to be back in profit and we are pleased with the profit before tax of £1.6 billion for the first half, compared to the loss of nearly £4.0 billion last time.

Our core tier 1 ratio has significantly increased to 9.0 per cent, driven by benefits of lower risk weighted assets and the generation of core tier 1 capital through a number of liability management exercises.

Before I get into the meat, let's just look briefly at the divisional performance ………

Retail delivered a particularly good performance with a significant increase in profits. This was driven by strong income growth and margin expansion, tight cost control and a significant reduction in impairment losses.

Wholesale returned to profitability driven by a significant decrease in impairment losses reflecting the improved economic climate, and further supporting previous guidance that impairments peaked this time last year. This was offset by lower net interest income, primarily from successful non-relationship asset reductions and of course the previously guided decrease from trading income.

Wealth and International delivered a better performance for the first half overall, and pleasingly a reduction in Irish losses compared to the second half of last year.

Our Insurance business performed well in a difficult market and delivered profits up 18 per cent on the first half of last year. This was achieved from lower sales as the division focuses on its value and not volume strategy.

At the Group level, the combination of improving margins, cost synergies, and lower impairments led to a strong performance in the first half, and these trends confirm or beat the guidance that we set out for the Group in February.

Let me now look at key revenue trends.

Excluding liability management gains, income rose 8 per cent.

Growth in net interest income was 7 per cent, driven by a strong margin expansion (more on that in a second) which outstripped the impact of reducing assets. The main contribution to this growth came from Retail and includes the effect of continued migrations of mortgage business on to standard variable rate products. Across all areas, new business margins were higher as assets were priced to more appropriately reflect risk and the duration of the underlying funding.

Other operating income also increased by 8 per cent and this includes an increase in mark to market values in our ECNs. These increases partly offset lower income in Retail, due to lower gross lending volumes and reduced fee income and also in Insurance reflecting our withdrawal from the PPI market.

Turning now to margins

The net interest margin rose strongly to 208 basis points, as higher asset pricing more than offset the impact of lower deposit margins, and a 5 per cent reduction in average interest earning assets.

Asset margins benefited as pricing better reflected the true cost of funding and risk, as well as seeing the benefit of funding spreads normalising. In all businesses, the continued return to appropriate pricing for risk and lending duration, together with a more stable LIBOR to Base Rate spread, resulted in a strong increase in net interest margin. One driver of this, as we touched on just a moment ago, is the continued trend of customers moving onto, and staying on, mortgage standard variable rates encouraged by the current low interest rates.

Looking at our expectations for margins going forward

Margins in the first half are at the upper end of the range of our expectations that underpinned our previous guidance for 2010 but I do expect to see a modest amount of further margin improvement in the second half of this year.

In addition, we continue to see prospects for margin expansion in the future alongside asset pricing gains, slow but steady base rate rises - which will eventually feed into wider liability margins - and of course an assumption of stability in wholesale funding markets.

Overall, we believe that the margin is likely to return to more than 2.5 per cent by 2014.

This margin outlook reflects our core economic and regulatory assumptions for the medium term and includes the impact of the Group's asset reduction programme, together of course with the assumed costs of refinancing as wholesale funding matures.

Now let me pull together the drivers of income and look at how it is going to perform going forward

We expect net interest income to grow over time, reflecting the expected increase in margins. The negative effect of the anticipated fall in Average Interest Earning Assets, due to the desired reduction in non-relationship assets, will be partially offset however by core business growth.

Our relationship strategy will support OOI growth through both banking cross-sales and growth in the insurance business, particularly including the benefits of increased product profitability, although I guess I should add that we must expect some volatility from ECN valuations. On balance, we expect OOI to be a fairly constant proportion of total income.

In summary, and as Eric said, we are targeting 6 to 7 per cent income growth from core businesses, which will be partially offset by the desired reduction in non-relationship assets.

Turning now to cost performance

I am going to be brief on costs. They are down 5 per cent through strong cost management and integration delivery.

Adjusting for lower operating lease depreciation, you can see that Business As Usual costs, including inflation, rose modestly - allowing for the continued investment in growing our core businesses.

On synergies.

Well ….what more can I say …? We are delighted with progress made and we are firmly on track to deliver £2.0 billion per annum of cost synergies and other operating efficiencies by the end of next year.

So where does this all get us to in terms of costs?

Well we have seen a continued improvement in cost efficiency with a further reduction this time of the Group's cost : income ratio to 43.5 per cent equivalent to 45.1 per cent if I exclude liability management gains.

We have further cost savings from the integration programmes to come through and thereafter we will still be seeking further efficiency improvements as we optimise our cost : income ratio in the medium term.

The combined effect of all this will help us work towards operating at a cost: income ratio of about 40 per cent by 2014.

I would now like to spend some time on impairments,

As we have said, impairment losses have halved since the first half of last year and are materially lower than the charges in the second half of 2009, and as we all know, these reductions are significantly ahead of previous guidance.

In Retail, impairment losses were materially down, particularly reflecting prudent risk management, stabilising house prices and the benefit of continued low interest rates. We saw an improvement in credit performance both in the secured and unsecured portfolios and these improvements have come through somewhat quicker than we had expected at the year end.

Pleasingly, the number of mortgage customers new to arrears has stabilised in the last twelve months, and is now well below the peak experienced in the second half of 2008.

We expect to see modest improvements in retail impairment charges in the second half of 2010 (compared to the first half). Next year and as the UK economic environment gradually improves, further improvements will be delivered, but at a significantly slower rate than this year.

The Wholesale charge for impairment losses also fell significantly to just under £3 billion. The decrease reflects the stabilising economic environment with particular reductions in commercial real estate losses and a material slowdown in the value and volume of newly impaired loans.

Within these trends, we expect the volume of underlying impairment losses from traditional trading and manufacturing businesses to increase this year, as the full impact of slower economic growth filters into business insolvencies and asset values. We have spoken previously about this typical lag effect …… which we have all observed in previous recessions as the economy grows into its recovery phase. However the effects of this are significantly less than the benefit of lower absolute impairments from the Commercial Real Estate and real estate related portfolios that we saw last year.

Of course we remain vigilant in monitoring changes in economic conditions and to individual lending positions and we continue to invest heavily in expert resource to help us work with customers to restructure their businesses onto sustainable bases, thus protecting employment wherever possible.

In Wealth and International, impairment charges were down 15 per cent on the charge in the second half of last year and the level of losses continues to be dominated by the economic environment in Ireland. We continue to believe that the impairment charge for the Division peaked in the second half of last year, although economic conditions continue to be monitored closely.

Looking now at the impacts of our portfolio management and provisioning policy if I may.

The value of Retail impaired loans fell during the period as a result of improving portfolio performance, and including the benefits of credit criteria changes made up to 2 years ago resulting in fewer cases now entering collections.

I have already commented on the lag effect of realising impairments for corporate type loans and this is evidenced in the NPL trends for both Wholesale and W&I. These patterns are to be expected and reflect the longer curing and rectification periods for such assets as we seek to work with borrowers to land the best overall result for the borrower and the Group.

At Group level, impaired assets increased slightly but our coverage ratio also increased, principally due to increased provisions on Irish assets.

Of course we are not driven by a target coverage ratio, but our independent Group Risk teams are confident that we have appropriate coverage.

Turning now to how we see asset quality in the future.

Over the past 18 months we have seen substantial improvements in the Group's asset quality ratio. We believe, given our current economic outlook that the impairment charge will decrease modestly in the second half of 2010 with further reductions next year and beyond.

We therefore expect further reductions in impairments and we aim to bring the Group's overall AQR down to 50-60 basis points per annum in the medium term.

Before turning to the balance sheet and capital strength, I would like to update you on the drivers and performance of our Insurance division.

As you saw in the earlier numbers slides, the business is doing well. This is the result of strict product and channel participation choices emanating from a value over volume strategy. Their integration is progressing very well with synergies in the first half ahead of our expectations.
Following the launch of our new product suite for IFA's last year, the integrated bancassurance suite has just been launched providing a consistent base from which to deploy our bancassurance expertise.

The business continues to make excellent progress in improving the profitability of the combined product set and certain low returning products sold through the HBOS heritage channels have been discontinued.

As a result, the first half of 2010 has seen strong increases in new business profits, new business margins and, importantly, in internal rates of return.

Managing the use of the Group's capital is critical. Significant work has been undertaken to optimise this division's contribution to Group capital and mitigate the potential impact of Basel III. Over £2 billion of core tier 1 capital was repatriated to the Group during the first half, and as a result we have delivered a material reduction in the potential impacts of Basel III.

I would now like to move on to our balance sheet, the progress made in asset reduction and the strengthening of our capital base.

Firstly asset reduction.

Looking at the assets in our banking businesses, which encompasses loans and advances to customers as well as Available for Sale assets, we have continued the good progress on the reductions we achieved last year.

In the first half, we have achieved a £23 billion reduction in assets whilst maintaining our support for core businesses and core customers where overall asset levels were flat as new lending fully offset customer repayments.

Let me take you through the position now on non-relationship assets.

You will recall that last year we set out our strategy to reduce non-relationship assets by some £200 billion by the end of 2014. It continues to be our intention to manage these assets for value and, given the current economic climate, our primary focus is unchanged and remains on running these assets down over time.

In addition, we are progressing well with initial plans to execute the divestment of Retail assets in line with our state aid obligations.

The overall balance sheet reduction will provide the Group with increased optionality and flexibility from the resultant releases in both funding and capital. Over time, this will facilitate further reductions in wholesale funding, the repayment of government and central bank funding and of course provide substantial capacity for core business growth.

As mentioned, in the first half of this year, we achieved £23 billion of reductions of such assets on top of the £60 billion that we delivered last year. Although sadly this included some impairments, I am actually very pleased with the progress made in what were more difficult market conditions than the second half of last year.

On top of strong reductions in treasury assets, we made good progress on reducing other portfolios including commercial real estate, joint venture investments, leveraged loans, etc. Overall, very good progress.

Moving on to our RWAs and capital.

Risk-weighted assets have reduced by 6 per cent as a consequence of balance sheet reductions, the lower risk mix of the loan portfolio (particularly with reduced exposure to unsecured retail lending) and the generally improving credit outlook.

Over the medium term, we expect to see further reductions in RWA's as a result of both balance sheet asset reductions and a positive procyclical impact from the expected improvement in the UK economic environment.

The Group's capital ratios have increased significantly with a total capital ratio now over 13 per cent, a tier 1 ratio over 10 per cent and perhaps most importantly these days a core tier 1 ratio of 9.0 per cent.

As I said earlier, through the implementation of capital management and restructuring initiatives, we have reduced the amount of core tier 1 capital embedded within the Insurance division by £2 billion increasing the core tier 1 capital in the Group's banking entities by the same amount.

Whilst this has no overall impact on the quantity of the Group's core tier 1 capital under current Basel regulations, the quality is much improved and these initiatives will significantly mitigate the impact of the proposed rule changes announced by the Basel Committee.

The Group has a strong capital base and is in a solid position to deal with what are constantly changing regulatory capital requirements. But putting all our guidance together, we expect capital and capital ratios to strengthen materially over the medium term.

If we have a look at the changes to Basel III as announced last week, I believe we all agree that the impact for the Group will be positive.

The easing of the rule on the deduction of insurance capital together with the transfer of capital that we achieved in the first half, would mean a substantial reduction of the potential impact on our capital base.

Now that the Group is profitable again, the Group's Deferred Tax Asset is expected to have reduced considerably before the implementation of the new regulatory capital requirements.

The other increases in deductions from core tier 1, if implemented as proposed, are not expected to have a material affect our capital base. The definition of future tier 1 capital securities may well be tightened, but we expect all of our existing securities to be grandfathered.

The proposals around increased risk weightings of course are mainly concentrated in 'investment banking' activities rather than 'retail and commercial banking' activities. Therefore, the impact from this aspect of the proposals is not expected to be material for us.

Changes in other areas such as liquidity rules have either been deferred or actually they are easing the criteria initially set out earlier this year.

Overall we welcome the changes announced by the Basel Committee and we continue to work to ensure that we maintain robust levels of capital as capital requirements for banks continue to change.

Turning now to funding and liquidity.

During the first half of this year, we have substantially reduced the absolute level of wholesale funding - by £15 billion to £311 billion - as a result of the combination of continued good relationship customer deposit growth and of course, the further reduction in non-relationship assets.

Not only is our wholesale funding requirement down significantly yet again, but we have also broadly maintained the maturity profile with 49 per cent of wholesale funding having a maturity date greater than one year.

The reduction of less than one year funding over the last 18 months of some £32 billion and our reduced use of Government and Central Bank facilities illustrates the very strong progress we are making.

Throughout the turbulence in global wholesale funding markets, the Group has continued to benefit from a diverse range of funding products – senior and subordinated, secured and unsecured – as well as, of course

a range of currencies. This included the addition of a US Medium Term Note programme; a second regulated covered bond programme and a new French CD programme.

At the same time, and as mentioned earlier, we have seen good growth in customer deposits despite a decrease in deposits in our Wholesale division reflecting a reduction in price sensitive deposits in Treasury and Trading.

This strong performance in the half has enabled us to reduce our funding taken from Government and Central Bank sources by £25 billion. A significant proportion of the remaining £132 billion matures over the course of the next couple of years. However, the Group's balance sheet reduction plans will avoid the necessity to refinance much of this funding.

Our primary liquid asset buffer has been maintained at over £80 billion, with over £50 billion of this held as cash at central banks and some £30 billion in 'triple A' rated Government securities such as Gilts or US Treasuries. This is a high quality, extremely liquid portfolio. It is these primary assets that are the main focus of our liquidity management and for the FSA's new liquidity regime, which broadly mirrors the proposed Basel III liquidity changes and we have been operating to for the last couple of months.

Relative to the size of the balance sheet, the Group does not have significant senior term funding issuance requirements. As I have previously guided, over the next couple of years we expect our public capital and term funding issuance to be between £20 and £25 billion per annum.

We have already made excellent progress on our 2010 term issuance plans, having already completed some £18 billion of our planned public issuance for the year. In addition, during the first half of the year, the Group completed a further £8 billion of term funding issuance via a series of privately placed transactions. First half issuances in aggregate have a very satisfactory average duration of 5.9 years.

It is also worth highlighting here that we continued to issue either publicly or privately throughout the volatility in funding markets in the first half of the year – but perhaps more importantly, we continued to do so without placing too much reliance on any single funding market. All of this confirms that, even in very volatile markets, the Group can successfully access diverse funding sources - tapping into the appetite of a wide range of investors and investor types in multiple geographies. We will continue to expand this approach over the next 12 months.

Let me therefore summarise our key messages on funding.

We have successfully continued to reduce the absolute level of wholesale funding and our reliance on short term funding, whilst growing our base of high quality relationship based customer deposits.

We are maintaining a substantial, high quality, primary liquid asset buffer, the majority of which is cash held at central banks, and we have substantially reduced our Government and Central Bank support.

We have successfully completed £18 billion of our public term issuance plan for the year, drawing on a very diverse range of funding sources.

And we are planning to continue to reduce our wholesale funding whilst reinvesting in our core business franchises. The flexibility we are creating is exactly in line with our previous guidance and over the next 4 years, we expect to achieve further significant reductions in the Group's wholesale funding requirements.

This reduction will be driven by the expected run-off of non-relationship assets of around £120 billion, and further customer deposit growth which, if we assumed growth at an assumed market growth rate of about 4 per cent per annum, would lead to around £70 billion of additional customer deposits for us.

Importantly, this combination will also allow us to continue to invest in building our core customer lending.

So in summary, overall we have delivered on all of our promises with higher income, higher margins, lower costs and impairments, as well as terrific progress on integration. The capital base is stronger and our funding position is being further strengthened.

But notwithstanding the words on the slide behind me, we have set out today a lot of guidance about how this management team will build on, and deliver, against the earnings potential for the enlarged franchise. The guidance covers target margins, income growth, cost efficiency potential. It covers the benefits of reducing the capital intensity of the balance sheet and the flexibility we are creating to grow our core business. It's a great combination.

Thank you very much.

<u>Question and Answer Session</u>

<u>Question 1: Peter Toeman – HSBC</u>

Could I test you on the robustness of your margin forecast of 250 basis points because within that there is a sub forecast of a 10 basis point increase in the cost of wholesale funding which you gave us six months ago, but in the interim, the Group CDS spreads are probably higher now than when you gave that forecast so I wonder how robust those forecasts are to changes in the cost of term funding, if you could give us some guidance?

Answer: Eric Daniels

What we feel is that we will return to something that looks more like our historical margins. As you recall, for about the first half of the decade up until 2007, we ran between 2.7 per cent to 3.0 per cent in terms of group margins. What we feel is, given the mix of business, that in fact we will return to something that will look closer to that. We have guided to above 2.5 per cent. Included in there is the refinancing of the SLS and CGS. Although we didn't include it in our disclosures this time around, we continue to believe it will be about 10 basis point impact. But very clearly in that assumption is also that we will expect base rates to increase and we will decrease our wholesale funding and some of the more expensive hot money that we have

already burned off. So it is a cocktail of impacts but we continue to believe that we will return to something that looks more close to our historical averages.

Answer: Tim Tookey

It is the combination of all of the above and I would stand by the guidance that we gave earlier this year on the 10 bps impact of refinancing our way through the repayments of SLS and CGS. Of course a large part of it won't need refinancing at all through the benefits of asset reduction and deposit gathering, but it is included in our margin guidance today.

<u>Question 2: Tom Rayner – Barclays Capital</u>

Given the improved margin guidance, I was a little bit surprised that revenue guidance seems to have softened from high single digit to 6-7 per cent before the impact of the balance sheet run down. I wonder if you could comment on that and maybe add what you think the impact of the EU state aid related disposals will have on both your target margin and ROE?

Answer: Eric Daniels

I think one of the ways to look at it is we have continued to refine our guidance, in part, because we are tracking ahead of where we previously guided. We have said that we expected to hit high single digits within two years. In fact if you eliminate the impact of the liability management gains, we are there in the first half of 2010. We have very carefully calibrated where we would want to set our risk appetite. And what we believe is that growing faster than the nominal rate of growth in the economy, conditio sine qua non, we don't want to lose ground. On the other hand we want to set our risk appetite so that we don't encourage unnecessary risk taking. We want to have lower volatility over the cycle. So that is how we arrived at broadly 6-7 per cent. What we expect is that as we run down the non core portfolio, obviously we will get closer to that number. But we feel that this is a robust business model because what we have said is that along with that 6-7 per cent, we expect impairments to normalise and share positive operating leverage. So we feel that it is a robust business model.

Answer: Tim Tookey

We haven't given any update on the likely income, cost, and impairment profile of the retail divestment since the prospectus for the capital raise last autumn, but clearly what we are doing is delivering an increase in profitability for our Retail business through a very strong delivery against our synergy targets. We are seeing our impairment profile improve. We are seeing a better pattern in both secured and unsecured portfolios. On top of that of course the actual shape of what we eventually divest, will take some time to be fully cemented and emerge. And at the appropriate time we will give more clarity on what we would expect the profit delta to become.

Further question

Just on the primary liquidity portfolio, £84 billion. Could you just say how much of that is made up of T Bills which are repo'd via the SLS? Is that something you can disclose?

Answer : Tim Tookey
Less than £20 billion is represented by T Bills.

Question 3: Ian Smillie - RBS
On the core revenue from which you are giving the 6-7 per cent growth ambition, could you quantify for us what you are defining as core revenues please of the total £12.5 billion and within that whether that includes the PPI contribution which you stopped selling earlier last month. Given that margins are ahead of expectations, could you perhaps revisit your thinking with us on the proportion of the wholesale debt funding which is over one year? Perhaps there is some temptation for you to carry a bigger proportion of over one year debt in order to have "a safer balance sheet structure" given that there is more coming back to you from the asset pricing story?

Answer: Eric Daniels
Very clearly over time what we expect is as we bring the non core part of the balance sheet down, we do not replace it one for one. What we have said is we are going to basically take off about £200 billion over the five years and that we will grow our relationship businesses by about £100 billion. But as we bring down the non core assets, as we grow our deposit base, as you know in the Retail Bank we grew by about £6.6 billion, as we in fact have pre-impairment cashflow, which is coming in very strongly over the next several years, and we continue term issuance, our balance sheet will change quite considerably. And what we will do is measure what we think is a prudent short term to longer term balance if you will and as we evolve that we will also obviously take reference to what is going on in the market places. But what we believe is that we will shrink our wholesale funding quite considerably over the next several years and we will evolve our funding strategy as we bring down the balance sheet.

Answer: Tim Tookey
Let me clarify the first part of that on core income. In page 10 of the release today there is a statement in my section which says that about 80 per cent of last year's underlying income relates to core. And underlying is defined as income excluding the gains on liability management transactions. So that gives you the anchor number.

Further question
Would you like to comment on the split between less than one year and over one year?

Answer : Tim Tookey
Well as you know our stated preference is to keep more than 40 per cent of it funded more than one year. We have operated materially more prudently than that profile for the last 18 months. And if you look at the reductions that we have achieved, all of those reductions have come in the less than one year. So we are today at 49%. I am pretty comfortable with that kind of a profile. But it will go up and down. It will go up and down just under the laws of gravity as you have lumps of maturity that comes towards you. I am reasonably relaxed over that. I would like to keep it over 40 per cent. So I think that is where we stand.

Question 4: Simon Samuels – Barclays Capital

I just wanted to ask you a question about the retail deposit market. If I look on page 67 of the release, it shows your customer deposits in the half year grew by about £4 billion. If I go back to the IMS Statement you said at the time customer deposits were up by about £5 billion in the first quarter. So £5 billion in Q1 and according to page 67, up £4 billion in the half year. And well I guess the first point is, is that analysis correct i.e., do you have a small deposit out for the second quarter? And the wider sort of question really is, how realistic it is to grow deposits at the circa 4% pace that you think the market is going to grow at? And in particular, at what cost? Because there are a lot of stories about other people being very aggressive in the deposit market. So two parts, first of all the volume side and secondly about price?

Answer: Eric Daniels

If you basically think about the attraction of sticky customer deposits, clearly we look to Retail and to private banking as the principle sources of growth there. Those are the highest quality, those have the longest duration behaviourally. And we are particularly well positioned. If you think about it, the branches do not really serve for the asset side of the balance sheet. Customers can get assets quite efficiently through other channels. What you really have branches for are in fact to have current accounts and savings accounts. That is where customers go primarily. And so we are very well positioned. We grew during the half, £6.6 billion in the Retail bank. We grew our private bank deposits about £1.3 billion. So those are clearly great progress. The corporate deposits, they are customer deposits and they do renew, but they are clearly more rate sensitive, they are clearly ones that have shorter durations behaviourally. So what we are doing is clearly growing the stickier deposits, the higher quality deposits and we are continuing to grow corporate deposits, but we are less concerned about those.

Answer: Tim Tookey

The numbers you quote are absolutely correct and I did reference from the podium a drop in some of the more price sensitive particularly in the Treasury and Trading area. Quite frankly it is nice to have the luxury of a strong funding position that enables us not to need to bid for some of these items that are price sensitive. And particularly in that desk they are very, very short term. These tend to be corporate treasuries that are placing money literally on the basis of a basis point here and basis point there and are very, very short term. Nice to have but if you don't need to have them and you can see from the progress we have made on funding, there was not a need to have them. So numerically you are absolutely correct. If you peel back the layer of the onion, what I would saw is that actually in the Retail division, deposits are up £12 billion in 12 months which is 5.5 per cent growth. And remember when I presented in February, I talked about letting go of a large amount of perfectly understandably as to why they were put on the balance sheet, heritage HBOS hot expensive Retail deposits. So peel that back, we are very, very pleased with the profile and the quality and stickiness of our relationship growth. It is a good story.

Further question

And so in your margin guidance, what assumptions are you making for the competitive environment for retail deposits in the UK?

Answer : Tim Tookey

Of course we have a whole range of assumptions in our margin guidance that does include reflections, worked on with the Retail management team, on what the competitive environment will be both for asset products as well as liability products. And that is incorporated in it. What I did say in my presentation, was that we do expect in time, which means not in the short term obviously, to see some liability margin widening. And that is reflecting our combined views on the competitive pressures there will be on both assets and liabilities. And the dynamic of those will change somewhat as the base rate environment moves and that will be perfectly normal actually.

Answer : Eric Daniels

I think the very broad answer to the question is that we expect to have a reasonably intensive competitive environment. The UK environment has always been top quartile value for the consumer. So the consumer does very well because the competition is high. And we would forecast that to continue. And we also believe that there will be more focus on customer deposits as we go forward. When we had securitisation markets open and other forms of funding, there was probably less of a concentration around customer deposits. We believe that as markets won't return to the same levels as previously, we will continue to see greater and greater competition. So that is incorporated in the forecast.

Question 5: Michael Helsby – Bank of America, Merrill Lynch

Just thinking about your capital position and I heard Tim you say your capital is going to grow strongly from here on out. You have clearly got a core tier 1 ratio of 9.0 per cent. While Basel III has been significantly diluted as you said, the RWA's are going down, you are not paying a dividend, well potentially paying a dividend until 2012. Presumably when you do sell Cheltenham and Gloucester it will be at a profit. You are upscaling capital from the life business which is clearly helping as well. So I guess the question is, when I look at your slide presentation I have see "control, profitability and sustainable growth". From 2012 onwards, do we have a box that says 'capital return'? So I would just like to hear your thoughts on that please?

Answer: Eric Daniels

Very clearly we believe that this will be an enormously capital generative Group and what we have guided and what we have said is that we think we have sustainable growth over the next several periods. We have told you how we are going to do it by growing the top line positive operating leverage and bringing down the impairments and it is based on adding customer value. So there is not a lot of mystery here. Yes we do believe that we will be capital generative. Dividend policy will be set at the time. As you know we have basically a prohibition until January 2012, at that point the Board will decide whether we are going to return to a progressive dividend policy which has been the hallmark of Lloyds for quite a while. So the capital levels that we will hold in some part will be determined by not only our dividend policy, but also how the regulatory environment actually plays out. So we can't give you much further guidance than we have given you either on capital levels or returns at this stage.

Further question

Just a follow up on Ireland. I noticed from the appendix and the slides that the Irish development commercial real estate book, the NPL's are running at 90 per cent and they were 76 per cent at the full year. I think there

is a joke out there that maybe they can go to 100 per cent! But what is the MPL cover in that book and how much the fair value has actually been allocated against that book please?

Answer: Tim Tookey

The NPL coverage in Ireland is 41.6 per cent on page 85.

Further question

So just taking the average is appropriate for the development book?

Answer : Tim Tookey

Well if you look in the appendix to my slideshow you will see it broken out there between development and investment properties. Yes, 46 per cent of the exposure is development, 90 per cent impaired. 54 per cent is investment, which 45 per cent is impaired and the coverage ratios as I quoted a second ago.

Question 6: Robert Law - Nomura

Can I go back to the margin guidance please? You are indicating over 2.5 per cent on the margin. And as you say that may go back to the kind of margins you enjoyed previously, but the mix of assets has changed a lot. A lot more mortgages now. So what I am trying to explore here is the kind of improvement or increases you see in the asset yield of your portfolio? Because presumably you are seeing liability pressure? You talk about pricing changes, but most of those are now already, I think you phrase you use is, already seen. Can you give us some idea of the increase in asset yield you are expecting as a result of this improvement in the margin? And can you comment about how much of the balance sheet reduction you are expecting to make up in new business growth? And thirdly, on the funding side, despite your comments about easing the short term funding. I think your wholesale under one year maturities only fall by about £2 billion this year and that helps the margin. Can you comment about how you see that moving over the margin guidance period so that we can get some idea of the drivers behind this guidance please?

Answer: Eric Daniels

Turning first to 'how do we see asset margins?' And you are right, our balance sheet mix has changed because of the heavy preponderance of mortgages. I think that over time what we will see is something that has basically a more balanced asset mix if you will. What we are looking for is to change the way in which we price virtually across the board and this will take some time. But what we have is superior customer information as you know. And as a result of that we will be able to price customers on the efficient frontier. This is part of our offering value to customers. So if we can better assess, because we have better information, our customers credit worthiness, we will be able to price them very efficiently. Somebody who prices below us is making a bad decision. Because of the customers' propensity to default and so on, won't warrant the pricing that is lower than that frontier. So what we will be able to do is to build competitive advantage. We will also be able to optimise our pricing models as a result of it. So what we are doing is looking to change our asset pricing models from what we have had historically albeit that you are right, they still will bear some relationship to the kind of products that we have on our balance sheet and we expect those to evolve over time as well.

Your second question was what are we expecting in terms of run down in assets versus how much we intend to grow the relationship businesses? We are staying by our guidance that we will run down £200 billion over 5 years and grow £100 billion in the relationship businesses net down £100 billion.

Answer: Tim Tookey

If you look at how the funding profile has changed over the last 18 months, then the proportion or the pound notes of 'more than one year' is flat at £151 billion and the whole of our £32 billion reduction is in the 'less than one year' space. What has happened in the last six months, the £2 billion that you referred to is quite simply the laws of gravity, meaning that the maturity dates are approaching us. And I think it is the strength of the term funding that was done during the period so far that is enabling us to maintain the proportion of our funding that has a maturity of more than one year. Just because the maturity dates are coming towards you of course does not change the cost of that individual piece of funding. So the margin impact overall the wholesale funding in the six months is a single basis point. So there is no benefit to the margin from what you are thinking might have been going on in there. It is simply gravity.

Further question

And how does that change over the next 3-4 years under your plan scenarios?

Answer : Tim Tookey

I think what I said on the margin guidance slide, I didn't speak it from the podium, but there are words in here which say, I will just read it to you: 'The blended average rate of wholesale funding rises as funding to source, mix and duration evolves over the plan period'. And that is a blended rate, but remember of course the volume is coming down significantly through the benefits of the asset reduction programme and deposit gathering and just the normal business generation of cashflow from stronger profits. So that is the delta if you like the rate 'on line' if I can borrow an insurance term, versus the volume effect.

Question 7: Jonathan Pierce – Credit Suisse

The fair value unwind in the appendix, I don't remember the old numbers you gave us, but it looks to be quite a lot bigger at the half year stage than your forecast at the end of last year. It looks like you have got about £3.6 billion to come through 2011 onwards. I think it was sub-£1 billion before. What has driven the increase in those fair value unwinds and are they completely tangible or completely benefit capital over the next few years?

Answer: Tim Tookey

They are completely capital benefiting yes. And one of the main reasons for the difference is the success of the liability management exercises that we have undertaken in the first part of the year which by definition has captured a future debit unwind that will have come through and hurt profits and capital. And therefore the outer years aren't suffering that debit and therefore the underlying credits are still coming through. That is the biggest reason for it.

Question 8: Steve Hayne – Morgan Stanley

Just two questions, one on the cost of risk guidance for 50-60 basis points. Can you clarify what proportion of the book will be mortgages by that outer year? And very explicitly does it exclude the required EU divestments, i.e. 19 per cent of your mortgage book? And question number two, on your per annum £20-25 billion of public term issuance over the next two years, how much of that will be senior unsecured?

Answer: Tim Tookey

Let me deal with the second one first. What we have said is from our term issuance programmes, we will continue to draw on a wide range of sources and work with a number of different investors and investor types and will do it on a global basis. There is a chart here which shows the proportion of our funding year to date that has come from securitisations versus unsecured. It is also broken down by currency. So I can't actually give you a proportion that will come from different markets. What I can say is that we will continue to use our assets where we can, but we will maintain our presence in a number of markets for debt issuance and debt investment. And our debt programme will be about the same size next year, but I haven't got it broken down between the different areas. It will, to a degree, depend upon demand which has clearly been higher than our initial thinking that it would be for the Lloyds name in the first part of this year, which is very encouraging.

We haven't split out or given guidance on what the overall size of any particular book will be in the future, with the exception of if you look at my non relationship asset run down slide, we have given a very, very rough idea of where the individual portfolio sizes of what we will call non relationship assets might be at that time. And I have attributed about £20 billion of that to what may be left on sub prime and self-cert mortgage books which are completely in run-off. There has been no new business being written on book that since the day of the acquisition of HBOS.

Question 9: Aaron Ibbotson –Goldman Sachs

You say that you think you are sufficiently provided for the impaired loans and you have got as mentioned, 90 per cent of the development loans impaired and I guess around 60 per cent if I combine the whole corporate and commercial real estate book. So basically my question is, shouldn't we expect a relatively dramatic fall of in impairments in Ireland. You seem very cautious in your guidance.

Answer: Eric Daniels

We have been cautious about Ireland ever since we started to report on the acquisition. The country continues to have a difficult economy. There is no activity as such in terms of buying and selling and we have basically seen the latest tranches going into NAMA coming in at very considerable discounts. So all of that needs to continue with caution. But we believe we have taken a very prudent stance and we will see how it develops over the next several periods.

Further question

So if you today look at your impaired loans you don't currently have any specific expectations that you will continue to take impairments on those currently already impaired loans? Is that how we should read it, that you are sufficiently provided?

Answer: Eric Daniels

Yes, what we would say is that given the expectations that we have for the economy, given where we expect the macro economics to work, we believe that we have provided sufficiently as of today. Now if there is anything that changes, whether it is some of the covenants or macro economy that could impact our provisions positively or negatively.

Question 10: Joe Dickerson - Execution

I just wanted to know in terms of the margin increase from 208 basis points to 2.5 basis points. That 42 basis points, can you give us some idea of what proportion is accounted for by including deposit spreads because I note that you have a 4 per cent base rate assumption by 2014 and I just wanted to know what proportion are from deposit spreads so that we can put some sensitivities on that?

Answer: Eric Daniels

We have not given specific guidance on how that 250 basis points will break down. And very clearly the evolution between 208 and 250 plus basis points will depend in large part on base rates. But it also will have to gauge the competitive temperature at the time for deposits. We will have to look at what asset demand looks like and so on. So it is very hard to give absolute precision. But what we feel is that that guidance and returning to a more historical view of what profitability should look like in this marketplace, is what led us to the guidance and we feel reasonably good about it.

Answer: Tim Tookey

I would love to be able to give you some more guidance, but we have given an awful lot of guidance today about how we see the business performing and enough for you to size the business and balance sheet and get a view of the opportunities that we have for building our core businesses. So I am afraid I have got nothing to add.

Question 11: Andrew Lim - Matrix

I notice on page 104 of the report, you have got a £1 billion pension curtailment gain. Would it be fair to say that in the absence of that in the second half, operating costs would increase half on half or would you be still be guiding to a reduction? And secondly, you talked about a £2 billion capital repatriation to core tier 1 capital. And core tier 1 capital has increased by over £3 billion, much more than the earnings you made in the half. Where does that £2 billion come from exactly? Is it the insurance business and if so what would be the impact on the solvency ratio?

Answer: Tim Tookey

You can rest assured that the pension curtailment gain is not included in the expenses that contributes to the £1.6 billion of profit that we are reporting for the first half. We show that separately below the line and we have not allowed the reported numbers that we present today to benefit from that one off item. So fear not, for the impact on the second half expense profile.

As far as capital is concerned, the overall Group core tier 1 capital is of course unchanged under the current rules from the repatriation of capital from the insurance companies. But you have an increase in quality of the capital that you have. The benefit that we get under the current regulations is actually at the total ratio where I have today to deduct my investment in insurance companies and clearly I have a lower investment in insurance companies today because they have repatriated some capital back to Group. But the core tier 1 quantum is not different. The largest contributor to the increase in absolute core tier 1 that you are seeing, actually comes from the liability management gains, where we have got the conversions into core tier 1 one of both some tier 1 and some tier 2 debt as well as the absolute profit that one captures on those transactions through the face of the income statement which is the £430 million that I pulled out separately on my slide.

<u>Question 12: Arturo de Frias - Evolution</u>

Two questions on insurance please. One I think you nearly answered. Now the reason why the supervisory deductions for fall vs. December to June is because you have taken out this £2 billion from the insurance, is that correct?

Answer: Tim Tookey

That is part of it, it also rises because the business is profitable.

Further question

The second question is on the profitability of the insurance business. Even if having decreased the embedded value or having decreased the future allocation of capital to insurance, because of this £2 billion reduction, the return on equity on the insurance division, is still lower and I think you have reported nearly £500 million of pre-tax profit which after tax, annualised, could be in the region of a £100 million or something like that. You still have £11 billion of potential supervisory deductions which would imply future capital allocations under Basel III. So we are talking about a business that is just generating below 10 per cent return on allocated capital under Basel III. And now that you have a Group guidance of ROE of above 15 per cent, Insurance then is increasingly out of sync, if I may say so, with the profitability of the rest of the Group. So what is your view on future profitability for the insurance division and that 15 per cent Group ROE target includes a substantial improvement in the insurance profitability, or is because you are expecting the non insurance divisions to deliver close to 20 per cent?

Answer : Eric Daniels

What we fully expect is that, we have seen the shape of things to come. If you looked at our results during the first half, you in fact saw that our ongoing internal rates of return came in at over 15 per cent and that is a result of basically being much more selective in our products and focusing in on profitability. And we will continue to do that. What we also signalled and I included this in my comments, was that we expect bancassurance will take up much more prominent view over the next several years than it has in the past and bancassurance as we know is much more profitable than going through the IFA's. What we also know is that we are going to have a fairly substantial change in the distribution in insurance as we have the changes to the retail distribution coming through and we will have to see how those finally shape. But that will change the profitability as well as the channels. So what we fully expect is that the insurance businesses will in fact

be better performing over the next several years. They are an integral and strategic part of our Group. What we believe is that with an aging demography and with a higher saving nation, what we will find is that more people are turning to insurance products for their investment and pension needs. And so that is where the insurance businesses fit.

Answer: Tim Tookey

I think part of the proof of this is in the pudding that has already been baked. We have seen a significant improvement in new business profitability in the insurance division with new business margins you know up from 2.4 per cent a year ago to 3.4 per cent this year which is a terrific performance. We have turned off all distribution of a large number of very poor returning heritage HBOS, Clerical Medical branded, products and we are now redirecting all of that activity into Scottish Widows based products which have a better customer proposition and also give us a better return overall. So profitability is growing strongly and a value not volume strategy is absolutely the right way to play this business going forward. And that is what is delivering the step up in new business profit and encouragingly the levels of IRR that we were seeing in the first part of this year at over 15 per cent.

Question 13: Ian Gordon – Exane BNP Paribas

Just to clarify your previous answer, when the Board meets in February 2012 to work out what to do with the emerging capital surplus, to the extent that it does decide to declare a dividend, would that be described as a '2011 final dividend' and have the same characteristics notwithstanding that the embargo runs out in the previous month? And on the evolution of customer loans during the first half, I guess I was mildly surprised when there was modest growth in the first quarter, the shrinkage in the second quarter felt more in line with the previous guidance and more in line with what the Bank of England data was telling us. Never mind what the Right Honourable Member for Twickenham may think, is your view on the drivers of the Q2 reduction primarily the fact that credit worthy customer demand has remained weak or was there any notion or view of choosing to be more proactive in managing down your wholesale funding requirements by choosing to shrink the balance sheet a little bit faster?

Answer: Eric Daniels

First, our prohibition imposed by the EU is that we can pay no dividends before January 2012. So you could perceive a dividend paid based on final results of 2011 should the Board choose to view that as a sensible thing to do.

Second, in terms of the question of supply or demand. What I would tell you is that we are very pleased. Now let's separate out the pieces. On mortgages we extended £15 billion of new mortgages during the half. I think that you know that part can be taken out. We are basically ahead of our targets there. In terms of the SME's and corporates, we extended £24 billion of new credit facilities during the half. Now that is up 27 per cent over prior year. And what you have to remember is that that is a gross number and it is on credit facilities. In other words, the customer may not actually drawer down against those facilities. So we are very pleased that we are continuing to make credit available, but that availability is not always taken during the same period as the granting. That would be the first point.

The second point is our application volume is down about 25 per cent over the past couple of years. And what it basically says is that customers are taking a very prudent view that they are no longer extending themselves because there is some uncertainty about what their order books will look like and what the future holds. In addition to that if you look at the net figure, we are about flat which means we are seeing a fair number of repayments even though we are making more credit available. I think there is some further evidence when you look at our overdraft usage and our usage against committed lines, that that again is relatively flat. It says the customers are not taking up the credit lines that are available. So we would say that it is a demand issue, but clearly what we are doing is supporting our customers during these more challenging times by making credit available whether they choose to avail themselves or not is again a different question.

Question 14: Simon Samuels – Barclays Capital

I just want to go back to the revenue target number. You will appreciate there is going to be a lot of focus on that, particularly today. The remaining shrinkage of the 'not wanted' assets are generally going to be fatter margin assets. And so the very simple question is, I assume you know what the revenue impact of the remaining balance sheet shrinkage is going to be so why don't you share that with this audience? Why don't you tell us what you actually think revenue growth will be after including that impact?

Answer: Eric Daniels

Well no, it is actually not quite that level of precision. Let me give you an example. We have an over concentration in commercial real estate. And we are very happy to commit that we are going to bring that down, but you couldn't say which specific loan is going to come down during that period. So there is a range of alternatives and that is why we in fact don't give further guidance. That would be an example.

Answer: Tim Tookey

I would agree with that. I would also challenge the presumption that all of the items in the run down portfolio is high margin assets. I wish that were the case!

Further question

My point is that you have to make a zillion different assumptions in getting to the 6-7 per cent growth number excluding this piece that is shrinking. So to make a whole load of assumptions about margins on mortgages and SME's and everything else, there is a ton of assumptions that have gone into that so why can't we just…?

Answer : Tim Tookey

Well what we did say and what I said in February was that we don't expect the run down of these non relationship assets to have a material impact on our financial performance. So we have repeated that. Yes of course I am talking about earnings. Along with a supposing one had one of those non relationship assets and was indeed high margin, I might still want rid of it because I would not like the impairment risk. So I am actually far more focused on earnings impact than I am on individual line impacts.

Further question

You have given us guidance, it seems, a hybrid. Some of the items include the effect of the asset run down, some like the revenue growth don't. And it seems an odd thing to do...?

Answer : Tim Tookey

I think to a degree it will be what it will be. I mean what we have said is what we believe the core business will do which is that we are targeting 6-7 per cent growth on total income from the core business. What we are saying is that we expect that to be partially offset. So we wouldn't expect it to be fully offset, partially offset. And otherwise, where are the partially? I guess it depends largely of course on the pace at which we achieve the run down. And we have been very, very clear right from the start of the asset reduction activity 12 months ago, that we will manage this portfolio for value over time. Our capital position is very strong. Our funding position is perfectly satisfactory. We therefore have a very "comfortable" position that we can take on these assets which is that we will run them down for value over time and we will not be flooding the market with anything that we happen to think has to go. And of course if we were to give more concrete or restrictive income guidance then actually we might be restricting our own ability to do the right thing by some of those customers and some of those opportunities potentially even hurt the overall Group value. So we are retaining a degree of flexibility for ourselves and we can do that because of the strength of the overall position that we are in at the moment.

Question 15: Chris Manners – Morgan Stanley

I just had a question on the risk weighted assets, this is page 120. It seemed that most of the reduction in your risk weighted assets came on the Retail side, about a c.£22 billion reduction from a c.£30 billion total. Now your Retail loans actually only went down by 1 per cent, your retail RWA's went down by around 17 per cent. Is that a definitional change or a change of risk weights there or and how should we think about that moving going forward?

Answer: Tim Tookey

I would refer you back to the words I gave in the script. Part of this is a low risk mix in the portfolio. Some of it is the improvements we have seen in house prices as well as the overall credit performance of individuals. But of course what you do have in there is you also have a reduction in our unsecured retail exposures and they tend to have a higher risk weight. So if you like there is a bit of everything in there.

Question 16: Michael Helsby – Bank of America Merrill Lynch

Just two questions really on funding. £18 billion of public issuance, public issuance, £8 billion of private issuance, so you have kind of got to your £20-25 billion for this year already. So I am just thinking for the second half of the year, do you just carry on and start to pre-fund 2011? So if you could give us some thoughts on that? And just also on the net stable funding ratio, that was quite a significant change given the size of your mortgage book. So I was just wondering if you could put that into the context of how you think about the mix of funding in long term, short term and that whole funding requirement and whether that regulatory shift has actually influenced what you think you need to do in terms of term funding?

Answer: Eric Daniels

If we committed to £20-25 billion of public issuance and we are clearly about 75 per cent of our goal if you take the higher number. And we didn't set a goal or guidance for the private issuance. So I don't think you want to add the two together. What we will continue to do is to as we see opportunity, we will, continue to use the term issuance market and no we are not wedded to a specific year end target. What we will do is look to the markets and we will see when things are good for us. So we very well could pre-fund if we so chose and if the markets allowed. Tim did you want to take the second point?

Answer: Tim Tookey

You are absolutely right Mike, the changes announced by the Basel Committee on the net stable fund ratio and the other liquidity pieces do favour retail banks. Clearly the change in the weighting on mortgages as an element of that calculation is beneficial to us. Likewise the change in the sensitivity assumptions around retail deposits is also of benefit. In terms of the second part of your question which was, does that affect our strategy and our mix and everything else? The answer is no not really. One of the great things about the mortgage book that we have and the mortgage proposition that Lloyds has is that it is very much focused on the prime market. And that has given us a huge amount of AAA collateral that enables us to access funding markets that maybe not all mortgage providers can have. And you have seen us access the RMBS market very successfully in the last 6 or 9 months. That is also part of our thinking around the loan to deposit ratio guidance because you know Eric and I may be the only people in the land who don't like the ratio particularly and won't be guided by it. It says nothing about the quality of your assets or the very significant flexibility that you can get from quality mortgage assets, which actually help you open up much more diverse funding opportunities for such a book. Diversity as to duration, which is important for a prudent liquidity risk profile of your balance sheet as well as diverse accessibility for global funding markets to access. And you can do that much better if you have got a prime mortgage book. So at the moment no I wouldn't say it is affecting our mix strategy. We are comfortable with the direction we are going.

Eric Daniels

Thanks very much for coming. And again we are very appreciative that you could accommodate the different time than usual. Thanks again.

End of Presentation