Barclays PLC Q2 2017 Results

Sell-side analyst breakfast transcript (amended in places to improve readability)

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Tushar Morzaria, Group Finance Director

The second quarter did achieve some important milestones for us and it’s worth calling them out and giving a sense of priorities that we’ll constantly reach back to as we have these sessions prospectively.

The first milestone which is really important for us is our capital position. To get to our target end-state range of around 13%, and we’re a little over 13%, is quite pleasing for us. And we did that a little bit earlier than we probably anticipated. The sale of Africa was the catalyst that got us there very quickly. That generated 47 basis points of CET1 in the quarter, but there are a further 26 basis points from the sale of Africa that’ll still flow through our books – I think about half before year end, and the other half when we fully deconsolidate as a regulatory matter, and that’ll be sometime before the end of next year.

The other thing that’s quite pleasing is that whilst we, unfortunately, continued to have some conduct headwinds – PPI was a large charge – even if we exclude Africa, the profit generation of the company managed to absorb that and still take us forward. So capital’s been very important to us, and it’s very pleasing that we got to our end-state target range a little bit earlier than we’d anticipated.

Many of you will have questions on IFRS 9, I imagine. I’m not aware of any UK banks really reporting much about that yet. That’s something that will come in obviously on 1 January 2018, and I’m happy to take questions on it, but I won’t be giving any guidance. The one thing I do want to just remind people on, particularly when you guys are updating your models, we talk a lot about the capital effect of IFRS 9 which is probably the most important thing, no doubt, but don’t forget the tangible book value effect as well, because that’s a day one impact. There’s no transitional framework there. The accounting will go ahead on 1 January 2018 fully loaded, so just bear that in mind.

The second milestone for us was on Non-Core. We are very pleased that we got to a risk-weighted asset level that was slightly below our guidance, with a P&L consistent with the loss we were expecting over the course of this year. And that’ll be the last time that we’ll formally call out Non-Core. But that’s again a pleasing milestone for us. It’s been a long journey, at least three years plus, but it’s nice to see that journey’s complete, at least in that regard.

We gave some guidance as to where Non-Core will fold back in across the three reporting units in the
Group, and the expected P&L and capital consequences of that – that’s in a slide, and I’ll just leave that there.

And the final thing I’ll say is that as we pivot away from the restructuring of the company, we have an increasing focus on the returns and profit generation of the company. And a number we’re very focused on, and you’ll see us probably highlight more and more, is the Group returns. The measure I use is to look at the first half numbers, excluding the effects of the Africa sale and excluding the effects of PPI – there’s a lot of other puts and takes, and you can include / exclude whichever items you like – and that’s the measure I use and that’s about an 8% return on tangible equity for the first half, and that’s the number we want to continue to drive up, and I’m sure we’ll talk about that. You’re obviously aware we’ve set the objective of ensuring the company can generate a greater than 10% return on tangible equity, and we’re pretty confident in our ability to do that. We think it’s a very realistic and very tractable objective for us. And in some ways the first half measure of 8.1%, with what I would consider still quite significant Non-Core losses going through the books which I wouldn’t expect to repeat in subsequent years (it’ll be on a diminishing trend, on a continuous march down) in of itself provides some form of tailwinds into our future results with all other things being equal.

We’re keen on further efficiencies within the company and we have some tailwinds in the trajectory of our costs as well, which will also be helpful in that regard. But I think that’s one topic we’ll probably talk more and more about as we go through the subsequent quarters – how we’re tracking against that underlying profitability level.

The final thing I’ll mention is that we reaffirmed that the expectation is we’ll pay three pence full year dividend for this year, in-line with previous guidance. Of course we don’t have a dividend policy or any form of policy around how we return capital to shareholders [beyond this year], or utilise excess capital in the company; we’ll do that at the full year results. So just to put a marker out for that as well, but guidance is for a three pence dividend this year.

**Chris Manners, Morgan Stanley**

I thought it was quite interesting what you were saying about your CIB loan book, the £90 billion of RWAs and that 25% of it is returning below cost of capital. I’d be interested to know where do you think the best opportunities are to deploying the £23 billion of RWAs. Will that be going back into corporate clients? Is there more opportunity in Markets? Within Markets, where do you think you have opportunities that maybe are being left on the table?

**Tushar Morzaria**

I think there’s more work we can do on sweating our balance sheet harder, making sure we’re being
very rigorous in ensuring that all parts of our balance sheet are generating the right returns hurdle. I think there are improvements we can make in the corporate loan book, as you called out and Jes certainly called out on the call. Where we could recycle that certainly could be back into other parts of the corporate business, and we’ll look for opportunities there. We obviously like that business a lot and have a very strong market share there.

The other area that is interesting to us is parts of the Markets business. One of the areas I felt that we’ve been a little bit underweight on, and it’s a good counterbalance to some of the more standard market-making businesses in Markets, is Financing. Obviously we had significant leverage constraints going back two or three years. Financing is a very leverage-heavy business, but very risk-weighted assets light, and it’s a relative stable generator of sales and trading revenues, that nicely counterbalances some of the more volume sensitive businesses. So that’s an area that we may look at. I always felt we were a little bit light on Equity Financing – I’ve mentioned that a couple of times, and I think that we’ve seen some of our peers probably step further into that business, as we haven’t. So that’s an area we may look at as well. So all of this is recycling within the CIB business itself.

CIB on a reported basis, just for the first half, was just slightly under 10% RoTE, and there’s various things going on there with VocaLink gains, so people can adjust them, as you wish. But I think on most measures you get to about the 9% RoTE, and we definitely need to drive that into double digits. And one of the levers is to make that part of the balance sheet more productive.

The Corporate business does have a lead time, a cycle time. These lending facilities, on average it’s a three year or four year book, so a half-life of one and a half to two years. So I would say that by the end of this time next year, I would have thought that we’re mostly through either renegotiating terms on that part of the book, or recycling that balance sheet elsewhere.

**Chris Manners**

So I guess of that £23 billion of RWAs you’re not going to put too much in Equity Financing because it’s a more leverage-heavy business?

**Tushar Morzaria**

Yes.

**Chris Manners**

Where do you think in Markets is RWA effective, in terms of where you’d like to put the capital, or maybe it’s too early to say?

**Tushar Morzaria**
I think it’s too early to say. The ones that I know that make a lot of sense, we’ve got our Financing businesses. They’re relatively RWA-light and, of course, as I say, there’s a reasonable lead time before this thing will rotate around. It’s not like we’ve got, say £10 billion of risk-weighted assets refinancing in the next quarter or so. So it’s a slow motion recycling, but I think we’ll be meaningfully through it probably by the end of next year to 18 months; that sort of half-life. And we’ll look at opportunities as and when we get there.

On our business in Markets – we like the setup that we’ve got, which is somewhat more volume sensitive than direction sensitive, and that’s generally how our results will be viewed. You can look at volumes and you get a reasonable view of how we’re doing, if we can get more share of volumes. So I think something that’s got a more stable revenue base, and Financing sits well alongside that. So we’ll look for other opportunities, but too early to say yet.

Jason Napier, UBS

The first question I had was, there is a lot of press coverage this morning about the regulator taking an active interest in overdrafts in the UK, and I just wondered whether you could talk about Barclays’ position within that, and how you feel about non-interest income in the UK business in general going forward. And then secondly, just a follow on on the reallocation of capital question, would you be able to, in the broad terms, give us a sense as to what Corporate and Markets returns are on the two parts of the transatlantic business, in Europe and US? Just so we can get a sense of where the action is needed and how much change is required.

Tushar Morzaria

On the UK business first, not hugely concerned about the FCA’s review as I understand it. I think they’re going to consult on this in the early part of next year. It feels to me like they’re probably doing a sensible thing, which is highlighting something that’s concerning them, and looking for the industry to deal with it before they come up with any prescriptive measures. For us in particular, overdrafts are something that we looked at at least a year ago, perhaps even longer, might even have been the summer of 2015, where we stopped charging late fees and capped out our late fees. And we’ve seen other large UK lenders move to a charging structure that looks more similar to ours. So I’m not hugely concerned about that, but it’s fresh news, so probably takes some time to digest it and see if there are other things that I haven’t seen yet.

In terms of the reallocation of capital within the CIB, between Europe and the US, the Corporate business is essentially a European/UK-centric business. So it covers corporations from large multinationals, mostly headquartered in the UK or at least with very large UK presence, through to more medium-sized companies that are regional in nature. Our Corporate business in the US is really there to
serve clients that want ready access to the UK. A good example would be McDonalds in the UK; we’re not the corporate bank for McDonalds in the US, so it’s those kinds of clients that we use our US operations to feed into where we can realistically bank them in the UK.

The one area of interest that we have there is Euro clearing. And we’ve got some exciting work behind the scenes on being able to provide Euro currency corporate banking services, actually being launched already and we’re on-boarding more clients. It’s very nascent yet, but I think that’s looking like a very good initiative for us and that will make us more relevant to some of these international companies that look for their corporate banking needs not just in the United Kingdom in isolation but probably in the European block, so sterling and Euro capabilities.

In the Markets business, it depends by asset class. So I’d say our Equities business is certainly more US-centric and pretty decent business in the US and we’re probably underweight in Europe and in the UK. The Macro businesses, currencies and rates, were really old Barclays’ businesses rather than coming from a Lehman heritage, so that tends to be slightly more anchored in London; obviously foreign exchange being more of a London-centric business. Credit is probably again slightly more biased to the US, but a bit more balanced. It sits very nicely alongside our debt capital markets business which we’re very strong in in the US, and Europe’s a relatively smaller market even though we tend to be one of the largest market shares in non-dollar issuance and the dollar market is still the big juggernaut there for debt capital markets. So I don’t know if that helps give you a balance of the scale of our businesses across the two regions.

Jason Napier

Just in terms of present returns in those two businesses?

Tushar Morzaria

So the Corporate business, I think of it as broadly a UK-centric business so don’t think of it as having a regional split of returns. In the sales and trading activity, probably overall we do better in the US than we do in Europe, but again it varies a little bit by asset class; Equities for sure, Credit a little bit more balanced and Macro a little bit more balanced. But overall, when you put that all into the mix, we’re probably better in the US than we are in Europe.

Ed Firth, KBW

Talking about news today, there’s a report out I think from Oliver Wyman talking about Brexit. I don’t know if you’ve seen that but they’re talking I think an additional 15% to 30% capital requirement, 2% to 4% to the cost base, etc., it all sounds quite catastrophic or quite severe anyway. Can you give us an update about what your thinking is now on Brexit, what the costs will be, capital requirements etc.?
And I guess as a supplementary question, there has been a lot of focus on Euro-clearing and can you give us some idea of what revenues you make from that, how many people work in that area etc.? Thanks very much.

Tushar Morzaria

Yes sure, I caught the headlines but I haven’t seen the report so I can’t talk in any specific detail. The headline, I must admit, was quite striking as you mentioned. It didn’t resonate with me from what I’ve seen. It did sound like if there was a net c.30% increase in capital, it sounded like an awful lot to me, compared to anything I’m seeing. I haven’t read the report but the headline at least didn’t resonate with how we’re thinking of it here.

For us here, as you probably already know, we’re operationalising our Irish bank – it’s already licensed and operational, but it’s more used for corporate business at the moment. It’s already licensed, but I guess turning on the licences that already exist for other activities that we haven’t really used it for – we’re mobilising folks to get that done. Probably reorganise our business, our branches that currently already exist in mainland Europe will become branches of the Irish bank. So that’s a relatively straightforward corporate finance reorganisation rather than an operational reorganisation of real significance.

We’ve put our applications into the Irish authorities, and that’s progressing well, in that regard. So it’s a proper project, it’s got proper operational work that we need to do, but as we’ve maintained all along, what we’ll have to do is nowhere near of the quantum of other forms of reorganisation, whether it’s UK ring-fencing or even US intermediate holding company type work – it definitely feels smaller than that. And frankly it will be done within 18 months, because like all organisations, we can’t wait for any other form of transitional framework to be agreed. We just can’t wait to find out whether that’s going to happen or not. We’ll be ready to continue running our operations in the first quarter of 2019. So in my mind this is a very intense, but relatively quick, project that we’ve unfortunately had some practice in in other jurisdictions. So I don’t feel as overwhelmed as much as those headlines would suggest we should be. That’s how we’re thinking about it.

So I think clearing you’ve got to split into different things; clearing of the currencies, clearing of derivatives, and clearing of securities – I guess it’s derivatives clearing that’s probably the most important thing. Clearing of OTC derivatives isn’t a huge business for us, so that in and of itself I don’t think it is going to be a big deal for us. Moving clearing houses outside of London to mainland Europe may have some friction costs associated with it, which I don’t have a sense of how much they would be. But I don’t see that changing our execution capabilities. As I say, we’re not a large OTC clearer so executing, giving up trades to a clearing house; I don’t see it being a huge difference for us. It may well make a difference to the broader London and UK economy, but I don’t think to Barclays itself there will
be a huge difference. And clearing of the currency is something that we’re actually quite interested in because of our Irish bank – it does have the ability to clear Euros. And our UK corporate clients increasingly want us to bank them in Euros, a little bit like how we have US companies coming to the UK, and how our own UK domestic companies do business in Europe. We think actually this is a fairly interesting business opportunity for us. So as part of operationalising our Irish bank we should be able to offer Euro currency clearing services for those clients.

Tom Rayner, Exane BNP Paribas

When Jes first became Chief Executive he pointed to a few things that he said were responsible for the [price to tangible book value] rating being where it was, which was Non-Core and the obvious drag it had on profitability, and uncertainty about the capital position of the Group. Now as you look at Barclays today both of those things have been largely addressed, yet the rating is still pretty much where it was. So I just wondered if we’re going to hear more about other areas now, other focus areas, which you need to look at to address this sub-book rating that you’ve got? The obvious one being the investment bank, I would guess.

Tushar Morzaria

Yes, it’s a bit like a game of building blocks – you’re building success for the future, block by block. The repositioning of the bank in terms of getting rid of businesses that were no longer strategic or something that we couldn’t make a success of, as I say with Non-Core folding back in, is mostly behind us – the sale of the French bank will close in August, Zimbabwe will also close as well. That, in some ways, is quite pleasing, that we don’t have to worry about those things.

The capital position feels like we’re in a much more secure underpinning. I think what will drive shareholder value from here, I suppose there’s no rocket science here, will be driven by profitability and return of capital back to shareholders. And I think that will be our main focus now that we’ve repositioned the company. That 8% RoTE in the first half is a really important number for us, and that’s the number we’ve got to drive upwards. And alongside that, to be in a position to start returning capital back to shareholders at some point. There are some headwinds on the horizon there – we’ve got some conduct headwinds to deal with, so that’ll be taken into the mix. But still we’re quite a capital generative company – even excluding the benefits we’ve had from releasing capital out of Non-Core – our organic profitability should be enough to deal with any conduct things that come our way and leave excess capital for us to deploy and return back to shareholders. But that’s something we’ll talk more about over time. I don’t think there’s anything cleverer than the fact that we have to drive up our EPS and return money back to shareholders.
Tom Rayner
So no strategic level thinking, regarding the businesses you have now...

Tushar Morzaria
If Jes was here, I think one thing he would say is that it’s very important for the psychology of the company to stop restructuring at some point. If you’re permanently in a restructuring mind-set, it’s very hard to point the company in a single direction and drive performance. And the other thing is when you’re the restructuring of the company, it’s very easy to use that as an excuse for why things aren’t coming together. What the closure of Non-Core means is probably much more of a profound effect inside the company than perhaps is felt outside the company. It’s the first time, I don’t know for how many years at Barclays, that this is the set business we’ve got and we’ve got to make this work. And by and large there are many businesses, most of the businesses are already working well. Our UK bank, our payments business, our US card business etc., all of these businesses are working well.

Even our ClB, where we do need to improve performance, when I compare ourselves to peers, certainly our 9% RoTE in the first half doesn’t feel a million miles away from where other folks were. It’s not good enough, so we’re not trying to pat ourselves on the back, but we’ve got ideas of how we’ll drive that forward. We’ll get some benefits from sweating our balance sheet harder, we will do more on the efficiency side of that business. And we do think our funding costs over time will reduce, were spreads to stay at the levels where they are at the moment, that benefit will start flowing through. I know some of you have written about that as well. So we’ve got to capture those benefits and drive profitability up, and it’s really the Group profitability that we’ve absolutely got to be focused on and make these things work.

But we think with this capital position, with the jumping off point of about 8% RoTE, with Non-Core in those numbers and that was probably a bit elevated to how you’d expect it to affect a prospective [return] – it’s a good foundation to build on, and that’s what we’ve got to focus on.

Joe Dickerson, Jefferies
You mentioned on the call on Friday that you expected the FRTB implementation to be delayed. Could you elaborate on that, because I think you’d previously flagged about £10 billion of risk-weighted asset inflation, so is that one that we should think of beyond, say, a 2020 time horizon? What’s the time horizon that we should be thinking of?

Tushar Morzaria
That’s my best guess, but we don’t have the inside track. But just looking at the legislative process in Europe, to be part of the next CRR which hasn’t been enacted yet, usually there’s some implementation
date beyond that. I think 2020 probably feels like the earliest, possibly beyond that even. And I think with all of these things, FRTB is a good example, when banks are given plenty of notice of a fairly significant rule change like that, banks have become very good at adapting their business models to manage the effect of that in the most constructive way. And I think FRTB is a good example where I think the numbers originally were quite substantial, and I think over time the industry’s figured out ways of repositioning their business accordingly.

So FRTB, of all of the regulatory type changes or anything that may be on the horizon, is probably not one I spend an awful lot of time concerned about at the moment, to be honest.

**James Invine, Societe Generale**

The first question is on your 15% stake in BAGL that you’re retaining. What’s the point of that? And I think previously you said that it would be ‘skin in the game’ if you were selling to a private equity buyer or not, but you haven’t, so why are you keeping it? And is it strategic in the same sense that your 20% stake in BlackRock was strategic very briefly?

And then I think six months ago you told us you were thinking about expanding the footprint of your US consumer business. This time around, all the reallocation capital talk is around the Markets business, so does it mean that that piece on the consumer side has been forgotten, or the expansion’s been forgotten?

**Tushar Morzaria**

The 15% of BAGL is [actually] 14.9% for a very deliberate reason, because anything below 15% is at the point at which we can get full regulatory deconsolidation. Under South African law, if you own more than 15% of a bank, you have to write a comfort letter to the authorities to say that you’ll be there to act responsibly if the subsidiary bank gets into trouble. We can now remove that comfort letter, so that allows regulatory deconsolidation.

We have to actually, as part of our sale conditions, hold 10% as a minimum for a period of time. So we’ll have to hold somewhere between 10% and 14.9%, and we’re at 14.9%. It’s returns accretive at the moment, quite frankly, so it’s not costing us much money holding it.

And you’ll see that, as an accounting matter, it’ll be Available for Sale accounted, so the dividends will be paid from that bank to us through other investment income in our P&L twice a year. It’s relatively clean from that perspective. So we may sell the rest of the stake when we’ve got permission to divest of it. But as I say, it’s returns accretive and doesn’t cost us much. On regulatory deconsolidation, it’ll be 250% risk-weighted on our balance sheet, so it’s an accretive position for us to hold while we have to hold it.

US consumer is still something that we’re very interested in and we have got some ideas of what to do.
It’s not a very capital consumptive business, things like the cards businesses. For example, take UK cards, obviously we don’t report Barclaycard as a division in the way we used to, but if you look at old Barclaycard divisional reporting, mostly in UK cards and then US cards, in total I think that was about £6 billion of capital, and we’ve in that card business for half a century. So you don’t need a lot of bank capital to get into those businesses. You do need the investment capacity, but even then, that’s nowhere near the quantum that’s going to make a huge dent in our numbers.

What’s really interesting to us in that space is payments, because we believe we’re the market leader in the UK in payments overall. We’ve got a strong number one position here. We’re the only bank in the UK that has that full loop of payments from, whether it’s issuing credit cards or managing a corporate credit card programme to having the merchant acquiring business, to managing foreign exchange etc. And so in UK we’ve obviously got to retain that position and get as much revenue as we can in new products and services, and we have ideas around some of the data and some of the closed loop around payments that are very exciting for us.

In the US it’s quite different. The US payments business is relatively unsophisticated compared to the UK and parts of Europe. It’s quite surprising in some ways, probably the most advanced economy doesn’t have the most advanced payment protocols and processes. So the idea there is, could we take some of the stuff that we know works well in the UK and we’ve been pioneers in, and export that to the US in a disruptor-type concept. So it will be small but something that we are focused on doing. We’re not talking huge capital numbers or even huge investment spend at the moment. But it is a potentially very exciting play for us and sits very well alongside our Delaware Bank, which is a virtual bank [in that it doesn’t have a branch network]. So we’re very asset-light, capital-light, a nascent form of banking in the US that could be very exciting for us over a longer term period.

Robin Down, HSBC

Coming back to the pensions issue, obviously you’ve got a massive gap between your version of the deficit and the actuarial version. It’s just something I’ve requested in the past, but is there any way we can get some more colour as to what the actuaries are assuming in coming to that number, because my sense is that some of the market discard your version and look at the actuarial version when they think about the valuation of the stock. So it may be something you can’t answer now, but in future it would be nice to see what their assumptions are and where the differences are.

Tushar Morzaria

It’s not our version, it’s IAS 19, so it’s not something we decide for ourselves. It’s International Accounting Standard 19 that all the European banks, and most global banks these days, have to abide by. And they’re just computed on different bases. Unfortunately, they do measure different things. It’s a curiosity that that IAS 19 deficit or surplus gets computed every quarter and gets immediately deducted
from capital – you never get the surplus added back to capital. And it can be quite a bouncy number, so it’s a curiosity that something that’s a 50 year liability gets marked to market every quarter and bounces around the entire bank’s capital position.

The actuarial deficit, that’s a triennial process, using, obviously, more assumptions around long-term funding. If we were to do that triennial exercise again here and now, that funding deficit would have dropped just because we’re in a different economic environment than where we were last September. The thing that is important though, under current UK pension guidelines, companies need to make whole any deficit over a ten year period, and you’ll see all FTSE 100 companies look to do that. And so you work with the Trustees to look for a deficit reduction contribution schedule that works in the interest of the company and makes it a strong employer, a strong covenant, but obviously, ultimately, the Trustees need to be made whole. And we think we’ve got to a good outcome there, where for the last Triennial valuation and for this Triennial valuation, the agreed deficit reduction contributions pushed the larger contributions into the later years, so it takes a lot of capital pressure off the bank in the nearer years.

And of course, by the time we get to those larger payments, which peak at £1 billion a year, there’ll be another Triennial valuation, and of course, who knows what the [actuarial] funding deficit will be. It may even be in surplus. As an accounting IAS 19 matter we are in surplus at the moment.

Robin Down

But my issue is that the gap between your IAS 19 and the actuarial valuation must be one of the largest we can see anywhere. We can’t see the actuarial assumptions, so if we could get the actuarial assumptions and see why they’re so much more conservative building that deficit?

Tushar Morzaria

We’ll show you what is out there in the public domain, if that’s helpful. Part of the problem with the IAS 19 calculation is every time you contribute to it, it takes you into a surplus. So it’s a slightly asymmetric calculation.

Robin Down

You mentioned the TNAV impact of IFRS 9. Your RoTE target of 10% - is that on a new basis including the IFRS 9 impact? Are you going to rebase the 10% target?

Tushar Morzaria

It’ll be on the TNAV in the future. I don’t give a forecast on what TNAV’s going to be in the future.
Michael Helsby, BAML

In the UK bank, fee income was quite weak quarter on quarter. It fell £50 million. I was just wondering what was going on there, because you’ve not called it out. And in bad debts in the UK bank and in US cards, obviously you don’t give disclosure of the impairment charge by type of product, but you do give us the charge-off rates. So I appreciate that it’s not going to be the same number because of recoveries and things, but is that the best proxy that we’ve got? Is there anything in your accounting that would make that very different in the way that you treat them?

And then, finally, I mentioned this on the call, but there does seem to be an increasing focus around the leveraged loan market and CLOs. So I was just wondering, given the legacy of Barclays, what controls you’ve got in place, what limits you’ve got that give you the confidence that there’s going to be no repeat of what happened in 2008. Thank you.

Tushar Morzaria

It may be the Visa Europe gain flowing through, that might mix up the comparison a bit.

In terms of accounting for impairment in the UK and US, they’re both on an IAS 39 basis, so there’s nothing different in treatment. I think what is interesting though, and we make this point which I’ve always been curious about, charge-offs versus impairment levels, and I came from a US business, and everybody wanted to know what the charge-off rate was, and we actually monitored the charge-off rate and then the credit cost, as it’s called under US GAAP. And I’ve found since I’ve been here, it’s one of the first times anybody’s actually asked me for a charge-off rate. I think it’s because IAS 39 was more of an ‘incurred’ impairment standard, rather than an ‘expected’ impairment standard. When we get to IFRS 9, I suspect that folks like you, and certainly us in the company, charge-off rates I think will become a much more visible and interesting thing to be discussing because of the impairment build and the impairment release will be a sharper rise and a sharper decline. So I think people will want to look at the underlying charge-off rate to get a better sense of what’s really going on here. So I suspect this time next year it would not surprise me that we’re talking a lot more about charge-offs than we do at the moment. I think charge-offs at the moment proxy quite well to IAS 39 impairment levels. It is not usually a big delta.

Michael Helsby

As a follow-on to that, because the arrears that you disclosed are really low in the card book and in the Personal Loans book, after what period does it go into charge-off?

Tushar Morzaria
The way we do it here, and I suspect the way it’s done in other banks, we have something called ‘cycles’, and as soon as you’ve missed a payment cycle you’re immediately into delinquency cycle number one, and we start impairing a portion of that book then. If you then miss another payment you enter delinquency cycle two and impairment ticks up. And there’s several cycles before you’re fully charged-off. So it’s relatively quick in terms of, you miss a payment and you’re [partly] into the impairment bucket already. In the card business you get charged off relatively quickly as well. So it’s a relatively responsive thing. What it doesn’t do though is – which will change under IFRS 9 – the unknown unknowns, you’re then forecasting what may impair that hasn’t already impaired. That’s going to be far more of a pronounced effect under IFRS 9 than you currently have under IAS 39.

You asked a question on leveraged loans. It’s a good question because leveraged loans is an important business for us and in fact, we had our record market share in the second quarter. So it’s a business that is important to us and our debt capital markets business, it’s a big part of that. It’s something that we’ve spent an awful lot of time on, as a risk management matter. There are two counter-forces there; one is our own institutional memory, and I can’t remember a Risk committee meeting I’ve been to where we haven’t talked about leveraged loans and made sure we’re comfortable with leverage levels, comfortable with underlying responses, comfortable with terms of any pricing flex that we have etc. And we don’t call this out so much, but we certainly do forego quite a bit of that business as well. So it’s nice that I see business turned away. Every time I come in for underwriting approval, I see plenty of examples of where the business has not brought deals to the Committee, and that’s always a good thing to experience in an approval process.

The other thing is of course that regulators have become very prescriptive in the kind of business that can be done. So if you look at what happened in 2008, there were an enormous amount of deals in the market simultaneously, and they all got hung simultaneously. So I think if you look at all of the loans in the market at any one time now, it’s a fraction of what it was in 2008, and that, in some ways, the regulator has forced on us. So even if everything got stuck, you won’t see anything like the damage that was caused in 2008, simply because the sequencing of these loans is much more strung out. But it’s something we’re super vigilant on. We’re not at all casual about this. It’s an important business, and because Venkat, our Chief Risk Officer, came from an American firm, of course, who are very large in leverage lending, he’s put in even more checks and balances from the techniques used there as well. So we do feel pretty good about the risk management of it, but it’s a risky business and we’re not naive about that.

Andrew Coombs, Citi

My first question is on Non-Core, there’s £300–400 million loss guidance for the second half. Any unusual one-offs, divestment losses, gains etc. in there or is that a pretty clean underlying number?
Tushar Morzaria

It’s pretty clean. There are some costs running through there in the second half of the year that will stop when the business sales have completed, the two I’ll call out are probably France and Zimbabwe because they’re in the public domain. So they’re a declining trend on the cost side into next year. But no spiky movements.

Andrew Coombs

So if France closes in August the vast majority of that should already be through in the second half?

Tushar Morzaria

That’s right. So we own the company for another month or so, it’s not that big and you’ve got some transitional services work that goes on just like you do with any other M&A, but on a declining trend. But there’s no real spiky stuff going on in the second half, no.

Andrew Coombs

And then just thinking forward to 2018, obviously, you are going to reintegrate this so we’re not quite going to get the same visibility. But you’ve given quite good guidance on the cost base, the £0.5 billion dropping to sub-£0.3 billion. In terms of the revenue drag from these Non-Core businesses that are going to be reintegrated, should we see this in a similar trajectory for that? Or is that, given that a lot of this relates to legacy derivatives, Italian mortgage book and so forth, is that revenue drag going to be here for some time now?

Tushar Morzaria

The Italian mortgages could be here for some time. It’s pretty small revenue. I don’t think we’ve ever quoted it but if we took it out, you probably wouldn’t even notice it. It’s relatively small in revenue terms and we’ve outsourced the servicing. So, yes, it’s a drag but, that will not be very visible for people whether we include it or not. The legacy derivatives, of course, we won’t really see anymore because they’ll be part of the IB derivatives portfolio so even though we won’t track it like that, we will hold the business accountable for meeting its revenue objectives with all that in mind.

Just want to just make sure I correct you in case you may have misunderstood; the £300 or £400 million that we talked about for the second half of the year is a loss before tax, not a cost.

Andrew Coombs

I’m just trying to get a feel because if I look at consensus, they’ve got the opex and the revenues in Non-Core falling quite dramatically and that, obviously, will be quite important when you think about
reintegrating this into the Core bank. So I was just trying to get a feel, the revenue drag has been easing somewhat but given that you’re now reintegrating, is the case that the revenue drag should fall at a less aggressive rate from here?

Tushar Morzaria

It’s a hard one for me to answer because it’s now just inside the book of derivatives so even I wouldn’t be able to [see it]. If you asked me in a year’s time ‘what happened in Non-Core derivatives’, I’m not tracking that anymore but I can tell you what happened to the [CIB] derivatives revenues. And no excuses if they’ve had weak revenue, they can’t say, ‘it’s because of these pesky Non-Core derivatives’. That it’s not going to work anymore. We have to manage it in the aggregate.

Andrew Coombs

And just switching gear to CIB, when I look at your CIB numbers, the return tangible equity for the first half includes a provision relief in the second quarter. So I’m quite interested to know what you think your normalised provision charge is with CIB?

Tushar Morzaria

It’s not going to be a net credit, that’s for sure. I’m not expecting a big uptake in provisions over the course of the rest they year. Nothing I can see would suggest that there’s going to be a large tick up. The impairments in CIB, it’s actually not much at all that comes from the Investment Bank. It’ll come from the Corporate business and there’s nothing I can see at the moment that suggests anything outsized so, but it won’t be zero. It’ll perhaps be what you’ve seen in the previous two or three quarters, I don’t see anything too unique going on. We had a build last year on oil and gas positions. It doesn’t feel like we’re seeing something similar at the moment, but that’s probably an area of commodities, one to watch carefully. But nothing suggests that there are risks there at the moment.

Martin Leitgeb, Goldman Sachs

The first question is on the CCAR in the US, and obviously your IHC, similar to the other European investment banks, was subject to the first private run. I know the limitation in terms of what you can comment on, but is there any colour you can give us in terms of how the process went? And also to that, there is the US Treasury paper outlining some of the proposed changes to the CCAR. How would you see the impact on the US IHC going forward?

Then the second question is on ring-fencing and the non-ring-fenced bank. When do you expect that process to be completed? And when would be a time when we could get financials of those two entities? Would that be around mid-2018, I guess?
Tushar Morzaria

On CCAR, there's not a lot I can say, it's a private exercise. It was about as hard as we thought it would be – it's a monster submission. I think it was 18,000 pages so it's enormous and pretty tough. From a standing start, we've got to get to the same standard as the US banks after the six/seven versions of this that they've had. In fact, probably even more than that now. So it's a monumental lift, and I don't want to underplay that. We're quite conservative in what we're expecting next year. History has shown that you rarely pass these things first time round, but we're going to do everything we can to do that. But we're prudent in our planning assumptions around what we rely on for the US IHC, and we don't need it to do a whole lot of work, in terms of capital redeployment.

Our objective is to pass CCAR first time round but I wouldn't understate how operationally intensive a process it is for banks doing it for the first time. And it gets better, rather it gets more manageable year on year.

The US Treasury paper, way too early to say. It's some stuff that will certainly make life a bit easier for us as a by-product, but I'm not pinning my hopes on any of that crystallising. We'll assume that it's the current rule set that carries on for some time.

Ring-fenced, non-ring-fenced bank financials – they may be at the interims in next year, we may have to publish them, so that will probably be the first time we see them. We should probably confirm that to you. I don't think we'll publish them before we have to. These are one of these things that are going to get quite interesting for the bank complex. There ought to be, and rightly so, a lot of interest in the subsidiary banks. People will get a sense of what they look like and feel like, but we'll manage the consolidated capital position of the company and ensure that the subsidiaries are fully compliant with all regulations as we are today. But I understand the desire for people to see them but it'll be a bit like the US IHC – you got to see that for the first time when we had to file a Federal Reserve Y-9C report. I don't think we'll do anything much in advance of that.

Martin Leitgeb

And if I may ask, in terms of profitability for the ring-fenced bank and non-ring-fenced bank, would you expect the proportion of the UK bank being more profitable than the international bank?

Tushar Morzaria

The UK is a smaller bank and a higher return, probably. But with all things being equal, the non-ring-fenced bank will be higher in terms of absolute profitability.

On a statutory basis, there are going to be some differences between the current UK division and the future UK bank. I'll give you a couple, and we'll get into this next year because they're more technical in
nature rather than business orientated. The Service Company, for example, which will provide most of the operations for both banks, is a legal company and will have to make a profit, as a transfer pricing matter for tax. So the ring-fenced bank will have to pay a margin to the service company. Of course that’s all socialised within the Group, but therefore the new UK bank, as a statutory matter, will look less profitable than the current UK division, because we’re socialising that profit centre back into the UK division. Another example, there’ll be some other technical effects when you get to hedge accounting and things like that. So again, more technical in nature than business substance. So we'll probably have to spend a bit of time with folks that are really interested in these financials and take them through some of these technical effects, but it will be a little bit more complicated to get it first time round.

Martin Leitgeb

And, I guess, the same impact for the non-ring-fenced bank?

Tushar Morzaria

Yes, it’s exactly the same.

Chris Cant, Autonomous

If I could just ask about your investment spending, you’ve got a slightly woolly or undefined investment budget for an undefined list of projects. I’m just wondering if you can tell us what the internal rate of return on the investment spending is going to be, and what type of projects you are looking at? Because one of the frustrations for investors has been that your sub-60% cost–income ratio doesn’t have a timescale attached to it, and nor are you really giving people any optimism that you’re going to go meaningfully below that level. And I’ve had a question, ‘well, what are you actually investing in’, because we don’t know?

Tushar Morzaria

On our cost base we've given some sense of costs that will naturally leave our cost base over time. Obviously Non-Core winds down, structural reform costs wind down etc. and that gives us, if you like, a jumping off point. Beyond that there will be further efficiencies. We’ve had Paul Compton, our Chief Operating Officer, speak at public forums, and we’ll ask him to speak again at other public forums, to talk more about the further efficiencies that you’d expect the company to drive out, a lot of the automation, digitisation and various things that are going on.

What that allows you to do is to create some capacity to reinvest that, and the way we’d like to run the company is on an efficiency measure. If we can’t afford to invest, then we’ll bank it, and that will protect profitability. If we can afford to invest, which is our base assumption, then we’ll look to invest and
that’ll go into two types of areas. One will be new business initiatives, so the payment space for example is very interesting to watch. Now, we’re not talking large quantums of investment spend required in the business like that, but that is an area that will sow the seeds of some really interesting opportunities, probably in the medium to longer term, rather than the very short term.

In banks these days and all large companies, there’s a technology arms race. You’ve got to continue to modernise and improve your infrastructure. That, you just expect us to do. We’ll always create capacity to reinvest, to equip ourselves with the latest, quickest and most efficient technology. Where we’re doing meaningful projects for new products and services, you’d expect us to call that out, but it’s probably a bit too early yet to tell you where we’re embarking upon a new revenue opportunity. When we have anything of substance, then we’ll obviously call that out.

Chris Cant

Just in terms of the technology piece, should we expect – obviously we’ve got a balance sheet headwind to capital from the pension’s contributions – when you’re talking about investing, presumably, part of this would be capex rather than opex? You’re giving us guidance on the cost income side but if you’re investing in new product initiatives, are you talking about amortisation increasing down the line? Is that why we get back towards 60% cost: income ratio? Would you be capitalising this, or is it all going to be opex?

Tushar Morzaria

That’s a very good question. We manage everything on a cash basis. If we were storing up on the balance sheet investment spend that was coming – if it’s of a quantum of real significance – then we would call that out, but we manage everything on a cash basis. In fact, it’s something that’s important, and we shouldn’t get technology managers too involved in software capitalisation or intangible capitalisation, because if do you start, you start to lose control of your actual spend.

Chris Cant

What would be the typical split between opex and capex on a typical investment project for you? I’m just trying to get a sense of the returns profile?

Tushar Morzaria

It depends on the life of the value of the assets. Some of these things can be quite long term, five to ten years, some can be quite short term. So it is much more product specific as to what the valuable life is. If it were a meaningful build in, for example, merchant acquiring in the US – we don’t have plans to do that, but let’s use this as an example – and we wanted to build that all for ourselves, that would be a
fairly meaningful investment spend. Those are the kind of things we would call out, because that’s something that will be a multi-year spend, that will be significant. A lot of that would probably sit on the balance sheet, and we’ll call that out. But we don’t have any plans to do anything of that quantum or anything quite as radical as that, but to the extent we do, we’ll certainly call it out.

Claire Kane, Credit Suisse

Can I follow up on the cost comment? So you mention ‘if you can afford to invest’. So what does that mean? That doesn’t sound like it’s related to the IRR on the investment spend. It suggests, maybe you’re thinking if you have a lever on your own return targets…

Tushar Morzaria

It’s balancing that. It’s very, very important to us that we get the company to a reasonable return. We think 10% plus is a reasonable return. It’s very important for us to get the company to a 60% efficiency ratio. Those two things go hand in hand. Of course, we’d like to continue to reinvest in the company, to ensure that the company grows its profitability over time, but those are choices and judgements we will make for ourselves, and we’ll get a better sense of what the economic environment is, what our revenue and impairment outlook is, and what’s the right amount of money to be spending through our P&L at that point in time. So to try and give ourselves that flexibility to make those choices. If the environment’s much more conducive to making profits, then you’d expect us to utilise that to invest a bit more into the company. If it’s not as conducive, then we will take those discretionary investments and that’s what managements do; every day we make choices of where we spend money, where we don’t spend money. It just gives us that flexibility to make those choices in our budgeting cycle. So it’s nothing more secret than that. It’s just what all companies do, just management having choices where to spend on discretionary projects and where not to.

Claire Kane

And if we think about where consensus assumes the net investment spend is, probably around £600 million of the £1 billion that’s being saved, that sounds quite a lot when you think you may call out a big investment spend. Can you maybe help us consider what the marginal cost is of some of these revenue investments or initiatives you’re taking? Because, I guess, there’s a concern that the £600 million goes towards higher compensation in the investment bank.

Tushar Morzaria

I can probably kill that pretty quickly. Unless our revenues in the investment bank change fairly dramatically, I can’t imagine our performance costs going up. At the Group level it’s about £1.7 billion
or something like that, so [£600m would be a one] third increase. I can’t see that happening. It’ll be in non-performance costs if we were to reinvest on that scale. I won’t comment on consensus costs because we are managing on an efficiency basis rather than a hard cost target, but if we were ploughing back that quantum of cost back into the company specifically for generating new products and services, you’d expect us to call it out.

Ian Gordon, Investec

Can I just re-clarify on cards, you’ve dealt with the merchant acquiring aspirations, but in terms of your UK cards, quarter after quarter after quarter, it’s been stable volume and stable credit. Is it a stable outlook? And then for the US cards, we’ve seen stable-ish credit, stable volumes. Obviously, you’ve implemented the positive mix shifts and does that put us on a new line of resumption of growth, albeit at a slightly lower margin, or is it more ‘stable, stable’?

Tushar Morzaria

We’re relatively cautious in the UK, so ‘stable, stable’ is about right, although we’re not seeing any signs of distress, but we are quite cautious. The US is a bit different. Soon you’re going to see the effect of the American Airlines J-curve coming through a little bit. It’s a great deal for us, but we’re beginning the marketing spend for account acquisition, in the actual planes themselves and in hotels and terminals. And that’s an enormous account, so you’ll see revenues coming through in subsequent periods, but costs being incurred in the earlier periods. We announced the Uber transaction on Friday. That’s an enormous transaction as well, and that’ll come online later on in the year. That’ll have a J-curve associated with it as well, but again, a very productive cost for us in terms of revenue space.

As for the impairment outlook for the US, it ticked up a little bit, as you saw with most US banks and then stabilised off. It’s something we’re monitoring very carefully. Unlike the UK, which has been very, very stable, and recoveries nudges down a little bit every time, the US has very low levels but we have seen, at the lower end, a tick up in delinquencies. So a little bit harder to call in the US as to whether that’s a trend that continues, or whether that’s just a temporary item. So it’s probably quite different, but the UK is probably very stable and predictable, whereas the US has got a few more things going on there.
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