

Barclays PLC Q2 2019 Results**1 August 2019****Results call Q&A transcript (amended in places to improve readability)****Alvaro Serrano, Morgan Stanley**

I have two questions. First of all, there was a press article earlier last month talking about Barclays targeting \$20bn of assets from Deutsche. Can you make any comments about how you think the restructuring there is going to benefit you? What kind of market share can you take? Is that going to be profitable? And just generally if there's any change to your RWA or leverage commitment to the division, given the opportunity there.

The second question is around your capital distribution. You've increased the payout, which has been well received. I'm just wondering when you've decided to go for the dividend versus a buyback, is this the payout ratio we should be thinking about going forward? And from a financial perspective, is it not better to do buybacks? I am just wondering what your thoughts are and what to expect going forward.

Jes Staley, Group Chief Executive Officer

Vis-à-vis prime balances, it is true that we gained some Prime balances recently, roughly in that neighbourhood. It's very good business for us. It's net interest earnings. It's the part of the Markets business where you earn revenue on Saturdays and Sundays and holidays. It also reinforces the important relationships you have with the principal actors in the capital markets. It is very profitable and we will continue to pursue that business.

Overall, our commitment to the capital markets globally, but principally in New York and London and across Europe, when there is capacity in the capital markets. We're committed to the strategy, and the prime brokerage business is an important component of that.

Tushar Morzaria, Group Finance Director

On your question on capital distributions, as we've said earlier, our capital distribution policy remains unchanged. We will expect to have an appropriate mix of ordinary dividends, which we talked about this morning and, at the right time, additional distributions, possibly through buybacks.

The way we think about it is that it's important to set the ordinary dividend distribution to the right level first. If you think about it as both a Board matter and a regulator matter, there's a higher hurdle. We think of these as perpetual distribution, not one-time in nature, so not only would we have to have conviction in our capital position now, but also conviction in the future capital position of the company and, importantly, earnings now and in the future. We obviously have a more optimistic outlook for this year in terms of earnings than consensus does at the moment, given our returns target, but even on consensus earnings, we think that the dividend guidance that we provided will still get you to a pretty comfortable payout ratio, so it's important that we get that right. To the extent we generate further excess capital from here, we'll consider what we do with that – but leaving our distribution policy unchanged.

Jonathan Pierce, Numis

My first question is on gilt gains and the second one on the UK margin. On gilt gains, there's about £216m booked in the half, which is a big reversal on the c.£200m loss that we saw in the second half of last year through P&L. Could you just remind us where these get booked? And as of today, there's probably still a stock of these gains at c.£500m – is there an assumption that we're going to get more of these gilt gains in the second half? Is that a big part of the delta between where consensus is at on your return for the year and your 9% target? So that's the first question – gilt gains and the outlook for those.

On the UK margin, I'm just trying to interpret the comment on the impact of refinancing. Are you suggesting that it's actually a bit more complicated than it looks, in the sense that there's a one-off EIR assumption change in the half because customers are refinancing away more quickly? Is that what you're trying to tell us? Or is it just that there's a lot more new business coming on at lower spreads?

Tushar Morzaria, Group Finance Director

In terms of gilt gains, I'm not sure how far you've got through our disclosures, but you'll see in the notes that we have split out how much of the revaluation of our AFS reserve has been recycled to P&L in the normal course of business, as we recycle our liquidity pool positions. It's actually slightly lower in H119 than H118 on an after-tax basis. I think it was a little less than £100m this half and a little over £100m in H118. On the outlook, as bonds have rallied very substantially, there are a lot of gains there. We're not really trying to do anything too clever here. Obviously if we're recycling those gains into income, that will lower net interest income into next year unless yield is back up. I'm not sure there is anything that we're doing that's beyond what we would normally do, so I wouldn't give any different guidance. It'll be regular disposals as we would have done anyway, and recycling of the pool.

On UK NIM, yes, the refinancing activity is translating itself through an EIR adjustment. Essentially what we've been seeing is the behavioural life of customers is shorter – I guess it's possibly a function of the ease in which you can switch products. There's a lot of digitisation going on in the industry, and probably aided and abetted by some incentives that brokers have as well. As people come off a typical two-year fixed rate product, for example, they tend to stay on the follow-on rate for less time than they used to historically, and refinance into a new fixed rate product. When you look at the reduction in our NIM in the quarter, about a third of it was from that EIR adjustment, a third of it was from having lower unsecured card balances and some very deliberate actions that we've taken, and another third from the mix in secured lending versus unsecured lending, but obviously growing our mortgage book. When we look at it from here, the EIR adjustment is really just an adjustment to the stock – it doesn't really change the NIM from this point on, assuming we've calibrated customer behaviour appropriately, which we believe we have. I think we're done with the specific actions we took in reducing interest earning card balances, so that'll be broadly favourable from here.

There are a few things I'd remind people of. One is we expect our NIM to be around these levels for the remainder of the year, and we expect our mortgage book to grow. This means we'd expect our income in Barclays UK in the second half to be higher than the first half. Obviously sitting here in the beginning of August, we have reasonable visibility of that, so we are comfortable giving that guidance.

Jonathan Pierce

Just to follow up quickly – so one third of the margin drop was the EIR, and that's a one-off adjustment. Presumably that's a £25-30m hit to the net interest income in the quarter that won't repeat going forward?

Tushar Morzaria, Group Finance Director

That's right. Probably a little bit lower than that, but yes, in that sort of zip code.

Joe Dickerson, Jefferies

My question is on the liquidity pool. The LCR ratio is very high, so it looks like you've got £83bn of surplus against quite an overfunded balance sheet. You mentioned the Brexit uncertainty – has there been, either directly or indirectly, a drag to the net interest margin, and would you be willing to quantify it? And certainly there's an opportunity cost from not lending these funds out. If loan demand picks up – I'm not saying in the second half of the year, but in the future – presumably that would provide quite a tailwind to your net interest margins, irrespective of what's happening with rates?

Tushar Morzaria, Group Finance Director

You've seen our deposit balances continue to tick up quite nicely in commercial banking, corporate banking, as well as in our UK bank. In our UK bank, for example, I think we hit £200bn of deposits. Deposit growth has certainly been quite strong. It's good business for us because we're not paying much for those deposits. If you do a straight comparison, you'll see that we have probably one of the lowest rates in the UK market. Having that sort of liquidity in our liquidity pool is a profitable activity for us, given it's cash that's arrived recently.

Your other point is also fair. We do have a relatively conservative loan to deposit ratio. As a group, it's in the low 80s and in the UK bank it's in the mid 90s, which compares quite favourably with some of our peers. I think that potentially gives us some opportunity into the future when things settle down. At the moment, we're seeing a reasonable amount of customer caution, so a lot of cash is being left with us and there's less demand for borrowing. To the extent that changes as we go through this period of uncertainty, I think that's a pretty interesting opportunity for us to think about how we recalibrate our liquidity pool, and by inference our loan to deposit ratio.

Chris Cant, Autonomous

You've given us some incremental disclosure around your structural hedge. Could you quantify the potential drag from the structural hedge into 2020, in the same manner that one of your large peers did this week? And where does that net income from the hedge get assigned divisionally? Is that primarily in the UK division?

The second question is on your <£13.6bn cost guidance. You said that was based on a \$1.27 FX rate. We're 4.5% below that level at present. Does that £13.6bn still hold on current FX? If this FX rate persists, would you expect to be above that? And as a broader point, it would be really helpful if you could give us a sense of how much of your revenues were in dollars and how much of your costs were in dollars, to enable us to better understand how that dynamic might play out through a further hard Brexit hit to sterling rates.

Tushar Morzaria, Group Finance Director

I'll talk about the hedge contribution, and I'll just make a couple of comments on cost, and then I think Jes will want to add to that. On the hedge contribution, I know you've been asking for a while, and I appreciate it has taken us a little while to get the disclosure across to you.

If yield curves stay literally where they are today – and our intention would be just to roll our hedge, as we don't actively manage it in the way some others may choose to – it would reduce net interest income by about £50m into next year. Now that's a combination of product hedge and equity structural hedges,

so it's actually across the bank as a whole. Obviously the equity position is for the whole company and the product component is just a component of it. I think the gist of your question is how much of that would be in the UK bank specifically. A portion of it, but by no means the all of it, would go to the UK bank.

In terms of costs, firstly we have taken some meaningful actions in the second quarter that ought to give us a much lower run rate going into the remainder of the year. We've talked about headcount reductions that happened in the second quarter, and we've made other changes to our physical footprint. We've deferred some investment spend that we don't think really makes a difference in terms of medium and short term opportunities. We have good visibility into our costs.

Your point around currency sensitivity is a good one, and it looks like it just moved again this morning with the sterling weakening, though a fairly meaningful move is only PBT enhancing for us. As you've probably seen on slide 19, about half our revenues are non-sterling generated. I take your point that we haven't given you the equivalent cost mix, so that's something we should think about, but we're obviously positively geared towards a weakening sterling. Yes, any other comments you want to make on the cost base?

Jes Staley, Group Chief Executive Officer

We took action on the headcount side and we're now down in headcount by over 3,000 FTEs, and that does have an expense [implication], but we will feel the benefits of it in the second half of the year. The strategy of being diversified geographically is to try to minimise the impact of a fall in sterling to us. As Tushar said, it has a bigger impact on revenue than cost, so whilst it may challenge our <£13.6bn cost guidance, in terms of the overall jaws of the bank, it'll be quite positive.

Martin Leitgeb, Goldman Sachs

I have two questions, please. The first one is on Brexit, and the broader impact Brexit might have on your franchise, and what you're seeing at this stage in the various parts of your business. I'm particularly interested to know if you have seen any change in customer behaviour – in terms of sentiment, loan demand, potential depositors, or asset quality within the wider book.

The second question is more of a general strategic question. Over the recent weeks, we have had the announcement of one of your main competitors reassessing its strategy within the equities franchise. Out of memory, revenues in that segment were broadly similar to Barclays' revenues in equities over the year. I was just wondering whether this had led you to re-evaluate the strategy of your franchise, or how you see the opportunities for your franchise in that regard.

Jes Staley, Group Chief Executive Officer

So the first question on Brexit, vis-à-vis the bank's position, we began working right after the referendum vote to get the bank structured in such a way that we could deal with any possible outcome of Brexit. And what that really meant for us was changing the scope and scale of our bank subsidiary in Dublin. It looks likely to become, by the end of this year, the largest bank in Ireland. We then went through the process of every branch of the bank across Europe, from Frankfurt to Madrid to Paris, to relicense those branches as branches of the bank in Ireland. We built all the control systems necessary. We moved the necessary people. And then, over the last couple of months, we've gone through the client migration process. We've left it up to the clients if they wanted to migrate from one platform to another, which has gone quite well. From the bank's operational point of view, even if we had a very hard Brexit at the end of October, the bank is totally prepared for it, and it would be really business as usual.

In terms of what we're seeing over the last couple of month's vis-à-vis clients and customers, as Tushar alluded to, I think people are modestly being more conservative. Our cash levels are up. Demand for credit on the margin is lighter. On the institutional side, or the major corporate side, I think it's fair to say that some of the big decisions, whether they were M&A decisions or investment decisions, have been lighter than one might expect.

I think the big thing is, as we get closer to October 31st and there's a real possibility of a no-deal hard Brexit, we want to be very mindful. We want to be very constructive in terms of helping small businesses in particular to think about cash flow levels, etc., and we want to be committed to being a partner, to get the UK economy through that event. But I think we are prepared. Going back to the opening comments – two years ago, we looked at our unsecured credit card portfolio and really tightened our underwriting conditions since then, which hopefully has put the bank in a pretty prudent position as we go into the latter part of this year.

Vis-à-vis the equities business, we do believe it's important to look at the profitability of the Markets business overall. There'll be some aspects of your Markets business which are less profitable than others, but there is a connectivity between the two of them. We are committed to our position in the US and in the European capital markets across the equities platform. We have a very strong business in equities prime financing. We have a strong business in equities flow derivatives. We're going to stay committed, both on the research side and on the execution side, to equities.

Guy Stebbings, Exane

I would just like to clarify on a couple of points. Firstly, on risk-weighted assets – thanks for the new guidance on the regulatory changes – can I just confirm that was low single digits for each rather than in aggregate?

And then to follow up on RWAs – Jes, you mentioned again in the introductory remarks the slightly harsh treatment on operational risk, at least in Pillar 1 terms. Should we take it as a suggestion that you're getting closer to a change, and that's being moved more into Pillar 2? If so, when is your next ICAAP, and when does that have to be signed off?

And then just a final quick point of clarification. In Head Office, I saw quite a big jump in the period in tangible equity. Could you explain what's going on there?

Tushar Morzaria, Group Finance Director

Why don't I take the couple of clarifications on RWAs and Head Office, and Jes can talk about where we are on operational risk-weighted assets. Yes, single-digit billions for each of those impacts. So single digit billions for mortgage risk weight, an additional single digit billions for securitisation, etc. There is obviously a benefit on counterparty credit risk, as a leverage matter.

On Head Office tangible equity, at the end of the day, we capitalise our businesses at our target 13% ratio, so to the extent we've got excess capital at 13.4%, we leave that in Head Office, pending distribution, investment, etc. There isn't much more than that.

Jes Staley, Group Chief Executive Officer

On op risk RWAs, we're obviously in dialogue with our regulators. You should recognise that in many ways, this is optics, as it would result in a move from Pillar 1 to Pillar 2, roughly 60bps in our CET1 ratio. There has been questions about whether our CET1 ratio was sufficient, or whether we're sufficiently

capitalised – and with that 60bps, we'd land at 14% today. Plus what we're doing on the dividend, hopefully we have finally arrested this question of whether we're sufficiently capitalised.

Guy Stebbings, Exane

Is there any sort of timing you're able to give on it, or can you not really comment, given it's up to the regulator?

Tushar Morzaria, Group Finance Director

We're in discussion with the PRA. We will keep you posted, but I wouldn't give a timeline on it now.

Andrew Coombs, Citi

Was the 60bps gross or net, adjusting for the Pillar 2?

Jes Staley, Group Chief Executive Officer

So we would quote a CET1 ratio today of roughly 14%.

Andrew Coombs, Citi

Ok, and the reg minimum goes up for the adjustment on Pillar 2?

Jes Staley, Group Chief Executive Officer

Correct, that's right.

Andrew Coombs, Citi

Right, understood. My two questions are both on the International Bank. Firstly, I'd be interested in your thoughts on the implications of a lower Fed rate on CCP NIM – obviously most specifically the US Card business. Secondly, there's quite a jump QoQ, from £415m to £444m, in the transaction banking number. You said that's due to deposit growth, but I'd be interested to know more, because there's quite a big step change in that line.

Tushar Morzaria, Group Finance Director

The Fed cut will feed through into NIM in the US. Of course, it's a pretty high NIM anyway, so I don't think it'll make a huge difference to us in the outlook for that business. I would expect, even with the new Fed rates, income to continue to grow in the second half relative to the first half. And of course, a lot of that is just through the increase in balances that we've been generating over the course of the year.

Transaction banking has been really good for us. Obviously, some of that is as a consequence of the deposit levels that are increasing in our commercial banking business. As Jes mentioned, the general behaviour we've seen from customers is slightly more cautionary – in other words, leaving a lot of cash with us and, at the margin, demanding less credit. We've seen that in commercial as well as business banking. Whether the deposit growth continues to go up or not remains to be seen. We'd like to be lending out that cash at some point. I think what is interesting for us is that some of those deposits have been coming in through products and services that we're offering to European corporates. That's something we've been working on for some time.

One of the positive by-products of Brexit for us is that our European bank, based in Dublin, will be clearing Euros, and that makes us quite attractive for European corporates that wish to do business in both the

UK, Europe and the United States, as we are able to deal with all three of those currencies. We're seeing some benefit come through there, and that's coming through to our results.

Jes Staley, Group Chief Executive Officer

We put up a fairly substantial technology spend, beginning in the end of 2017, to make sure we have all the payment pipes built across Europe so that we could expand our corporate bank platform from the UK to across Europe – and a lot of the deposit growth has come from that. We turned on Germany and France and Spain, etc. A number of corporates, many of them connected, obviously, to our franchise here in the UK, are running their transactions and cash management through our pipe. And that's been one of the biggest contributors to the growth in deposits, which has driven the transactions revenue in the corporate bank.

The other thing I would say is that we've actually been doing reasonably well in terms of growing our trade financing in the corporate bank as well, which has helped there. And on your first question, clearly, the risk-free rate would have an impact in the US, but I think all the European banks would love to have the same risk free curve in Europe.

Robin Down, HSBC

Can I ask you a variation on the question I asked you at Q119 about the consensus? It is 1st August now and you're still repeating the 9%-plus RoTE target for this year, and I think, as Tushar said earlier, consensus is obviously much lower than that.

When I look at the consensus, you have a very big, marked revenue decline, H2 on H1, even allowing for seasonality within BarCap. If that revenue decline came through, how much flex do you actually have on the cost line? Obviously, consensus cost now is slightly below the £13.6bn number already, but how much lower could you go? And if you could go much lower than that, would that come from the bonus pool or would that come from cutting back investment? I just wondered if you could give us some colour around that, and anything else you would pick out that you think we've missed in terms of your outlook.

Tushar Morzaria, Group Finance Director

I think obviously the market is closer to an 8% return and we still have a degree of confidence we'll get to 9% and better. I think we have a different shape on the income outlook, and I think that's the gist of your question – if income outlook is closer to the market's view relative to our view, what levers do we have?

But just to touch on income, if I look at half on half, I would expect UK income to be better. I guided to that. I would expect Consumer, Cards & Payments income to be better. I've also guided to that. Of course, we've got the redemption of the 14% reserve capital instruments that you're aware of – that'll drop out of Head Office, so that's a tailwind as well.

If you look at the pipeline that we have in our investment banking business, capital markets look pretty good at the moment. It's quite constructive. We've got a very good pipeline, and as Jes mentioned, we're in the top five in US in terms of Dealogic fee share, which is a really nice position for us to be in. In our sales and trading business, we've continued to gain market share steadily over the last half a dozen or so quarters. We probably have a different income outlook to you.

The other thing I would say is that – it goes back to the earlier question around sensitivity to currency rates – were sterling to remain weak, that is not necessarily accretive to returns, because our capital is

held in dollars, and you can see that in our tangible book value accreting, but it's certainly a positive for earnings per share. There's been quite a reasonable move in the cable, and that can only be helpful for us.

On the cost side, we've taken a bunch of actions already, and you saw that in Q2 numbers because of the headcount reductions Jes has talked about, as well as some changes to our physical footprint and deferral of some investments. I think we have good control of our ability to glide those costs. As you get later on in the year, performance costs, principally in the investment bank, become more and more important, and of course, that'll be linked to income performance.

Jes Staley, Group Chief Executive Officer

I'll just add two things. One, again, to underscore our commitment on the cost side and our focus on it. We as a management team took decisions early in the quarter to drive down costs in the second half of this year so we could land below £13.6bn. A lot of those cost decisions raised your costs in the second quarter, but that should underscore our commitment to use cost as much as we can to deliver that 9% return on tangible equity.

And you could also see from the financials that we published today, that our variable cost number, year over year, was down 18% in the first half versus the first half of last year. We are committed, as best we can and without putting the franchise at risk anywhere, to use the cost number and manage costs to deliver the level of profitability that we've committed to our shareholders.

Edward Firth, KBW

I just have a quick question on your Level 3 disclosures, which you very kindly enhanced on page 68. I just want to check that I understand them correctly. So if I look in your income statement, you've got around £700m of contribution from the valuation of Level 3 assets. So firstly, is that correct? Because that's obviously a marked change on what we've seen in the past. And secondly, what is driving that?

And related to that, in the table below – I guess we've talked a lot before about the asymmetry on your valuation of Level 3 assets – that seems to be expanding now even further. What are the key drivers in that? It looks like non-asset-backed loans is one part of that. Is that leverage loans or what are those in particular?

Tushar Morzaria, Group Finance Director

These disclosures, as you know, are quite tricky to work through. And the reason for that is Level 3 assets, of course, are just one aspect of the matched position. So you'll have, for example, long-dated fixed-rate loans. Now, obviously, we've had a big move in interest rates, so those customer positions, in and of themselves, revalue quite meaningfully. But from our perspective, they're hedged through other interest rate products that won't necessarily be Level 3 – well, actually, they won't be Level 3, otherwise they wouldn't be able to be hedges – that would revalue in the opposite direction. So it's really more a function of the very large movement in interest rates, through interest rate sensitive products, that are matched. I think there's nothing else cleverer than that going on.

Edward Firth, KBW

Is it not possible to give us some idea of what the matched move is?

Tushar Morzaria, Group Finance Director

The net move, you mean?

Edward Firth, KBW

Yes.

Tushar Morzaria, Group Finance Director

We don't do things on an instrument by instrument basis. These are portfolio managed positions and that's not how risk management tends to work for us. We have lots of interest rate risks coming from lots of customer-facing positions that are hedged with a portfolio of interest rate hedges.

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