Tushar Morzaria, Group Finance Director

Just a few points from me that hopefully came across clearly on the call last week. You’ll see our first half returns were above 9%, which is in line with our stated objective of 2019, although obviously the income environment has been quite challenging, and we do have more work to do in the second half.

With that in mind, we have lowered our cost guidance from between £13.6bn to £13.9bn to below £13.6bn. Obviously, there have been quite dramatic moves in foreign exchange rates that are still going on, and a weak sterling is beneficial to us. We have said we’d expect to be below £13.6bn at June month-end FX rates – we’ll see where they are over the remainder of the year.

You will be familiar with this but just to remind you of the history: if you look back, under Jes’ leadership our costs have been down in absolute terms every year – from £15bn to £14.2bn to £13.9bn, and now we’ll be below £13.6bn, while at the same time revenues haven’t changed that much - it has been hovering around £21bn. Hopefully that gives some idea of our ability to manage down our cost base while retaining the top line, and that’s what we intend to do, at least for this year.

On capital levels, we’re pleased with the outcome at the end of the second quarter, at 13.4%, which is comfortably above our stated objective of around 13%. Of course, you’ll all be familiar with the interim dividend of 3p that we declared, which in a normal year should represent about a third of the full year dividend. Again, looking at Jes’ history – he obviously cut the dividend when he first got here, so in the first full year he was here we had a 3p full year dividend. That was increased to 6.5p last year, and if you just do the maths, it should be somewhere around 9p for the end of this year, assuming this year is a normal year.

On diversification, hopefully we’re getting an important point across – 50% of our revenues are non-sterling, which is helpful given the weakness in sterling, as long as it stays orderly. And we are exposed to non-UK traditional banking segments, particularly in the US, in both consumer and wholesale, so we do think that provides us with some diversification benefit, as the geopolitical events unfold over the next couple of months here in the UK.

I also talked about the capital ratio for Q3, and there are some headwinds there. We obviously had a nice step up in the first half, particularly in Q2. Again, you will be familiar with it, but we do have an additional pension contribution in Q3, and we are redeeming three of our AT1 instruments. In and of itself, those AT1 calls will cost 13 basis points at current rates. Obviously we’ll be accruing at a higher dividend rate as well, so just bear that in mind as you do your own forecasts.

And then, finally, PPI. We did put it on the front page of our release, in my commentary area – although we haven’t had to reassess the reserve as we were adequately provided at quarter-end, we have seen a pick-up in claims in line with the industry, which will run through until the end of August. It’s quite hard
to see through all this at the moment, because a lot of the claims that have come in tend to be ‘no PPI’ claims, so the headline number of claims may be quite large, but you’re not really quite sure what the impact is. I’ve seen a couple of banks revise their PPI numbers, as they’re seeing elevated claims as well. We have about £400m left in our reserve and we’ll see where we go for the third quarter. I’ll pause there and open it up to questions.

Jenny Cook, Exane
My first question is on the mechanics of your RoTE calculations. In the scenario that you were in a position to do a buyback at year-end, would you consider aligning the regulatory and the accounting treatments?

Tushar Morzaria, Group Finance Director
Do you mean the pro-forma 13%? I think for the moment it’s not very different because we’ve been running at broadly around 13% at year-end and Q1. It hasn’t really changed much. I think if there was a big divergence – if we had a significant amount of excess capital, then we would report the return struck at a 13% CET1 ratio, but at the moment it’s not significantly different. It may be in the future.

Jenny Cook, Exane
What about the pro-forma TNAV?

Tushar Morzaria, Group Finance Director
When you say pro-forma, you mean if we did one later in the year would we average it over the course of the year?

Jenny Cook, Exane
Yes.

Tushar Morzaria, Group Finance Director
I haven’t really thought about it so sophisticatedly. I’m hoping that we get to 9% on whatever capital we are running. I think at the moment because we’ve been hovering around 13%, whether it’s dividends or buybacks, it’s not significantly different. I think we’re probably at a stage now that we ought to be generating excess capital more regularly, and we’ll retain that capital and distribute it. I think then your point is quite valid. We’d probably start giving you a pro forma calculation, explain how we derived that so you can see the transparency of it. So maybe as we go further into the back end of the year. At the moment, we do look at it ourselves and they’ve been very similar, which is why we haven’t stated a different calc.

Jenny Cook, Exane
Just on the change in EIR assumptions. To the extent that you had previously been assuming a couple of months reversion in customer behaviour at the end of the period, this makes quite an appreciable impact on the economics of some of your front book rates. I was just wondering, is this something that could potentially see you move your front book rates up in order to still hurdle the same returns?
Tushar Morzaria, Group Finance Director

It’s a good question and I might ask Anna Cross, who is here with me today. Anna is our Group Financial Controller, but she used to be the CFO of the UK bank until recently, so she’s much more familiar with this business than I am. I’d say pricing tends to be set at the margin, so it only takes one significant competitor to be disruptive and pricing will respond to that. I think for us, we will determine whether we can still achieve our hurdle rates, if there is a disruption and pricing does move. At the moment, certainly at current pricing, we’re comfortably above our hurdle rates, and have been for most of the time. We got very close towards the back end of last year, and at that point we would consider stepping away. Anna, anything you want to add?

Anna Cross, Group Financial Controller

Yes, I agree. The EIR adjustment is largely related to the stock of mortgages.

Adam Terelak, Group Mediobanca

You didn’t quite give us the detail on the dollar – or the non-sterling cost base last week, so I just want to run through the lines a little bit, and to understand where the flex is on the HoH cost base, and where the pressure will be coming from.

Tushar Morzaria, Group Finance Director

I think as we get further into the year, the level of choices we have diminishes quite rapidly, and variable compensation would be left as the most significant choice. We made a number of decisions in the earlier part of the year, looking at the income environment, and the product of those decisions is that we’re guiding on a currency neutral basis, if you like, our costs coming down. And that’s a combination of some investment decisions that we have reprioritised, slowed down, deferred, and some reductions in headcount. We’ve made over a 3,000 reduction in heads. Obviously our variable compensation will track income, so if that’s weaker we’ll track that commensurately.

I think we have had the question, and I understand why you would find it easier if we just give you the cost split by currency in the same way we’ve given you the income split. That’s something we’ll consider. I think the average cost income ratio is probably not a bad proxy – it won’t be exactly accurate, but I don’t think you’d be significantly off, if you’re trying to get to some kind of sensitivity. We will update you at Q3, as we’ll have another quarter’s worth of foreign exchange rates then, and we’ll let you know what that’s telling us.

Ed Firth, KBW

Can I ask about the hedge? There seems to be some divergence in the sector – some people are renewing it, and some people are not. I guess you’re in the renewing camp, and I’m just trying to get a feel for why that is, because the yield curve is pretty strongly inverted now, so you’re sort of locking in losses that you were previously looking to hedge against. How are you thinking about it, and how might that change over time? Because with five year rates at about 30bps, I’m not quite sure what scenario you’re hedging against.
Tushar Morzaria, Group Finance Director

As a bank, and myself in particular, we’ve never been keen on actively trading the hedge. I don’t have a conviction on rates – I’m in the wrong job if I can forecast the rates markets. On top of that, I think if you’re very actively managing the hedge, the PRA – at least in my experience – would see that as us doing something more than income smoothing, and that would require some capital treatment, which may make that active management sub-economical, even if you were perfectly forecasting the outcome of rates.

We’ve just been running a robo-hedge, if you like, and it’s been very profitable for us so far. I’m sure there will be times where locking into lower rates is going to cost us some money, but so be it. Our objective here is really just to smooth our income and provide some certainty to our income profile, rather than trying to be too clever and run an active rates management desk. Some banks do, and if they’re good at it, good luck to them, but it’s just a decision we haven’t made.

Ed Firth, KBW

I can see that in the normal world, but obviously if five-year rates go to zero, there’s no point hedging bets because you’re not hedging any losses.

Tushar Morzaria, Group Finance Director

Who knows where the rates will go. Maybe rates will go negative, who knows? Look at Germany – the ten-year rates are at negative 50bps. I think with these things you’ve got to be a bit careful and not try to be overly clever. I’ve been around trading floors a long time, and people that look good in one year don’t tend to look good in the next year. You might feel you’ve hit something and then it turns out you get it wrong next time around.

I think the bigger thing that we as a bank spend a lot of time thinking about is the duration, and we would infrequently rebalance. We run a shorter duration in our product hedges than our equity structural hedge, and that feels right to us. I think if we had a very strong conviction that rates are going to be lower for longer – not literally at zero but at a relatively low level, you’d be tempted to go for a longer duration to pick up any yields. But, again, we would do that infrequently, and we’d have to have a relatively strong conviction. That would be in our equity hedge rather than our product hedge, where we would always run a much shorter duration.

Guy Stebbings, Exane

Thank you for your disclosure on some of the RWA headwinds on the regulatory side. On the SA-CCR, what’s happening on the leverage side? I think you said it was only a modest benefit in terms of the offset on the leverage exposure. What would be the dynamics there? And then just to check, one headwind that you didn’t quote was FRTB – presumably that’s just the timing, as it’s further away and you don’t think you can give guidance at this point, rather than because it’s less significant, but any colour there would be very helpful.
Tushar Morzaria, Group Finance Director

On SA-CCR, we’d have a slight pick-up in risk-weighted assets but a benefit in leverage, which is to do with the PFE treatment. I think that comes in 2021. It’s modest, but it is something and it’s not like you can ignore it. I don’t want to quote a number, I didn’t quote it on the call, but it’s not a game-changer. It’s not something that’s going to dramatically improve our leverage ratio, but it is helpful with capacity.

On FRTB, at the moment it’s a disclosure-only requirement in CRR2, so it doesn’t go into Pillar 1. That may change under CRR3, or indeed the PRA may choose to include it in Pillar 1, using their national discretion, but I’m not aware it’s something they want to do at the moment. I think CRR3 still feels quite far out on the horizon. As I understand it there isn’t a legislative package out there yet. We might get one this year, and it takes one to two years to go through the legislative process, which is usually one to two years before they are applicable, and there will possibly even be a transitional period. That feels quite far away.

I think the first time I gave guidance on FRTB was 2015. It feels like it may not go into Pillar 1, certainly in my lifetime – I hope so anyway. But it does feel a few years out. I can completely understand why people want to have a sense of what they are, but it changes so much, and it hasn’t gone through the legislative process yet, and it may change again.

The other thing I would say is that given enough notice, banks have got pretty good at managing their businesses to absorb the impacts by doing whatever they need to do – reposition the business, changing the business, whatever. I think we’ll see something similar. Given plenty of notice, banks have a reasonable track record of coping with these things reasonably well. So it’s not something that’s big on my worry list for now.

Chris Cant, Autonomous

Could I ask a couple of questions on costs? First, when I look at your bonus accrual for the current period it’s down quite a lot year over year, and obviously one of the national newspapers picked up on it yesterday. Can we infer anything about your revenue expectations from that? How does that accrual behave? Is that an accrual just for the first half, based on first half revenues, or is that an accrual based on the way you expect the full year to be? I’m just thinking about whether that behaves linearly as we progress, assuming things are exhibiting normal seasonality.

And, secondly, on the headcount reduction you flagged on the call. When I look at your restructuring charges and the breakdown of expenses, it was fairly flat year over year - there was no obvious change. I think it was about £50m, from memory; it doesn’t look like there was a restructuring charge in relation to those 3000 heads. Is that something coming in the third quarter, and should we expect a restructuring charge? And is that within your cost number, or are you going to be putting that below the line?

Tushar Morzaria, Group Finance Director

So, in the order you asked; on the bonus accrual, it’s as much an art as a science, because although we have an approach to accruing that somewhat starts with a formula and then we apply some judgement over it. Ultimately what you’re trying to do is not only reflect current income performance but also your outlook for full year compensation, and that’s where the art comes in, because obviously there’s a degree of unknown there. And the degree of unknown is not only in our own top line, but also market forces. We just need to be sensitive and make some decisions thereon.
If the gist of your question is whether there is some sort of accrual catch up, I would say that one of the things that we looked at very closely in the first half in the CIB when making those remuneration accrual decisions was the returns. It was important for us that the CIB generated a return of >9% in the first half of the year. And we were very transparent with the management of the CIB that that was an important objective for the first half of this year. That’s not necessarily a statement of where I think – and I don’t want to give guidance on where I think the CIB will get to, but hopefully this gives you a sense of how important it is for us as a management team to balance shareholder returns, as well as employee returns from this year and onwards. If you look at our returns historically, shareholders haven’t really got much of a return relative to employees, and I think we’d be interested in rebalancing that appropriately this year and beyond.

On the headcount reductions, there were some restructuring charges, but there is no restructuring charge to come in the third or fourth quarters. We’re not planning to have any, but to the extent we have any we will not put it below the line, which is something that Jes in particular has been very forthright about. It’s an 80-plus thousand person firm, so attrition will always just happen in the regular way of business. It was very much about letting headcount reduce through natural forces and not hiring back to replace, which has been quite a successful thing for us, and we’ll see where that goes in the second half of the year.

Chris Cant, Autonomous
Is that a conscious decision to have some kind of hiring freeze in place?

Tushar Morzaria, Group Finance Director
Hiring freeze is probably not really the right way of doing it; it’s about being disciplined and making sure that we’re only really hiring for roles that we really need, given the income environment. So we have been hiring, but it’s very, very selective.

Andrew Coombs, Citi
On the breakdown of the 3,000 FTE reductions – you said it was broad-based and across divisions. It would be useful if you could provide a little more colour there. Secondly, in terms of the growth and investment initiatives that were out there – is it a case that some of those have been shelved – or at the very least postponed – in order to save on costs? And in the press there are some headlines around some new initiatives you had in the US – could you elaborate a bit more?

Tushar Morzaria, Group Finance Director
It was broad-based around the divisions. You have a lot more people in our UK bank, just because of the nature of the business – call centres, branches etc., but they are relatively less expensive than the folks in many parts of the international bank where headcount is proportionally lower, but much more expensive, so sometimes the quantum of headcount doesn’t tell you where the impact is most felt in terms of the financials. I would say that the numbers are probably bigger in the UK, but the financial impact is probably more evenly spread.

In terms of the growth initiatives, we’ve been open about having slowed down and deferred the US digital bank. It’s something we’ve talked about in the past, where we have a reasonable revolving credit card business, but we don’t do much else beyond that. We do have aspirations and ambitions to do something
beyond that, but that has always been a medium, multi-year growth initiative, and that’s something we have slowed down and deferred. I don’t think it would necessarily affect this year’s financials. It probably wouldn’t really have affected even next year because by the time you’ve switched the product on and then grow it, you’d have the usual J-curve. It’s a multi-year thing – at some point we’ll switch it back on and we do feel that it’s the right ambition for us, but it’s not time-critical when we do it. That’s one example, and we’ve also taken some decisions around things that are probably less headline-grabbing and more local.

Andrew Coombs, Citi

In terms of the broader expectation for the US business – you’ve had a change in management as well in US Cards. The growth has remained around 6%, which is respectable, but your previous ambition was 10% - should we expect mid-single digits going forward?

Tushar Morzaria, Group Finance Director

I think so, yes, for two reasons. One is that the 10% is still achievable, but you’ve got to do it at the right time. Although we’re very constructive in the US, I think it’s a record expansion now – I think in July it’s 120 months, that’s a record. So who knows when the end of it is, and there’s the US presidential cycle next year, so who knows where all of this goes? 6% does feel like a nice place to be, given those dynamics.

The other thing that’s been good for us in that business is that most of our growth has been coming from our airline portfolio, which is pretty high quality – the FICO scores are well into the 700s. It is a lower margin business, but it has very good risk-return characteristics if you believe it’s time to be a little bit cautious. Our sense is that US growth is probably fine for a while yet – it’s just when you get to the other side of the presidential cycle, that’s probably when there’s a high degree of uncertainty. And in the consumer credit business, late vintage lending is always where pain can be felt, so at 6% with high FICO scores feels about right at the moment. And we’ll stick to that until we have more conviction on where the credit cycle may be going.

Jason Napier, UBS

The IFRS 9 experiment continues. I guess what investors really want to know is if we have a no-deal Brexit, what happens to the bad debt charge in Q4? The sensitivity analysis in the AR suggests that the move to downward one scenario is only £150-160m, and you’re carrying £150m of management overlay. What do we tell them?

Tushar Morzaria, Group Finance Director

Again, I’ll ask Anna to comment on this as well – in her Group Financial Controller role she’s all over it. I think the one thing that the downside one scenario picks up is the re-mark-to-market of the ECL stock. On a different scenario you’ve got that as a baseline and that is what it is. It’s not as big as what most people would think – they’d think ‘shouldn’t this be super pro-cyclical and things would be more painful?’ The answer is yes, but it becomes more painful in the tails. For the localised moves, IFRS9 isn’t as excessive as people may have once considered. The tailwinds are enormous; if you look at stress testing, Bank of England published stress test results and I think our drawdown on that was £16 billion in one year. Now those use a funky methodology where they pull everything forward, so that’s probably a bit fictional – works for stress testing, but it’s unlikely to be replicated in a real-life event. But you can see how dramatic it is if you go into the tails, and how big those losses are. And things like the mortgage
business, for example, exhibit virtually no stress until you get into the tails – then your collateral levels go below your loan values and the pro-cyclicality starts ramping up losses very significantly. I think the other thing that it doesn’t necessarily pick up is the actual experience; so that’s the re-mark-to-market of the ECL, but you’ll probably have a lot of migrations out of stage one and two into stage three over the course of the period after that. I think that will be additive to that.

I think we’ve got to be a little bit careful with the downside one scenario, which is too localised and probably doesn’t pick up all the effects, just by the nature of the way the maths works. Anna, anything you want to add on that?

Anna Cross, Group Financial Controller
No, not at all.

Jason Napier, UBS
It certainly seems obvious that the migration through the stages that kills you in a stress test is just a bit of a nonsense. But as management see things at the moment, in the event that a no-deal Brexit were to happen, nothing happens in the economy other than the consensus GDP forecast?

Tushar Morzaria, Group Finance Director
I think that’s right. If it’s no stress in the economy – just GDP assumptions revised down and unemployment revised up, that’s a reasonable proxy in that scenario. If that transmits to real stage migration, then the numbers start building up beyond that. I think the one thing that may be misunderstood is that IFRS9 doesn’t react instantaneously. It only reacts instantaneously for change in scenario, but then the experience starts happening. And the jumps between stage one and two are super-sensitive, so although it won’t happen on day one, it will be pretty shortly thereafter, so Q1 and Q2 if there is stress. That staging migration will happen in quite a size and will build up very rapidly.

James Invine, Societe Generale
Tushar, on the call you mentioned the success that you’ve had with your Dublin business and how you’ve enhanced that. I was just wondering if you could say a little bit more about that please. Is it existing Group clients that are now using more services, or is it new clients that you’re bringing in – if it is it could indicate that maybe you’ve got a bit of a longer runway with this business, and we could see it as a source of growth over the next few years.

Tushar Morzaria, Group Finance Director
Yes, it is new business, particularly European corporates. The question is, for those companies that have a nexus around sterling, euro and dollar – could we be one of the corporate banks of choice? In the UK we’ve probably got a differentiating factor against some of our peers. It is new business and we’re quite excited about it, which is some of the by-products of having to do all this work for Brexit.

One thing I would say, which is noticeable and you’ll see this, is that we are awash with liquidity. It’s a great business because people are leaving cash with us. I think the real trick for us is to convert that into a fee stream as well. At some point, hopefully, people will have an appetite for assets and then liquidity coming in can be lent back out, and that’s the best business for us to be in. But it’s a question of returns.
for now – converting those deposits into a fee stream, or indeed lending them back out. That's the next stage in our project. But the inflow of cash has been very positive and it’s mostly new clients.

Robert Sage, Macquarie
You’ve given a breakdown of your net interest income on page 22 and one of the big movements in the first half versus first half is the other interest income. It was -£635m last year and -£236m this year. I was just wondering what is driving that and how we might think about that moving forward.

Tushar Morzaria, Group Finance Director
I don’t think there is anything significant that I would read into. There is nothing significant I would call out there.

I think we're trying to be more directly helpful rather than getting into the individual job fit. I would say that if you go around the houses, there are three interest earning principal businesses, you've got the UK Bank, the international bank and the CCP segment.

I would say for BUK I'd expect income to be higher in H2 versus H1. I expect margins to be broadly stable. I can elaborate on that, although I think most people have probably heard my comments on that on the call. In the commercial bank, deposits have improved. We've seen a 10% year on year improvement in commercial deposits. All things being equal that ought to lead to interest income benefits into the second half, although that's a little bit more subject to the rates environment, because they're more floating-rate in nature. And consumer cards – particularly the US card business – I would expect continued growth in income on the back of balances going up. So hopefully that gives you some sense of what to expect in H2 rather than double-clicking on the individual accounting line items.

Guy Stebbings, Exane
I think there was a pick-up in intangibles in the second quarter, having fallen slightly in Q1. I think FX was part of the impact – obviously the US dollar intangibles are growing. Can we think of that as the stock of intangibles growing, or was it new investment into the business?

Tushar Morzaria, Group Finance Director
It’s a bit of both. Some of you may have written about a perpetual build-up of intangibles that will be amortised back in and be an EPS headwind in the future, although it doesn’t necessarily impact capital. I don’t think that’s a significant issue for us. I think we’re broadly in balance now. Further capitalisation and amortisation are broadly in sync, so it’s probably just the FX effects and minor effects, rather than a significant build-up of future amortisation that hasn’t come through yet.

Ian Gordon, Investec
Can I just check my understanding of your answer to Jason’s question? So we get what is the so-called negative scenario. Your broad guidance is what the observable Q4 impact might be - in the grand scheme of things, relatively modest - and then if it actually plays through to reality, that will be much more significant, as the stage one, stage two migration happens.
Tushar Morzaria, Group Finance Director

That’s exactly right. An alternative outcome could be GDP and unemployment revisions happen as a macroeconomic forecasting matter, and at the same time you’re getting a lot of data migration. It’s usually sequential, but it could happen at the same time. The only thing I would re-emphasise is that £150m ignores the sensitivity for staged migrations, which, if those forecasts are real, will happen and will add to that number.

Ian Gordon, Investec

And then just on the capital story – you flagged the greater dividend accrual in the second half. Is the maths as simple as assuming that it’s 3p/6p, and the accrual is double in the second half?

Tushar Morzaria, Group Finance Director

Under normal circumstances, approximately.

Ian Gordon, Investec

And then just in terms of the context, you have a situation where you’ve once again given pretty robust returns guidance. The market currently doesn't believe it, therefore other things being equal your shares will be below your view of fair value.

In that context, the judgement to put your excess capital to work through dividend rather than buyback at this stage just seems to be sub-optimal. I don’t speak to too many people who are buying Barclays as a yield stock. So it just feels that you’re not getting full value.

Tushar Morzaria, Group Finance Director

Again, it’s a very good question and it’s something that we spend a lot of time as a Board considering. The way the Board thinks about this is that first of all, you need to understand your ordinary dividend, because that’s a sticky, perpetual distribution. Only once you’ve established what you think that is do you really know what excess capital you have. And then you either retain it, invest it or distribute it back out.

So we’ve made the first determination. Again, the quantum here isn’t hugely significant, whether we end up paying an 8p dividend or a 9p dividend. A pence on a share is c.£170 million and that’s about five basis points. It’s much more of a signalling effect, but the capital effect isn’t so significant.

Hopefully the statement of increasing the interim gives some reassurance to the outside world that at least the Board have some visibility of the earnings, and we expect that dividend to be comfortably covered and sacrosanct from that point on. We have reaffirmed a progressive dividend policy. We’d only expect it to drift upwards rather than being downward revised and then upward revised. That is not the expectation of our dividend path. It will be drifting upwards. So the Board would have to have a high conviction in the capital level, and the dividend has to be absolutely sustainable under virtually all scenarios. Hopefully that provides some reassurance, and that’s exactly how the Board thinks of it.

And then you’re left with a flow of excess capital – around 40bps at the quarter end – which will be stage two of that decision.

Now, the challenge with stage two of that decision is that we have geopolitical events to get through, so we need to really understand what that means for us, and whether there is some pro-cyclicality of risk weighted assets, and what opportunities it may threaten. It’s going to be an uncertain two or three
months, so holding on to that capital for that period of time seems like a sensible thing to do. I think once we're through that we'll at least have some clarity of where we're going, and I think you will see us decide what to do with it.

One of our strong objectives is to get capital back to shareholders' hands, so I don't think you'll expect to see us reinvest that back into the business, certainly not at that quantum. That is quite a lot of capital for us to be wanting to reinvest back into the business, so we would like to get that back into shareholders' hands at the right time. The other thing going on in Q4 is the stress test. That alongside geopolitical events probably makes us want to hold on to that for a bit longer.

Ed Firth, KBW
Can I ask you about the 9% returns target? I guess my question is more about to what extent you're concerned about some of the actions that you're taking in order to deliver that, because I can see that you're a bank – you can make 9% if you want to, that's possible, you can sell off some loans, etc.

If we look at bonus accruals, they're clearly at the threadbare end. You're talking about cutting investment. I get what you're saying about your view that a digital bank in the US is not urgent, but a very small competitor of yours is already kicking off there, so arguably in a year's time it's not going to be the same market that it is today. I'm just wondering, how do you think about that internally? Is that something you worry about? And should we be worried that whilst you can pay low bonuses this year, the best people will all leave next year and that will have a knock-on effect going forward?

It seems to me that with the revenue environment that you're facing now, I would have thought banks should be looking to invest as much as possible, because you've got a whole host of restructuring in terms of the cost base that you need to do to get into a world of low interest rates, more competition, low barriers to entry, etc. It seems to me that it could be a mistake just to hit a target you happened to give us two years ago, and you might be making some decisions that are perhaps sub-optimal.

Tushar Morzaria, Group Finance Director
Yes, it's a fair challenge and it's something that we talk a lot about as a Board and in Exco. I wouldn't put the targets as come hell or high water – we'll do the right thing for the medium term. One of the things that perhaps is less obvious is that the management of this company is completely tied into the long term – probably longer than most shareholders. Someone like Jes and myself will be owning Barclays shares probably for the best part of a decade, as will other members on the executive committee who are making these decisions with oversight from the Board. We definitely take a multi-year view, and really our objective is to be stewards for the company for the next management team that's managing the bank after we're long gone. That's probably when we'll be in a position to start liquidating our shareholding. That's actually much more important to us than whether we make 8.5% or 9.5% return.

I think when you're talking about decisions around variable comp, it's easy to say everybody is the same type and they are all going to go somewhere else if there's a better deal. I think that comes to the skill of management, and I think it's incumbent on us to be able to manage through situations where we may not be the best payers in the industry, but we are able to retain the right people for the right reasons, and work on the culture of the place. I think one of the lessons we learnt from the last crisis was that the culture got completely out of whack, and monetary rewards were really what a lot of the staff in banks unfortunately were motivated by, rather than other things. I think Jes particularly has spent a long time in
the company repositioning the culture, so that there's a different proposition for the people that work here and the different types of individuals that enjoy being here.

With the investment decisions, you’re absolutely right. We’re very cautious where we change the pace of investment, and we're not damaging the medium and longer term prospects for the company. I'll give you a good example where we probably wouldn't take any risks – and that's cyber security. That would be an easy thing to cut. It's a lot of money we spend on cyber. I can see your point that it would make it dead easy for us to get to 9%, and I would have a much lower cost target, but it would almost be committing suicide within 12, 18 months. You'd be really damaging the place. We are very cautious on ensuring that we are only taking decisions around things that are less time-sensitive, and that we’re all locked in for the long term. It’s very difficult to be short-termist in that regard, and none of us are incentivised to do so. And then of course, we have a Board that looks at what we’re doing very closely.

Ed Firth, KBW
But if you look at some of the digital banks, they’re talking operating cost of about £15 a year for a current account. I don’t know yours precisely, but if I look at some of your peers, they’re probably about £150. Now I don’t know where the centre point is, and you’ve obviously got incumbency and all those advantages, but that is a monstrous challenge at some point in the next ten years. I’m not trying to pick on you, but I don’t see anybody spending the amount that I would have thought was necessary to get anywhere near dealing with that challenge.

Tushar Morzaria, Group Finance Director
Let’s see how the world of fintech plays out. We’re not naive to that. Obviously there are some very nimble competitors that can do things in a way that we can’t, but at some point they will become bigger companies and they will probably have some of the challenges that bigger companies face. At some point they'll have a degree of regulatory scrutiny that will be important to them, and they'll be attractive to cyber criminals. I think they will have to grow in the right way as well.

I think one of the things that we've learnt from the last crisis is that the regulators are particularly attuned to folks that grow very fast and start becoming important stakeholders within the financial infrastructure. They will get an awful lot of attention and they will need to be able to deal with that. And that starts levelling out I think. It's easy to be dismissive of the quality of the bank's technology and what we're able to do. I still go back to some of the things that this country did with its banking system. I think most people just don’t understand how catastrophic it would be if there was even one mistake. During ring-fencing, most banks literally turned off their banking systems for multiple weekends at a time, which is a huge open door for fraudsters. Virtually every customer in this country was touched in a way – but they probably didn’t even realise it as things were repointed and virtually seamless. No one realised it.

I get your point about structural cost. It’s something that big companies have, and there are things that they have to be very mindful of that smaller companies do. As smaller companies grow they’ll have to get good at that stuff as well.
Jenny Cook, Exane

I just want to ask on the pensions, because I believe the triennial is on the September-end balance sheet. I just want to ask on the mechanics of when those negotiations with the trustee happen, because potentially you’re looking at negotiations happening at the worst period. I just want to understand when some of those parameters get set, such as the discount rates, etc.

Tushar Morzaria, Group Finance Director

Yes, it is at September-end. With all these things there is no formula behind it. They will appoint their own actuary, we will appoint our own actuary. It’s remarkable how different opinions two actuaries can come to on the same set of schemes.

We then get into a negotiating period and figure out what we think is the appropriate compromise, in terms of surplus/deficit and the funding schedule behind it. Although you’re right that the rates environment isn’t particularly helpful as a technical deficit matter, it’s not as mechanical as that. A lot of the sensitivities are actually forward projections as much as they are the spot environment. Fatality assumptions and those kinds of things are also just as relevant – although I’m not an actuary, and there can be lots of discussions over that.

The final comment I’d make on pensions is that we don’t know what it will be at September month-end, but the deficit that we had at the last triennial was substantial; I think it was about £8bn back in September of 2016. I think the last time we reported it was £4bn or so, and since then we’ve made some further contributions. You’ll see asset prices have improved, the rates market probably hasn’t improved, mortality probably hasn’t made the deficit any worse, so there’s a whole bunch of opposing factors. It’s been a very meaningful step down, at least from the last reporting, so we’ll see where we go with the negotiations.

Chris Cant, Autonomous

Could I just follow up on the £4bn numbers you just gave us? If I just think very, very crudely, and I appreciate there are multiple factors at play, but between the £8bn and the £4bn number, the 20 year gilt rate went up quite a lot, and we’ve round-tripped all the way back down to where you were at the last triennial in September 2016. So are you really trying to suggest that the £4bn number will be smaller because of the contributions when we get to September? Is that what you were hinting at? It does seem quite optimistic.

Tushar Morzaria, Group Finance Director

No, definitely not. All I’m saying is there are loads of different factors – contributions, gilt rates, inflation assumptions – a whole group of things have changed. You can imagine how complex these actuarial forecasts are with the number of sensitivities you need.

Chris Cant, Autonomous

Ok. I just wanted to make sure I wasn’t over-interpreting your comment, which I clearly was.

Op risk RWAs is something we haven’t talked about today. Am I correct in getting a sense that you’re slightly more optimistic on this than your formal statements imply? You said this is going to go to Pillar 2A – that’s the working assumption, and therefore there’s no net reduction in capital required for the Group. But if I think back to what you were saying at the time of the Q1 breakfast – I’m paraphrasing
clearly – ‘it feels a bit unfair that op risk hasn’t changed during my entire tenure as CFO’. Are you expecting some of this to just disappear? Because when I look at what’s happened in terms of your operational risk allocations to the operating divisions for the last four, five years, you’ve allocated basically the same amount to the operating divisions over time, and all that’s happened is op risk that used to be in non-core now sit at Head Office, and obviously those assets are gone. So either you’re misallocating operational risk to your operating divisions, or some of the operational risk should just disappear. Do you really think that the regulator is just going to shuffle it all into Pillar 2?

Tushar Morzaria, Group Finance Director

It’s for the regulator to determine. We are discussing with them and it’s not fair for these discussions to be public. The point we’ve made all along is that if we were treated in a way that was consistent with other banks. And we believe the amount of Pillar 1 operational risk that we’ve allocated to the divisions is the amount of Pillar 1 operational risk that the Group should have – the regulator can do various things if they choose to keep total operational risk capital consistent. One could be to put it in Pillar 2. They could change the PRA buffer. There are various approaches that the regulator can take, and that’s up to them to determine. We just want a consistent Pillar 1 treatment. That’s all we’re really asking for, and we’re having a dialogue with the regulator. We’ll see where it goes.

Andrew Coombs, Citi

On the equities business, in light of Deutsche Bank’s decision, I’m just interested in how you conceptually think about the business. You gained a lot of market share last year; you’ve given some of that back this year. It’s very difficult to see how your equities business is profitable on a standalone basis. Do you think about it holistically and what value-add does it provide to your fixed income franchise or corporate bank and so forth? Or do you assess it on a standalone basis?

Tushar Morzaria, Group Finance Director

We think about it holistically. In my experience it’s very hard to have a profitable standalone secondary equities business. I think it has to be co-joined with the primary business as well. That has been my experience in the industry. So we look at it holistically in that respect. If you’re trying to make a living in just secondary sales and trading, that’s hard in equities unless you’ve got a primary calendar alongside it.

You can make the same point for fixed income sales and trading and debt capital markets in my view as well. In times gone by you could just be a strong trading house and be a counterparty, because you could do proprietary trades, you could do long-dated structured derivatives… but you can’t really do those things now. So I think if you don’t have a good primary calendar it’s very hard to exist on secondary activity only. Beyond that, of course there are interconnections, particularly within the other parts of sales and trading, and certainly within M&A and various things like that. So we do look at it holistically.

We didn’t really have an equities business until 2010-2011, so we haven’t been at it that long. We need to make it more profitable and generate better returns, but it is a profitable business. That’s a good place to be at the moment, and one of the things that we are keen on improving is our prime offering in our secondary sales and trading activity. I’ve probably said this a number of times here; I’ve always felt we’re a bit underweight in prime. The reason why I think prime is such an important part of secondary sales and trading is that it’s the one business that is very annuity-like and it’s repeat business. It’s a net interest income type business. If prime revenues contribute a meaningful percentage of your reported sales and trading line, that becomes a much more stable outcome, and it’s very high return on risk weighted assets.
but it is a leverage hold so you've got to balance it out with corollary business elsewhere. I think progress there has been quite good, particularly under Steve Dainton – and Tim Throsby before him. I think the prime business and the prime balances have improved nicely.

The other advantage of the prime business is if your prime has enough of the right type of asset managers, they will participate in your primary calendar, and that's a nice small virtual circle. If you've got the right clients in your prime platform, you're much more attractive to primary issuers of equity – because you have the investors lined up who will participate in that offering. And I think we've made good progress on that.

We've always been relatively weak in ECM and relatively strong in DCM, relative to some of our US peers. I think you saw that in the first quarter where DCM wasn't such a great period, so there wasn't much leveraged finance activity as a relative matter. It was more of an equity market, and our fee share did okay for the first six months. So these investments are coming through. That's how we think about it.

Raul Sinha, JP Morgan

Going back to the transaction bank, it was up by 6-7% on the last quarter. And if you look at the quarterly progression within the transaction bank, it's actually surprisingly positive growth given what rates might be doing. Could you unpick that performance for us a little bit?

Tushar Morzaria, Group Finance Director

Yes, some of it comes back to the point about liquidity attraction – some of which is from our Euro business. Commercial bank deposits are up about 10% year on year. Corporates are leaving a lot of cash on the sidelines, and it's a reasonable business for us. Hopefully at some point they will put that money to work and borrow from us – which is even better, but the real challenge for us is to convert that into a fee stream – from things like actual cash management, rather than just holding on to their deposits. We would like to be running their payroll for them, working capital lines and those kind of things.

So I think it's very much just liquidity coming into the company, but it's good because having new customers wanting to put liquidity with us is a terrific opportunity.

Raul Sinha, JP Morgan

So there is no funny in there. Can I check if you track the market share within that business?

Tushar Morzaria, Group Finance Director

We don't have great stats on market share on that. I think in the UK ourselves and NatWest are probably the largest corporate banks. Coalition does do something on corporate banking but we don't have a lot of market share stats unfortunately.

Guy Stebbings, Exane

I just wanted to come back to Barclays UK and the margin outlook. In the last quarter you called out certain headwinds that are not one-off in nature – there's the mix effect, and the structural hedge is probably going to be a headwind going forward. How should we think about how you could deliver
stability in that division? What are the offsets to those dynamics? I saw that you’ve increased high LTV lending in the first half. Did that make much of a difference?

Tushar Morzaria, Group Finance Director

Not so much. We have a little bit more buy-to-let but it’s not significant. You’re right about the structural hedge. The structural hedge is a very slow moving animal. Income impact is only £50 million next year, because like I said in the earlier question, we are just rolling these hedges, and it’s not much of an effect in the first 18 months or so.

I would say the card balances dipped temporarily. I don’t know if you will see that dip again. They might even start creeping upwards very slightly again. In the mortgage business I think margins have widened towards the latter part of the quarter, and it remains to be seen if they stay there. The mortgage rates haven’t fallen in line with headline rates. Someone could come and disrupt that and put pressure on the front book margin, but at the moment I think everybody is holding their nerve on that – and we certainly intend to. I think with that, from what we can see and where the stock of business is, I think it is reasonable to forecast stable margin for the rest of the year.
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