Lloyds Bank – AFM Conference Feb 2013

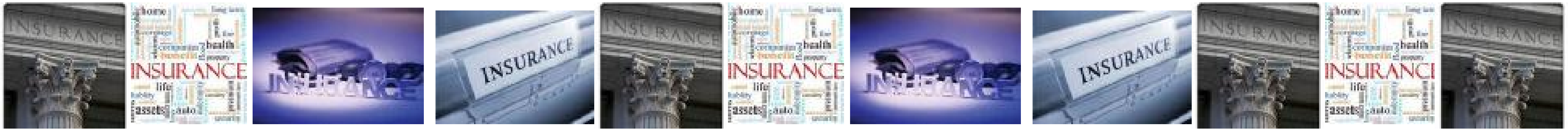
Presenters: Bill Cooper, Marcus Coverdale & Ingrid Hammond

Introduction

- Lloyds Bank - Introduction
    - Our strategy is client centric with a strong focus in supporting the UK economy

- The Insurance Industry is at the centre of our strategy;
    - Britain is home to the 3rd largest insurance industry in the world
    - The Insurance Industry is a key enabler of economic growth

- Topics that we think are relevant to the Mutual sector
    - Retail bonds – can they suit the Mutual sector?
    - With profit funds- regulatory reform & risk management



Focus on: UK Retail Bond Market

UK Retail Bonds

London Stock Exchange ("LSE") created the Orderbook for Retail Bonds ("ORB") to open up the bond market to retail investors

The Market

- The LSE launched the ORB in February 2010 to provide a framework of pricing transparency for retail investors, with the aim of increasing retail participation in bond transactions.
- Since the launch of the LSE's ORB, over £3bn of retail bonds have been issued by 15 borrowers.
- Lloyds Bank has been actively involved with the development of the UK retail bond market and in 2010 issued the first broker distributed transaction .

What could this mean for the mutual sector?

- The bond markets can provide a source of hybrid funding to support regulatory capital requirements
    - Particularly useful where equity capital is constrained
- As investors seek out yield, subordinated debt hybrid capital structures may soon make an appearance in the retail bond market
    - 10yr bullet
    - 10NC5
    - 30NC10
- The retail bond market supports much smaller minimum issue sizes than the institutional bond market
    - Minimum issue size of ~£50m rather than ~£250m
- Mutuals benefit from strong brand recognition and the rationale for the capital raising will be well understood by the investor base

Retail Bonds vs Institutional Bonds: What's different?

Just like institutional bonds, retail bonds are tradable debt securities. A few tweaks to the execution and bookbuild process facilitates the marketing of these bonds to retail and wealth managers.

Feature	Institutional Bonds	Retail Bonds	*Deposit Accounts*
Denominations	Minimum £100,000 with £1,000 increments (No maximum)	Minimum £1,000 with £100 increments is typical (No maximum)	*Typically ~£500 (sometimes have issuer imposed limits e.g. £10,000 min)*
Bookbuilding Period	Launched & priced in the same day	Typically a 5-10 day bookbuilding period	*No limit – until target size reached*
Pricing	Priced in the hours after bookbuilding period	Priced before bookbuilding	*Priced before bookbuilding*
Pricing Convention	Priced (floored) to nearest 1/8th of a percent	Priced at Par with coupon rounded to nearest 0.1% or 1/8th of a percent	*At issuing bank's discretion – typically with coupon rounded to nearest 0.05%*
Settlement	Settle via Euroclear / Clearstream	Also settles via CREST	*N/A*
Documentation	Standard EMTN	Additional disclosure – PD compliant prospectus with additional risk factors	*Standard retail deposit terms & conditions*
Listing	LSE Regulated Market	LSE Regulated Market & LSE Order Book for Retail Bonds	*N/A*
Trading	Over the Counter	OTC & via ORB	*N/A*
Distribution	Bookrunner: 1 or more banks	Bookrunner: 1 or more banks Authorised Distributors: Retail Brokers	*Via the issuing bank's website / branch network (if applicable)*
Tenor	Typically 7 to 15 years	Typically 5.5 to 10 years	*Typically 1 to 5yrs*
SIPP / ISA Eligibility	If years to maturity is greater than 5 years at time of purchase	If years to maturity is greater than 5 years at time of purchase	*N/A*
FSCS Guarantee	N/A	N/A	*Up to £85,000 (Sole account)*
Investor Tax Payment	Gross	Gross	*Net*

The UK Retail Bond Market

Development since the launch of the LSE ORB system in February 2010

Market Background

- The second half of 2012 saw significant volumes of new issuance in the UK retail bond market with over £1bn of supply
- Yields on 'high street' savings products continue to fall. With Gilt yields near all-time lows, many retail investors have turned to fixed income credit products
    - LSE Group's £300m 4.75% 2021 transaction pushed boundaries in the retail space with regards to size, tenor and coupon
    - A number of property companies issued deals in H2. Despite murmurs of 'investor indigestion' these largely continue to perform
    - Interest from corporates continues to increase, leading to a healthy pipeline into 2013
- On 26 November, the Stobart Group withdrew its retail bond transaction after early close of the orderbook
    - The issue was not one of size or capacity, rather the balance between pricing and the absolute risk profile of the Group
- 2013 has opened in good shape for the retail market with Enquest, Paragon and Beazley all announcing new transactions
    - Bouyant equity markets are providing retail investors with an alternative to bonds and the first trades of 2013 will sign-post the depth of demand in H1.

Issuance since Jan 2012 (via Brokers)

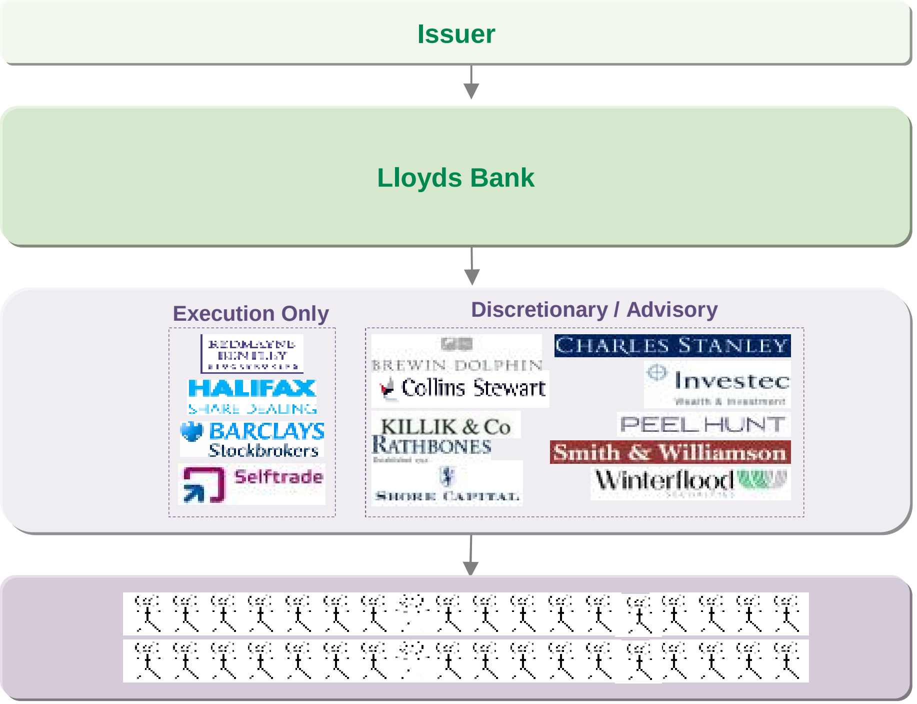
Issue Date	Issuer	Rating	Amt (£m)	Coupon	Maturity	Current Yield
12/01/12	Places for People	Aa3 / NR / NR	40	RPI + 1.00%	31/01/22	0.799%
30/03/12	Provident Financial	NR / NR / NR	120	7.000	04/10/17	5.082%
14/05/12	Tesco Bank	NR / NR / NR	200	5.000	21/11/20	4.131%
21/06/12	Severn Trent	Baa1 / BBB- / NR	75	RPI + 1.30%	11/07/22	0.444%
03/07/12	PHP	NR / NR / NR	75	5.375	23/07/19	5.089%
12/07/12	ICAP	Baa2 / NR / BBB+	125	5.500	24/07/18	5.233%
22/08/12	CLS Holdings	NR / NR / NR	65	5.500	31/12/19	5.659%
30/08/12	ICG	NR / BBB- / NR	80	6.250	19/09/20	5.959%
07/09/12	Beazley	NR / NR / NR	75	5.375	25/09/19	4.926%
19/09/12	Workspace	NR / NR / NR	58	6.000	09/10/12	5.115%
16/10/12	LSE Group	Baa2 / NR / A-	300	4.750	02/11/21	4.029%
17/10/12	St Modwen	NR / NR / NR	80	6.250	07/11/19	5.362%
~~13/11/12~~	~~Stobart Group~~	~~NR / NR / NR~~	~~N/A~~	~~5.500~~	~~04/12/18~~	~~N/A~~
21/11/12	Unite Group	NR / NR / NR	90	6.125	12/06/20	5.772%
22/11/12	Tullett Prebon plc	NR / NR / BBB	80	5.250	11/12/19	5.390%
27/11/12	Alpha Plus	NR / NR / NR	49	5.750	18/12/19	5.170%
24/01/13	EnQuest plc	NR / NR / NR	145	5.500	15/02/22	TBC

The Retail Broker Distribution Model

Using a network of UK Retail stockbrokers is the most efficient distribution method, allowing maximum penetration of the retail investor base

- A mix of discretionary, execution only and advisory brokers should be used to maximise distribution
- Brokers covering a wide geographical mix should be selected. The Channel Islands is a key area for this market and Lloyds has excellent relationships with a number of the largest companies in Jersey & Guernsey

Suggested Syndicate Structure



Issuer: Issuer PLC

Joint Lead Manager(s)
- Transaction advice
- Co-ordinating ADs
- Secondary market liquidity

Authorised Distributors – Roles include:
- Selling to end investors
- Typically a mixture of
  - Discretionary funds & advisory mandates (~85-90% of orderbook)
  - Execution only orders (~10-15% of orderbook)
- All are appointed, pre-vetted, regulated entities which have undergone KYD checks

End Investors
Discretionary retail funds, private banks
Mass retail, accessed via execution only ADs

Disclosure

Listing

- The listing requirements of the UKLA (UK Listing Authority) apply to all public bonds
- The prospectus must include audited, historical financial information covering the latest 2 financial years (or such shorter period that the Issuer has been in operation)
  - If the Prospectus is dated more than 9 months after the year end, the Prospectus must contain interim financial information covering at least the first six months of the financial year
  - For a March Year End, the window for issue is therefore September 2013 – December 2013

Continuing Obligations

- Throughout the life of the bond, issuers are required to prepare and publish audited annual financial statements within four months of year end and prepare and publish half-yearly financial statements within two months of the relevant period
  - In each case, publication can be by way of an RNS announcement and must also include an upload to the National Storage Mechanism (the electronic document viewing facility of the Financial Services Authority)
- Accounts must be prepared either in accordance with:
  - IFRS (if consolidated accounts are prepared), or
  - UK GAAP (if non-consolidated accounts are prepared)
    - (UK GAAP accounts must comprise (a) balance sheet, (b) income statement, (c) cash flow statement and (d) accounting policies and explanatory notes)

Key Market Themes

Key retail market themes

- Increasing investor due diligence focusing on key credit metrics
    - business models
    - use of proceeds
    - position in relation to other creditors
        - pari passu ranking with other senior creditors is increasingly expected for notes marketed as senior (ie not subordinated to security held by other lenders)
        - Contractually subordinated debt for regulatory capital purposes would be interesting to some key investors
- There has been insufficiently developed pricing differentiation in relation to other financing sources/markets, and other creditors
- The investor base is increasingly developing its level of sophistication, and press commentary is starting to highlight some of the key pitfalls for the unwary investor

Financial Times – 21st August 2012

*“**Know who you are lending money to** - When you invest in a bond, you are lending money to a company. Make sure that you are comfortable with that company, its management and its business model. Credit ratings can be an aid, but **there is no substitute for “DYOR” (Do Your Own Research**). Also, identify where the bond sits in the asset class pecking order. Bonds sit above equities in the ranking, giving the bond holder a prior claim on a company’s assets. But, there is a ranking within various classes of bonds. Secured debt is the highest ranking and will usually have a direct charge on the company’s real estate should anything go wrong. After that comes senior debt, the most common form of bond – which is where retail bonds sit. Below this is the higher-risk subordinated debt, such as the widely held building society Permanent Interest Bearing Shares. The latter typically have higher yields to compensate investors for the increased level of risk.”*

Euroweek – 19th October 2012

*"The question of suitability for investors is very relevant, and each lead manager should look at it very carefully," said Mollenbach. "We examine every deal in our commitments committee, which includes top management of the wholesale bank, both from the business and risk perspective. We have a clear view that we need to protect retail investors, and that whatever we bring to market is something we can stand behind. **We are also a lender to these companies, and we don’t want to subordinate retail investors relative to ourselves** — that would look very odd and wrong."*

Lloyds Bank – UK Retail Bonds

Lloyds Bank has a strong presence in the UK Retail Bond market, with a reputation for bringing high quality, well structured deals to the market

- **Lloyds Bank** has been **actively involved with the build-out of the UK retail bond market** and in 2010 issued the first broker distributed transaction
  - Having created, and now as **Chair of the ICMA Retail Bond Working Group**, Lloyds is at the forefront of structural and documentation discussions
- With a dedicated **UK retail sales team**, strong **trading credentials in the Sterling market** and **full service hedging capabilities**, Lloyds is ideally placed to advise on structural developments in the market and issuance opportunities
- Yields on ‘high street’ savings products continue to fall. With Treasury gilt yields at all-time lows, and equities remaining volatile, many **retail investors are turning to fixed income** products
  - Investors are looking for **new names and diversification** opportunities
  - Recent oversubscribed offers underline increasing retail investor appetite
- The recent **London Stock Exchange Group** £300m 4.75% 2021 transaction has pushed boundaries in the retail space with regards to size, tenor and coupon – opening up the market for a wider range of issuers
- The retail bond market is currently one of the few public markets to remain **consistently open for business**. Investors are less driven by headline risk and the latest political and economic news stories, and more by name recognition and coupon

Executed

tullett prebon
£80M 5.250% RETAIL NOTES DUE 2019
BOOKRUNNER
NOVEMBER 2012

London Stock Exchange Group
£300M 4.750% RETAIL NOTES DUE 2021
BOOKRUNNER
OCTOBER 2012

beazley
£75M 5.375% RETAIL NOTES DUE 2019
BOOKRUNNER
SEPTEMBER 2012

ICAP
£125M 5.500% RETAIL NOTES DUE 2018
BOOKRUNNER
JULY 2012

Pipeline

2 x Corporate plc
1 x Financial plc
GBP FXD RATE RETAIL BONDS
BOOKRUNNER
Q1 2013

Focus on: With-Profit Funds

With-Profits review: the predicament for Mutuals

- Existing WP business maturing quicker than new policies are being written

- Firms not writing a ‘material’ amount of new WP business require a ‘run-off’ plan
    - close to new WP business
    - distribute expected surplus to existing WP policyholders

- WP funds within a mutual are not necessarily distinct from the firm as a whole
    - a proprietary WP fund entering run-off does not imply the rest of the firm closes to new business
    - situation unclear for a mutual WP provider that operates a single common fund writing a mixture of WP and Non-Profit business

- Interaction of WP review (COBS 20) with run-off rules creates predicament for mutuals
    - can mutuals ceasing to write WP business, write new Non-Profit and Unit-Linked business?
    - how should different interests in the mutual’s common fund be attributed?

CP 12/38: a proposed solution for the Mutual sector?

- CP 12/38 (released Dec 2012) addresses concerns of mutuals
  - review suggests mutuals operating a single common fund should have the opportunity to formally identify and separate the WP element
- Firms would apply for a modification under what is expected to become s138A of FSMA
  - exercise to separate interests into a ‘Mutual Members Fund’ and a ‘With-Profit Fund’
  - focus regulatory requirements of COBS 20 on the WP element only
- Application for modification to be supported by independent expert report
  - report to address whether a given mutual has the required capital and business model to continue writing business outwidth of its WP fund. If not, merger or run-off may be more appropriate
- Expect WP Fund and Mutual Members’ Fund to be treated as separate for regulatory purposes
  - e.g. under Solvency II, sufficient Own Funds to meet the SCR for the WP fund on a standalone basis as well as for the firm as a whole must be held. Ring-fencing of WP fund under SII applies

Lloyds Bank: Our approach to With-Profits risk management

- Proprietary model developed for rapid revaluation of complex risks in Group WP funds
- Enables timely reporting and identification of key risks / hedging requirements
- Based on Least Squares Monte Carlo (LSMC) technique

Step 1 – identify main sensitivities

GAO Costs = -102m …

+ (20m * Equity) …

+ (2m * Equity Vol) …

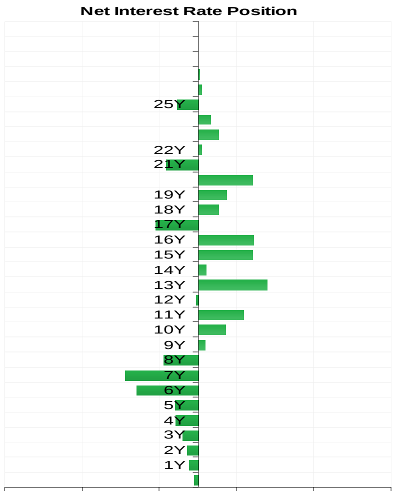
+ (78m * IR Level) + (33m * IR Slope) – (2m * IR Curvature) …

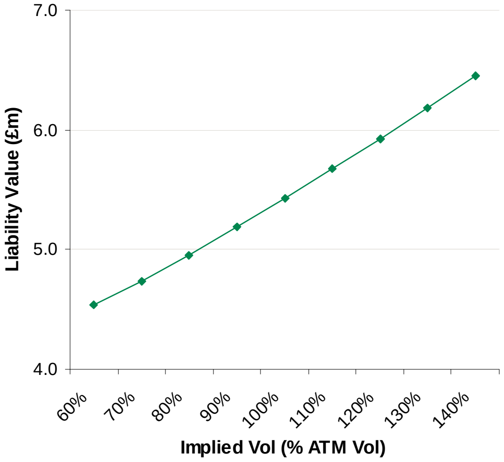
- (30m * IR Vol) …

- Equity * (14m * IR Level + 8m * IR Slope) …

- (6m * IR Level * IR Slope)

Step 2 – analyse delta / vega risks in more detail





Lloyds Bank: Our approach to With-Profits risk management

Step 3 – Propose hedge

e.g. GAO hedge:
Payer swaptions + ATMF Receiver swaps

Payer Swaptions

Option Tenor	Swap Tenor	Strike	Notional	Premium
5y	20y	5.0000%	10,000,000	2.9834%
7y	20y	5.0000%	15,000,000	4.1817%
10y	20y	5.0000%	35,000,000	4.9686%
15y	20y	5.0000%	50,000,000	4.5707%
20y	20y	5.0000%	30,000,000	3.9958%

ATMF swaps (Receive Fixed)

Start Date	Swap Tenor	Strike	Notional
5y	20y	3.6041%	13,000,000
7y	20y	3.7830%	20,000,000
10y	20y	3.8747%	45,000,000
15y	20y	3.8382%	70,000,000
20y	20y	3.7287%	40,000,000

Step 4 – Use model to monitor hedge performance

- Impact of hedge on overall risk profile
- Identify triggers for re-hedging
- Senior management concerns – test hedge performance under specific scenarios

LBG's structuring & execution capabilities in conjunction with model output propose optimal hedging solution

Why we like this modelling approach …

- Rapid revaluation & straightforward calibration

- Reflects complex interactions of market (e.g. rates, equity, credit) and non-market risks (e.g. lapse, longevity)

- Simple function or ‘formula’ to revalue given statistic in timely manner

- Alternative approaches are generally computationally intensive (e.g. Nested Monte Carlo), difficult to calibrate (e.g. replicating portfolio), or slow to converge (e.g. curve fitting)

- Potential uses include:
  - rapid updates of Solvency II / ICA solvency positions
  - hedging and asset allocations decisions
  - qualitative and quantitative management information

LBG’s modelling capabilities and experience play a key role in developing solutions for our insurance clients

Q & A

Contacts

Bill Cooper

Managing Director Global Insurance

Tel: +44 20 7158 2607
Mobile: +44776 462 5154
Bill.Cooper@lloydsbanking.com

Marcus Coverdale

Director| FI Debt Capital Markets

Tel: +44 20 7158 2018
Mobile: +44776 462 6244
Marcus.Coverdale@lloydsbanking.com

Ingrid Hammond

Associate Director| FI - Insurance ALM

Tel: +44 20 7158 2012
Mobile: +44755 793 9170
Ingrid.Hammond@lloydsbanking.com

Gabriela Lozano

Relationship Manager| Global Insurance

Tel: +44 20 7158 2655
Mobile: +44773 978 5988
Gabriela.Lozano@lloydsbanking.com

Francois-Xavier Herr

Derivatives Structuring

Tel: +44 20 7158 1981
Mobile: +44759 507 2684
Francois-Xavier.Herr@lloydsbanking.com

Deepak Seeburrun

Director| FI - Insurance ALM

Tel: +44 20 7158 2114
Mobile: +44785 072 3741
Deepak.Seeburrun@lloydsbanking.com

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