# Paragon Banking Group PLC

Financial Results for six months ended 31 March 2019

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# HY 2019 - results highlights



## Delivering on strategic transformation

### Strong operational performance

- Strong organic growth across all lending divisions £1.3 billion (+30.2%)
- Supplemented by Titlestone acquisition
- Improved customer retention, redemptions reduced
- Led to:
  - Net loan growth +10.4%
  - Higher NIM +8bp

### Delivering financial returns

- Operating profits +8.7%
- Underlying earnings per share +11.1%
- Dividend per share +27.3%
- Underlying RoTE approaching 15% target
- Achieved whilst maintaining:
  - Conservative capital ratios
  - Continued exemplary credit record

### Strategic development bearing fruit

- Increasingly diversified asset and liability structure
- Heightened focus on specialist lending
- Structurally NIM accretive:
  - Back book/front book structure
  - Specialist margins NIM enhancing
- Ability to recycle capital to optimise returns

**Building a specialist bank**

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# Section 1

## Financial Results

For six months ended 31 March 2019

Richard Woodman
Chief Financial Officer

# Income statement



## Consistent profit delivery as strategic focus develops

- Total income up 13.8% to £148.0 million
- NIM 8bp higher at 2.24%
- Loan book up 10.4%

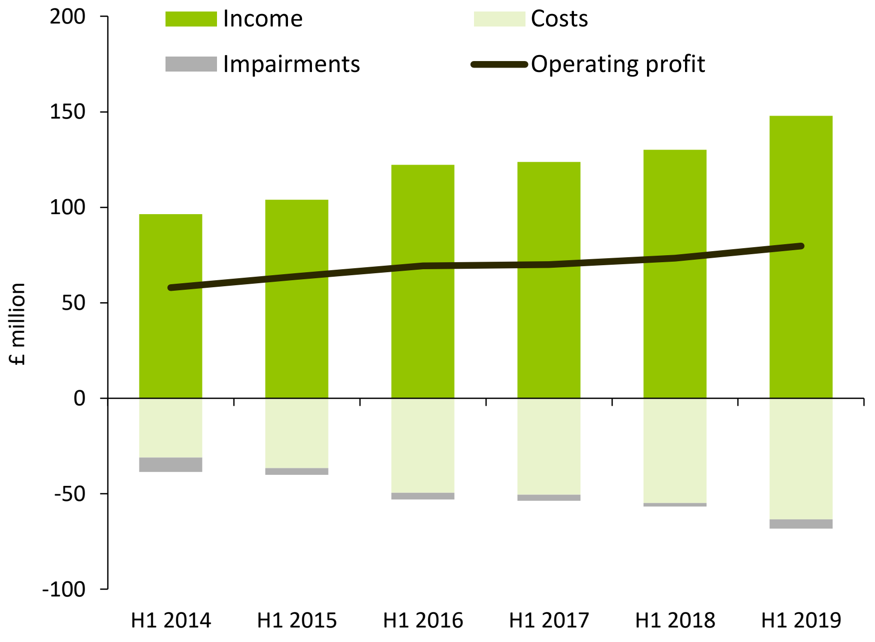
- Cost increase 15.3% with Titlestone integration and higher project costs (including IRB)
- Cost:income ratio 42.8%

- Steady improvement in operating profits to £79.8 million

- Bad debts increase to £4.9 million from £1.8 million in H1 2018 – but remain lower than H2 2018. Now reported under IFRS 9

- Statutory profit impacted by anomalous swap rate movements in March. Non-cash and reversing over time

Operating profits




| Operating profits | | | | | |
|---|---|---|---|---|---|
| **H1 2014** | **H1 2015** | **H1 2016** | **H1 2017** | **H1 2018** | **H1 2019** |
| £57.9m | £63.9m | £69.4m | £70.1m | £73.4m | £79.8m |

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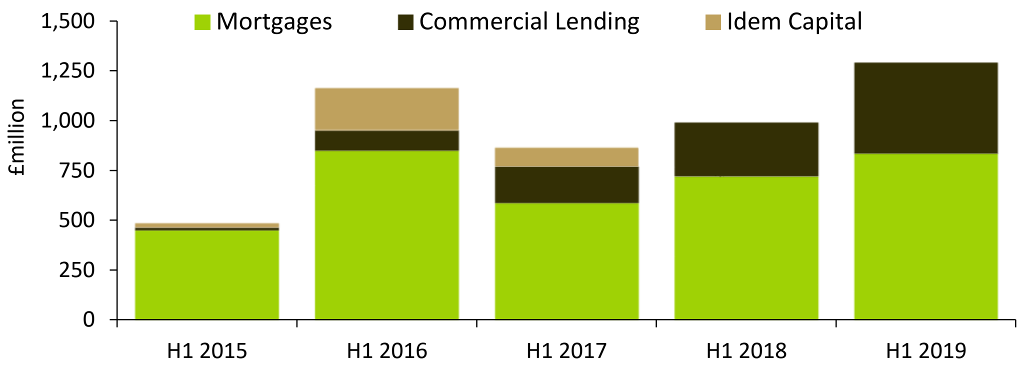
# Loan book



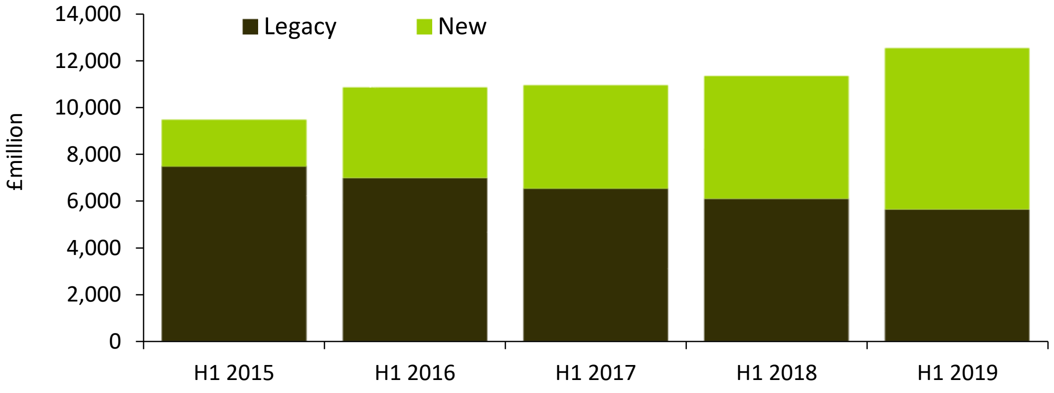
## Strong growth in new lending

- 10.4% increase in loan balances
- Pre-financial crisis portfolio dampens headline balance sheet growth rate but supports NIM expansion
- Excluding old book run-off, balance sheet growth £4.9 billion over 4 years and 31.2% since March 2018
- Fastest rate of growth in higher-yield commercial business

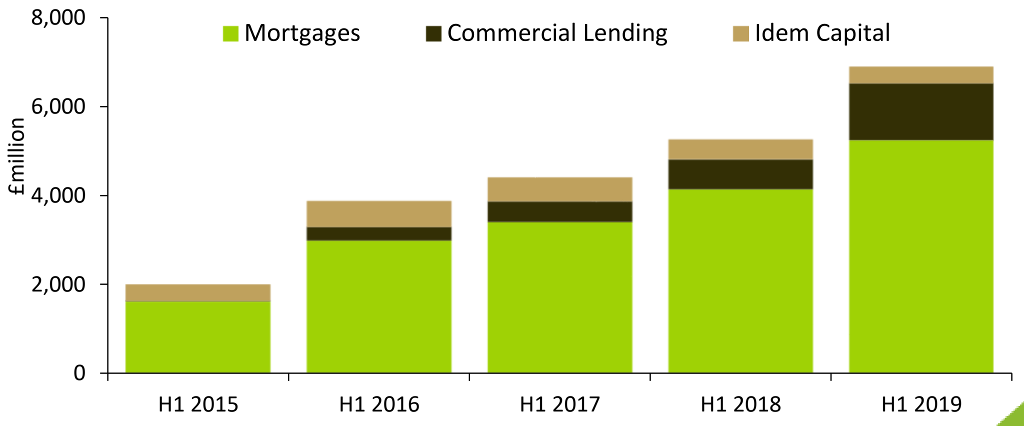
Originations and investments




Total – loans and advances to customers




Post-crisis – loans and advances to customers

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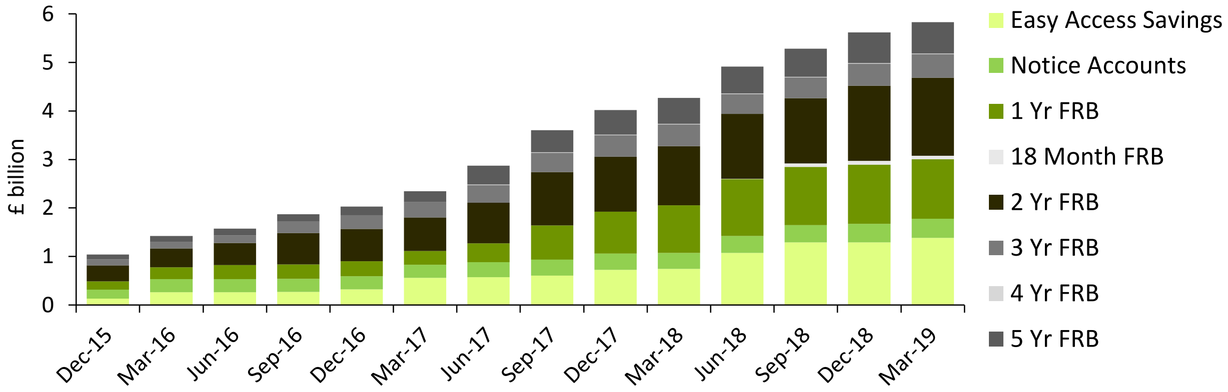
# Deposit funding



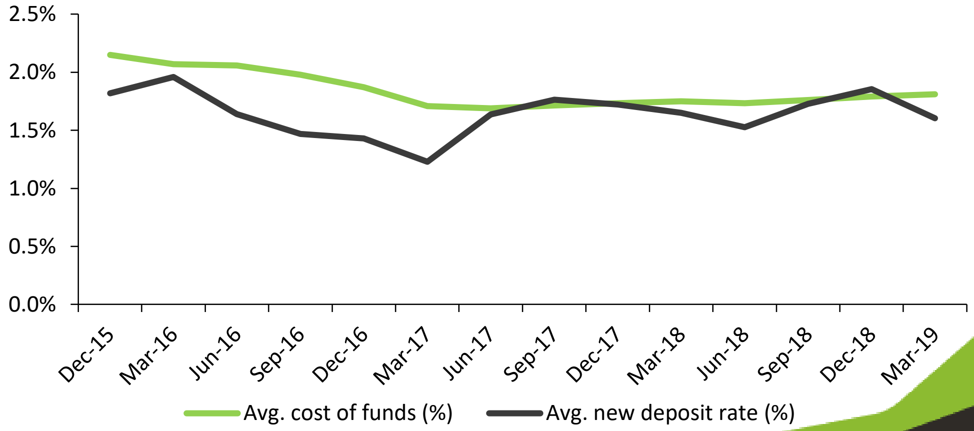
## Good progress, cautious mix, attractively priced

- Deposit balances grown to £5.9 billion at 31 March 2019
- Average cost 1.81% at period end
  - Up 6bp year-on-year despite base rate increase and new competitor entry
- Easy access represents just 23.6% of book
  - Growing steadily as retention rate experience increases

Deposit balances




Cost of funds

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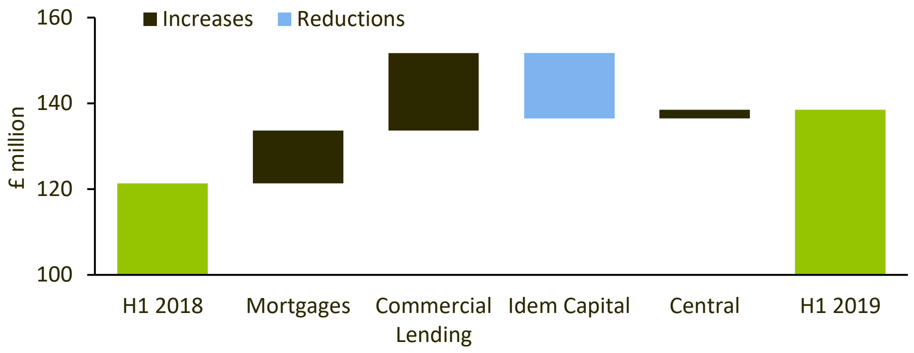
# Net interest income

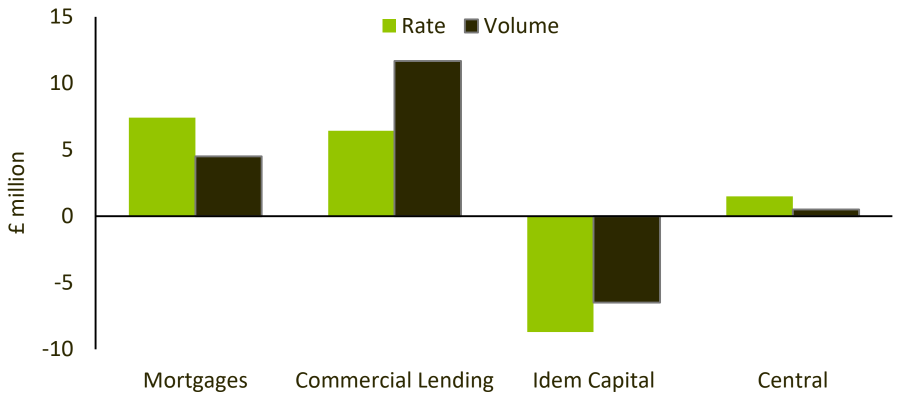
## Positive rate and volume drivers in key divisions

- Favourable rate and volume variances in Mortgages
  - Lower redemptions
  - New book margins exceeding old
  - Portfolio growth
- Favourable rate and volume variances in Commercial Lending
  - Underlying NIM up 23bp
  - +83bp impact from acquired Titlestone portfolio
  - Titlestone operations now fully combined and integrated
  - Strong portfolio growth
- Lower Idem Capital income
  - Portfolio mix (2018 addition was a performing portfolio)
  - Underlying run-off
  - Accelerated by September 2018 portfolio sale
- Central
  - Full period benefit from TFS
  - Benefit of Bank of England rate increase in August 2018 on liquidity

Net interest income




Rate and volume influences

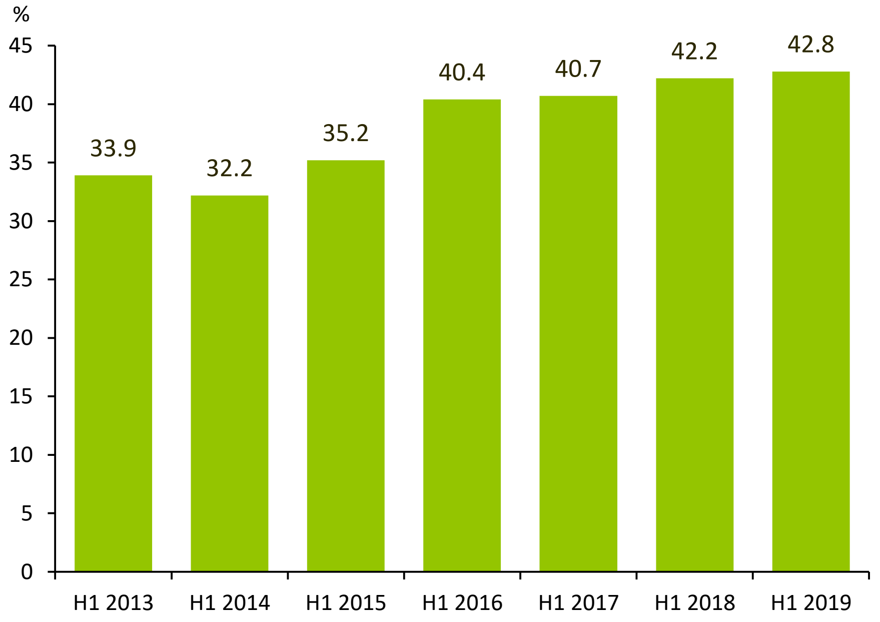


# Operating expenses

## Pace of development and project costs driving cost increases

- Move to banking model in 2014 generated additional overhead
- Commercial Lending acquisitions operate with higher underlying CIR than Mortgages
- IT developments largely expensed (rather than capitalised)
- Deposit book outsourced and growing materially faster than inflation
- Strategic projects incur cost ahead of longer term benefit ie IRB
- Continued volume growth to create operating leverage

Cost:income ratio

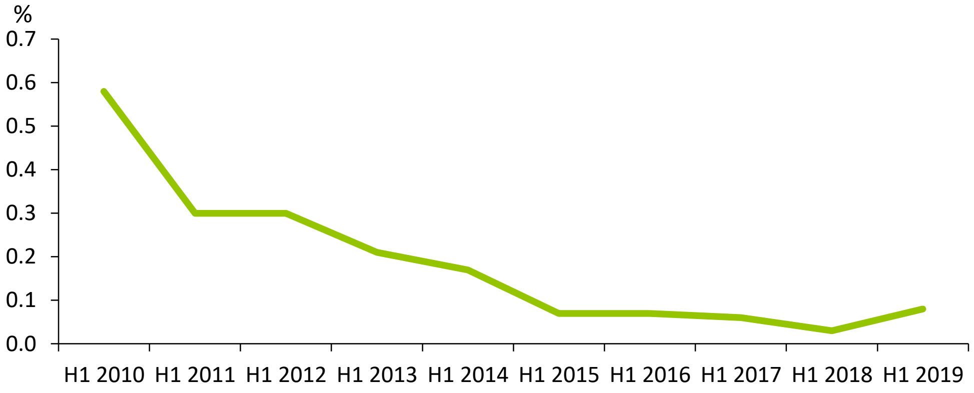


# Credit performance

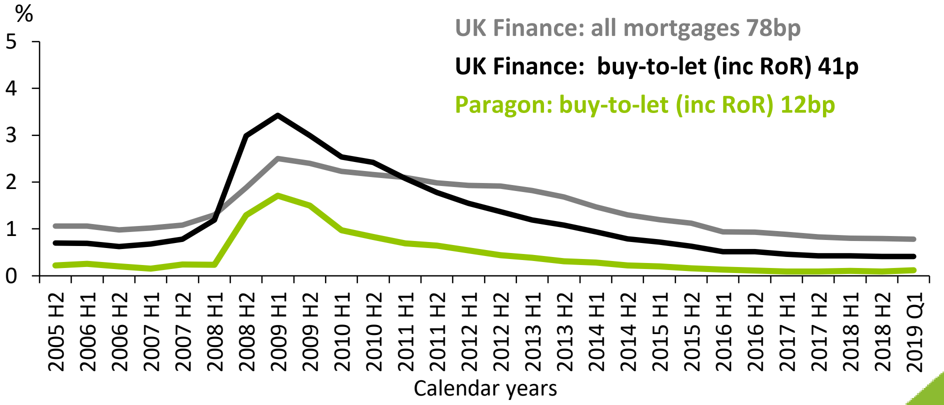
## Credit metrics remain strong

- Bad debts now reported under IFRS 9
- P&L charge higher in H1 2019 but lower than H2 2018 and in line with prior periods
- Buy-to-let charge lower year-on-year
- Commercial Lending higher, as expected, reflecting growth rates

Cost of risk




BTL 3 months+ arrears




*Source: UK Finance / Paragon*

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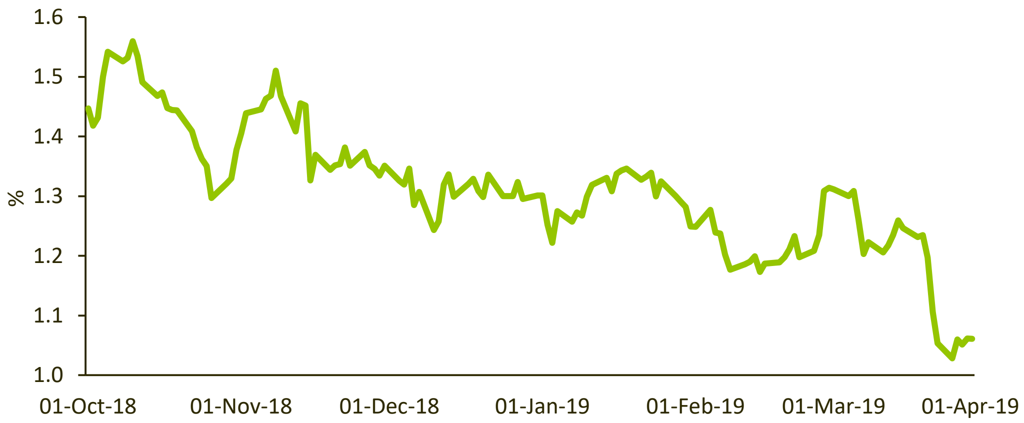
# Below-the-line items

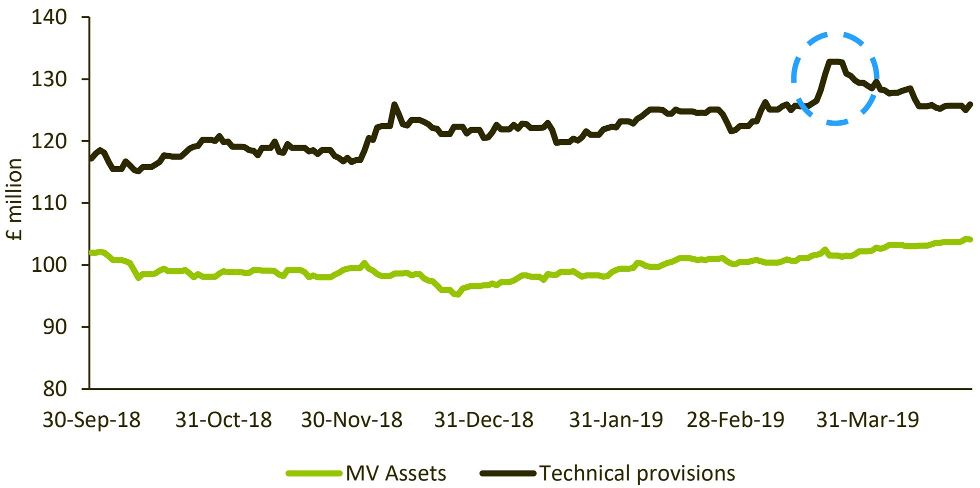


## March interest rate profile drove fair value and pension deficit charges

5 year swap rate




Pension – assets and liabilities




- Movements in yield curve in March 2019 had a material impact on fair values of pipeline hedges
- H1 charge for 2019 of £7.8 million compares to £3.8 million income for same period in 2018
- Portfolio is appropriately hedged, and charges will revert to zero over life of instruments with no cash effect

- Absolute rate movements drove IAS19 pension deficit movement in March 2019
- 40% recovered in first three weeks of April 2019
- No impact on P&L but does impact capital ratios

# Group capital



## Prudent capital ratios maintained

| Group consolidated capital | |
|---|---|
| Core Equity Tier-1 capital * | £918.7m |
| Tier-2 capital | £150.0m |
| **Total capital resources** | **£1,068.7m** |
| Credit risk | £6,123.9m |
| Operational risk | £485.1m |
| Market risk | - |
| Other | £91.1m |
| **Total risk exposure** | **£6,700.1m** |
| CET1 ratio * | 13.7% |
| Total capital ratio | 16.0% |

| Group consolidated leverage ratio | |
|---|---|
| Tier-1 equity * | £918.7m |
| Leverage exposure ** | £14,081.8m |
| UK leverage ratio * | 6.5% |

* IFRS 9 transitional relief, adjusted for proposed dividend and subject to verification

** Excludes qualifying central bank claims in accordance with rule modification applied to UK Leverage Ratio Framework

### Capital ratios

- CET1 ratio 13.7% (13.4% with IFRS 9 fully loaded)
- Circa 0.3% impact from anomalous rate movements in March 2019

### Risk weightings

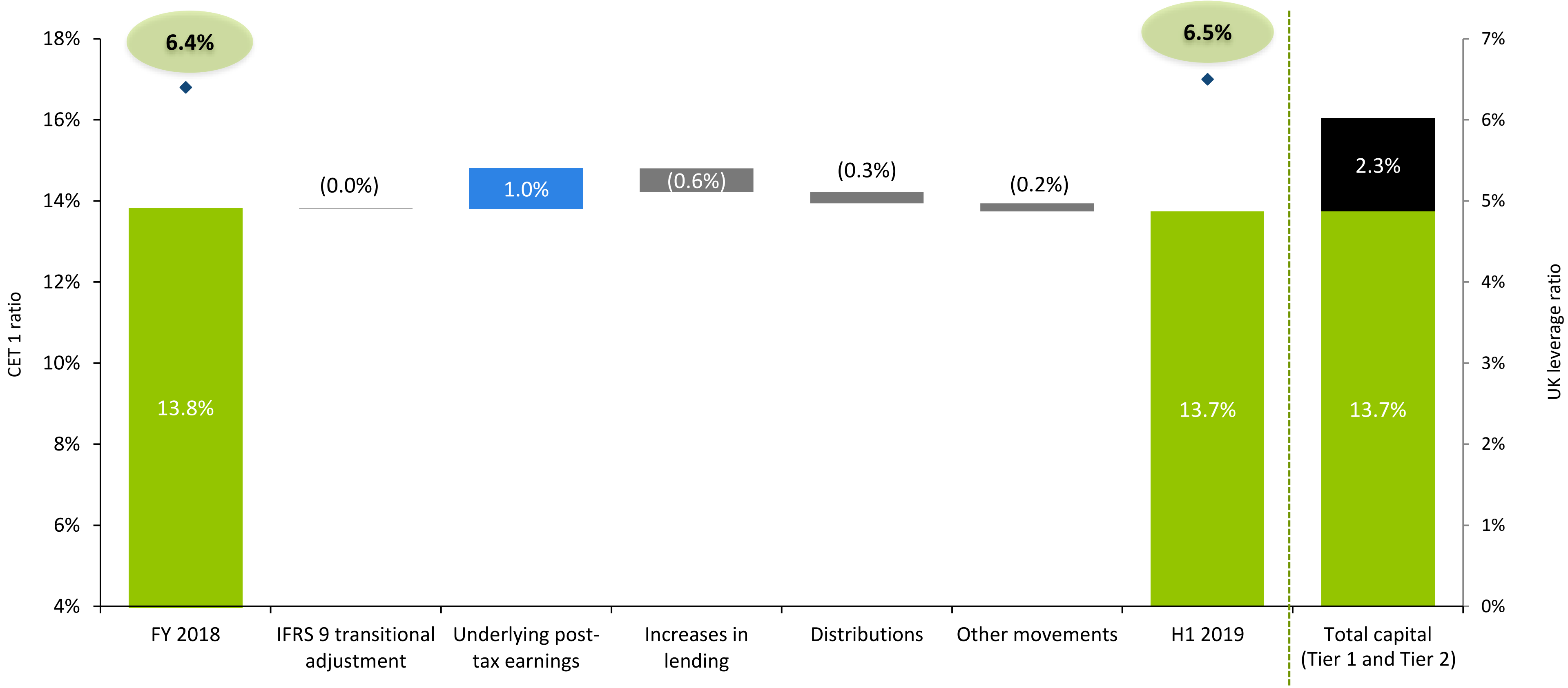
- Still on a Standardised Approach
- Addition of Titlestone increased risk weight density
- Risk weightings reviewed and confirmed in period

### IRB

- Application process well advanced
- Good interaction with PRA
- First portfolio will be BTL, with a phased roll-out to follow

# Capital bridge – FY 2018 / H1 2019

## Capital position remains strong and stable




UK leverage ratio

# Section 2

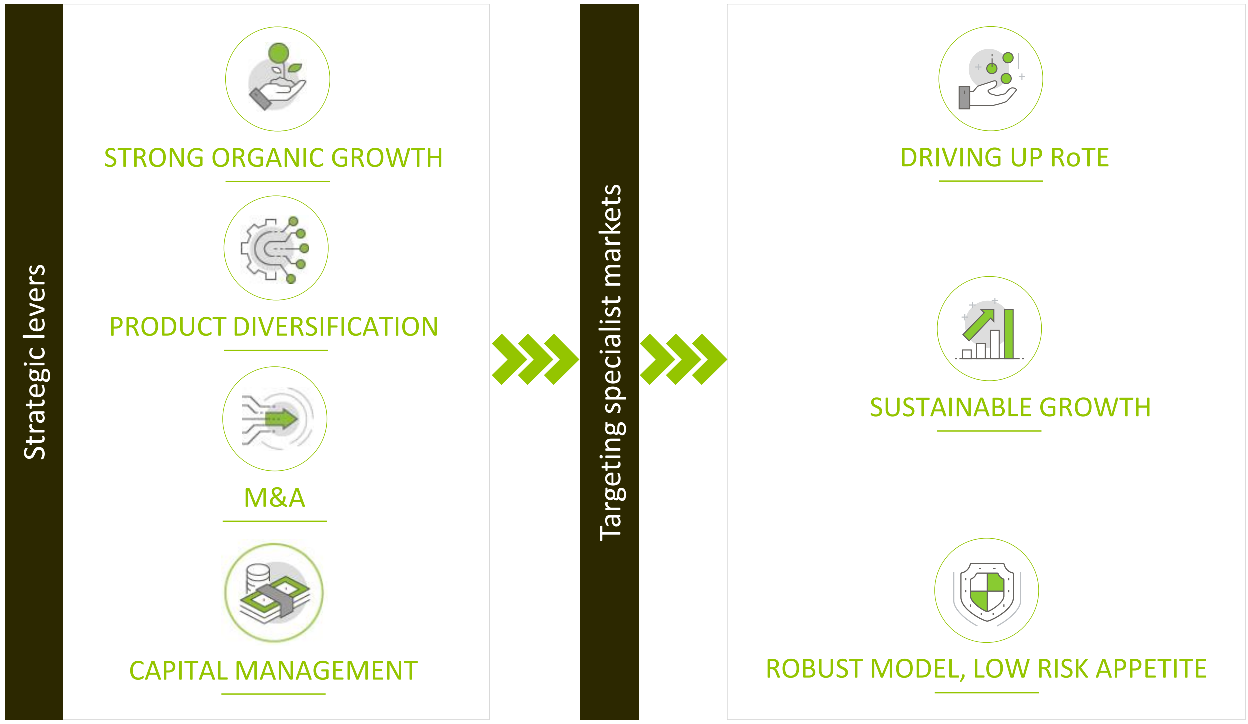
## Building a specialist bank

Nigel Terrington
Chief Executive

# Our strategy has been …



- To transform business from a monoline lender to a broadly based and diversified specialist bank
- Focusing on specialist markets where we can make a difference
- Employing our deeper understanding of markets, customers, products, services and the risks incurred
- Recycling capital to optimise returns whilst maintaining a low risk appetite
- Optimising capital for the benefit of shareholders

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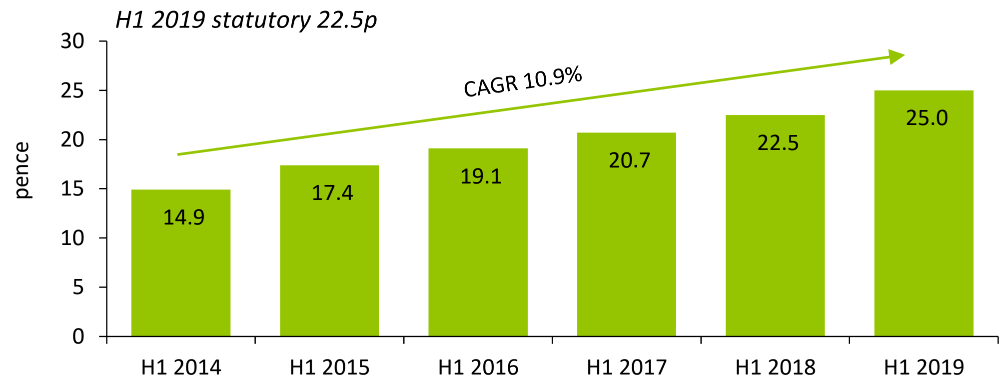
# Building a specialist bank

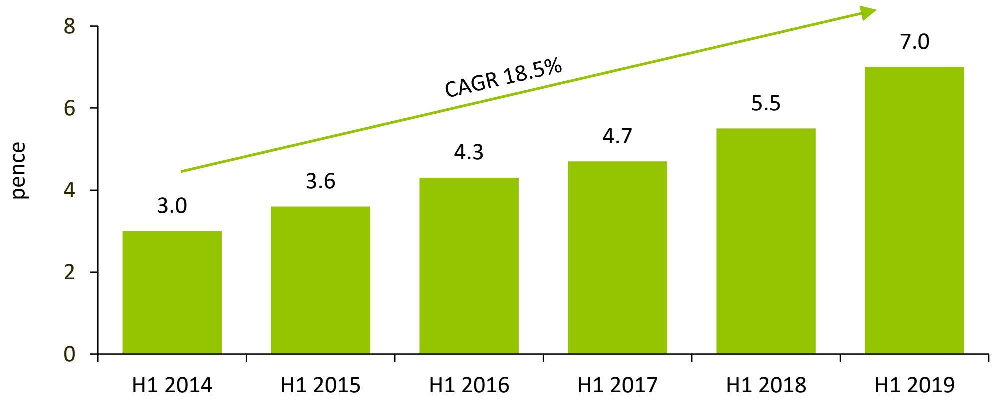
## Whilst delivering sustainable performance

- This has required significant effort and investment:
  - Starting a bank
  - Redesigning and restructuring the Group
  - Organic lending start-ups
  - Building a deposit franchise
  - Four acquisitions
- Notwithstanding this, the business has continued to deliver strong growth in profits, dividends and returns

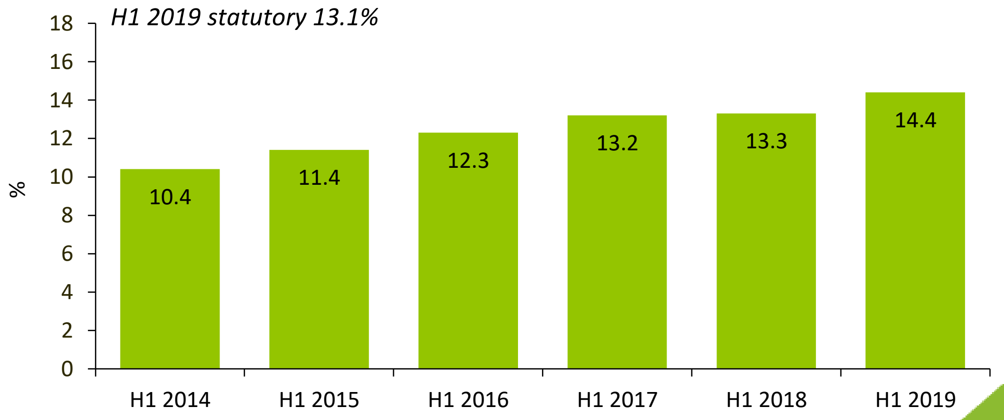
Underlying earnings per share




Dividend per share




Underlying Return on Tangible Equity

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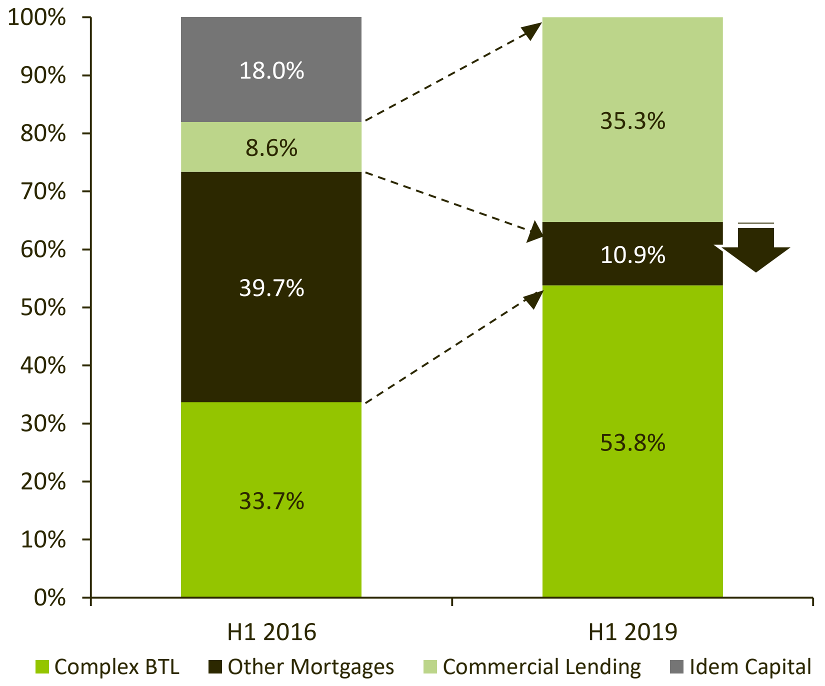
# Building a specialist bank



## Increasingly focused on specialist BTL and SMEs

- All markets competitive but specialist focus avoids commodotised sectors
- Professional landlords now 88.0% of new BTL flow
- Four acquisitions completed and integrated over last four years
  - 2015 – Five Arrows
  - 2016 – Premier Asset Finance
  - 2017 – Iceberg
  - 2018 – Titlestone
- Commercial Lending share increased four-fold in three years
- Full suite of capabilities to support SMEs and their asset financing needs
- Specialisation delivers ability to:
  - Better employ specialist skills, to make a difference
  - Lift barriers to entry
  - Achieve superior margins
  - Avoid commoditised oversupplied low margin sectors
  - Target growth markets

Significant shift in flow of new loan originations in 3 years

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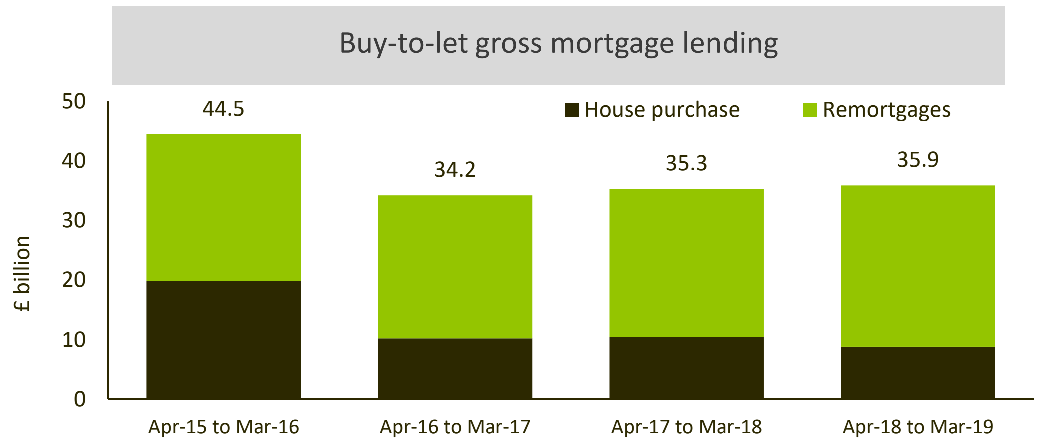
# Buy-to-let



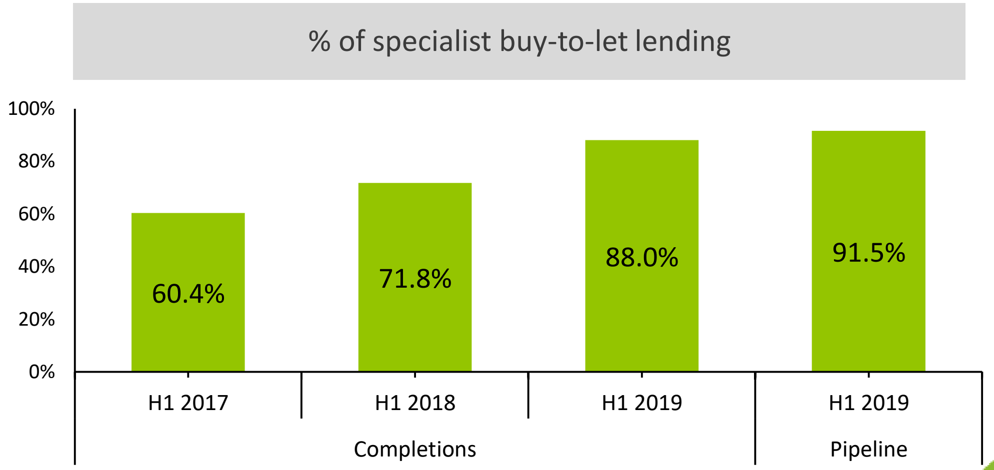
## Professional landlords driving growth

- Despite fiscal and regulatory changes, buy-to-let volumes have remained robust
- Remortgages have been the key driver
- Purchase business increasingly focused towards professional/complex landlord




*Source: UK Finance*

- Buy-to-let new lending up to £787.5 million (+17.4%)
  - Professional/complex +44.0% in absolute terms
  - Corporate lending 51.5%
- New business margins remain robust
- Pipeline £711.1 million with +10bp improvement in yield, year-on-year – reduction reflects lower amateur flows
- Professional/complex market share expected to increase

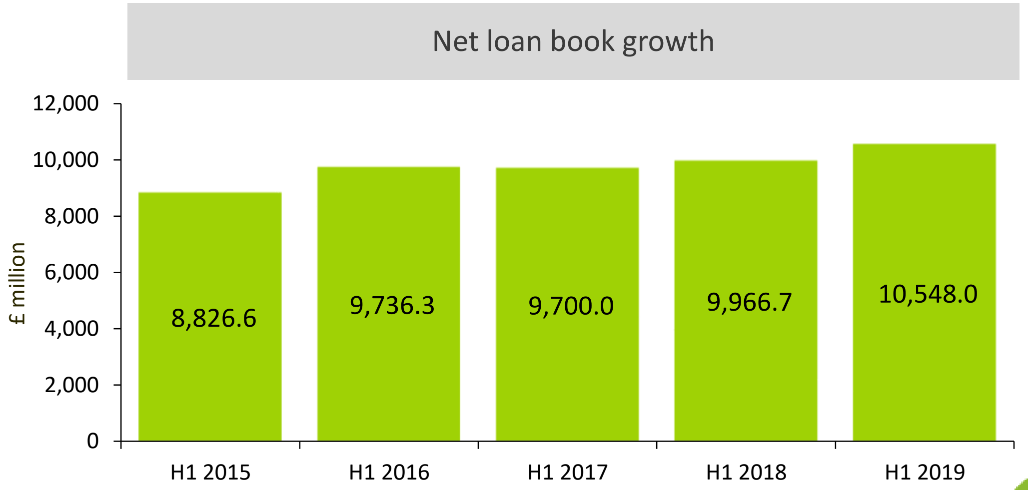


# Buy-to-let



## Better customer retention driving loan book growth

- Redemption levels reducing, helping to drive up net loan growth
  - Increasingly professional/complex with greater retention potential
  - Improved retention strategies
  - 5 year products extending redemption profile
- Improved service levels – 93% intermediary satisfaction
- Net loan book growth +5.8%

# Commercial Lending – development finance



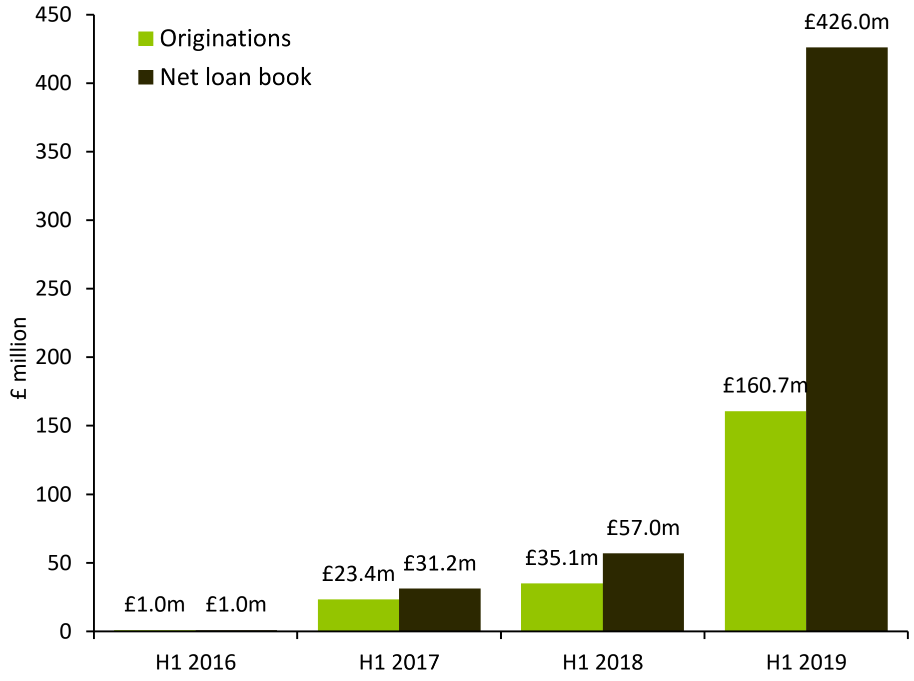
## Significantly strengthened existing platform

- Integration now fully completed, on time and delivering good progress
- Broadening geographic footprint
- Some uncertainty due to Brexit
- Undrawn facilities £276.9 million, strong pipeline
    - Credit and pricing discipline being maintained

### Titlestone acquisition

- Acquired in July 2018
- Total investment (goodwill/intangibles) £51.3 million
- Acquired portfolio £225.9 million
- Experienced management team with 30+ years experience
- 70% of new business through direct channels
- Service-led proposition

Originations and loan book growth



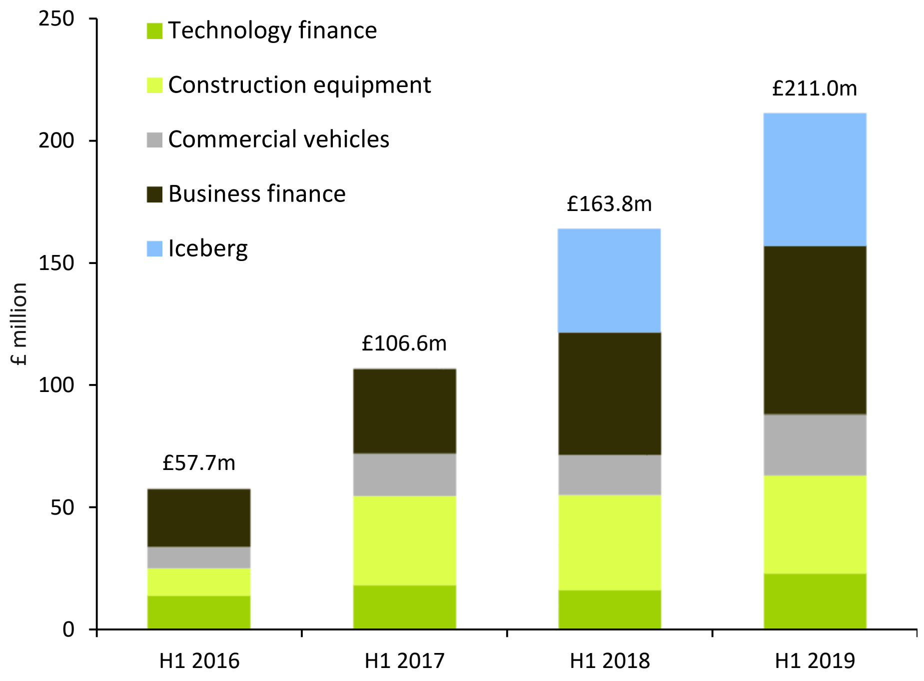
# Commercial Lending – asset finance



## Growing market share with improved platform delivery

- Market £32.1 billion (+6.5%)
- Paragon's new business flow £211.0 million, with multiple niches (+28.8%)
- Focus on mid-tier, negligible exposure to small businesses
- Asset finance utilises specialist teams of relationship managers and underwriters, enhanced with growing broker distribution
- Organisational restructuring and technology investment supported enhanced proposition
- Improved delivery supporting loan book growth +26.1% at wider yields

New originations



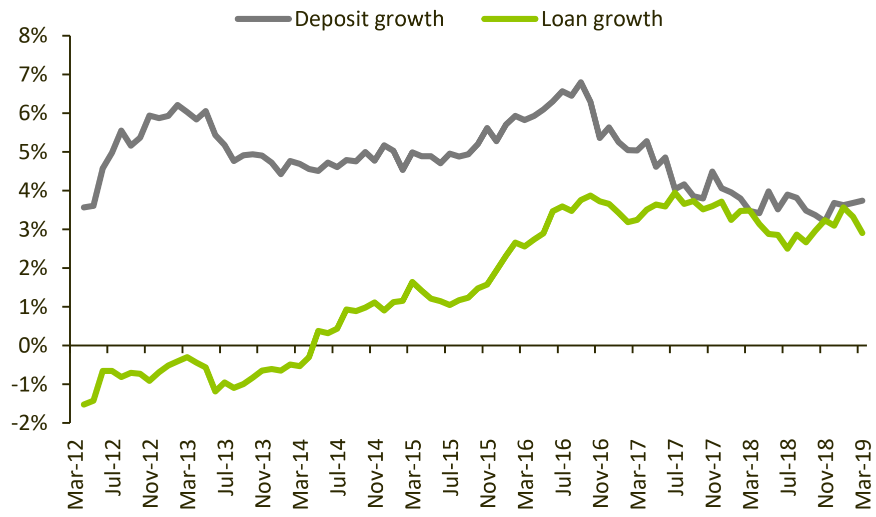
# Building a deposit franchise



## Deposit growth has much further to go

- Built £5.9 billon deposit franchise from scratch
- Focus on attracting term balances and understanding behavioural attributes of the book kept cost of deposits relatively high versus peers
- Sufficient market capacity to support plans without further product development
- Our market share is still very small
- Underweight Easy Access and no SME offering at present
- Emergence of platforms
  - Hargreaves Lansdown
  - Others to follow
- Open Banking presents an opportunity to disrupt inertia over medium term

Deposit market growing at same pace as loans




**Securitisation optionality**

- Market repriced wider in Q1 2019
- Now improving
- Accessing capital markets part of our optionality strategy

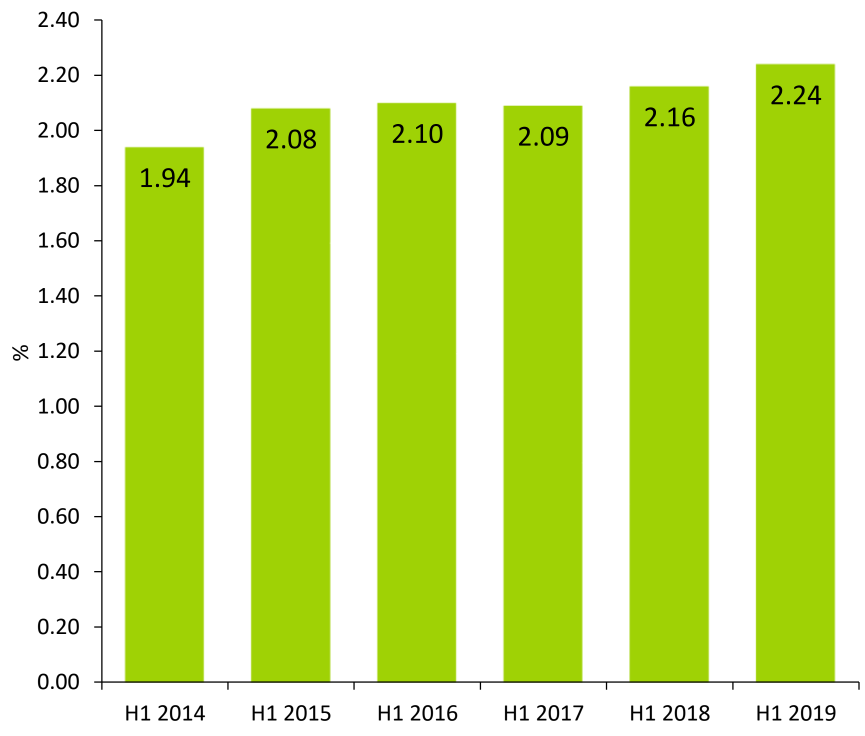
# Net interest margin



## Trend improvements underpinned by strategic business mix

- 30bp improvement over 5 years
- Structurally NIM accretive for new business despite run-off in Idem Capital (which carried highest margins)
- Complex BTL margins stronger than amateur business and back book
- Commercial Lending margins higher than Mortgages
- Robust and stable funding, with optionality underpinning price efficiency

Net interest margin

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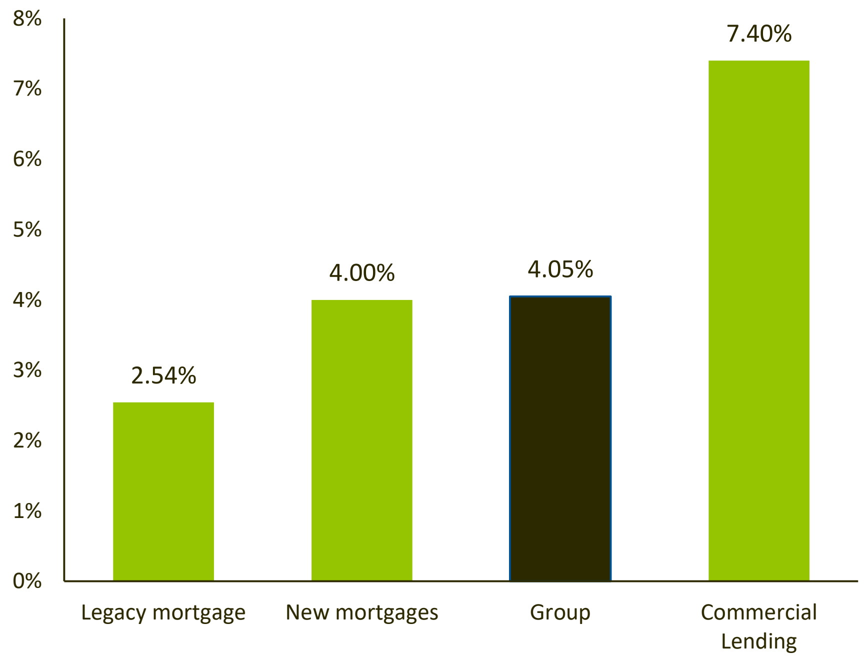
# Structural improvement in NIM

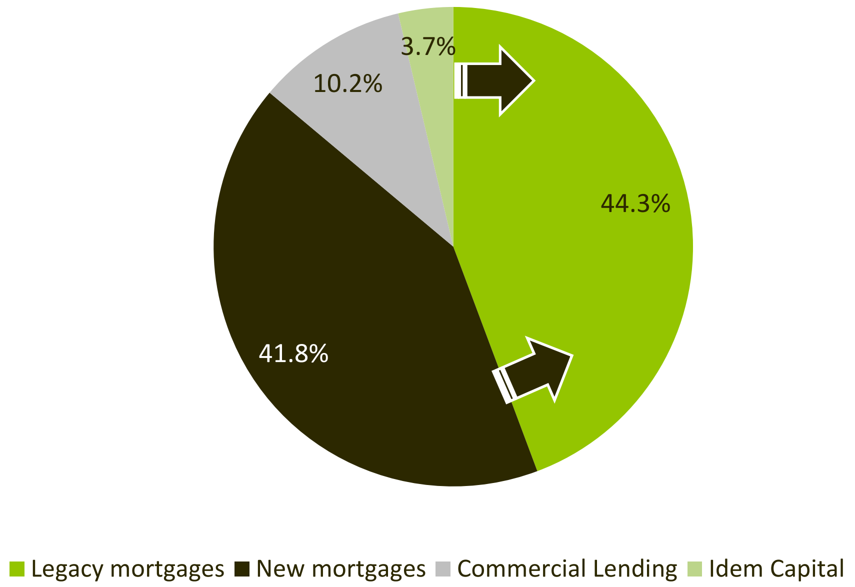


## Our front book/back book structural dynamic is rare in today's UK banking market

Evidenced via higher yields in new portfolio




Swapping lower margin legacy book for higher margin BTL/SME

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# Through-the-cycle track record



## Lead indicators continue to be positive

- Credit performance, data use and experience are differentiators for Paragon Bank
- 15 year BTL average cost of credit 9bp, average LTV 67.7% (80.8% in September 2008)
- Property risks poorly understood, but a key competitive advantage for Paragon
- Commercial Lending portfolio strong risk performance
- No emerging stress evident in customer base behavioural scores
- Open Banking will provide a new generation of risk-focused capabilities improving risk management and delivering:
  - Better lending decisions
  - Broadening customer reach and market access
  - Improved customer targeting
  - Better customer service
  - More efficient processes

- No emerging stress evident in behavioural scores

| Forward looking credit metrics | | |
|---|---|---|
| **Indexed credit behavioural scores by portfolio** | **Mar-18** | **Mar-19** |
| Buy-to-let: New | 100.0 | 100.6 |
| Legacy | 100.0 | 100.2 |
| New second charge mortgages | 100.0 | 99.4 |
| Legacy second charge and Idem Capital assets | 100.0 | 102.7 |
| Motor finance | 100.0 | 100.7 |

- 500 million pieces of data analysed every month

# Capital optimisation



## Recycling capital to improve returns

- Track record of returns
  - Dividends – £198.1 million paid to shareholders over last five years
  - Buy-backs – £190.0 million over last five years
- Bank restructure created enhanced capital mobility
- Idem Capital portfolio sale effectively recycled capital to acquire Titlestone
- IRB will deliver enhanced risk management and further ability to optimise capital
- Capital optimisation will remain a core strategic principle

# Conclusion



## Significant strategic transformation in recent years …

**Continued strong financial and operational progress**

- Excellent H1 delivery – strong new lending, loan book growth, improving NIM, exemplary credit
- Further progress in specialist segments
- £5.9 billion of deposits, ability to broaden and improve mix
- Track record for delivering earnings, dividend and RoTE growth
- Underlying RoTE now 14.4%

**Strategic delivery supports positive medium-term outlook**

- Strong delivery in specialist markets will deliver premium returns and mitigate competitive pressures
- Operational leverage to deliver better efficiency
- Multi-year drivers of NIM expansion are structural
- Prudent risk appetite supported by experience/data to deliver through-the-cycle
- Disciplined capital allocation with ability to recycle
- Confident in RoTE target of >15%

**… Building a specialist bank**

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# Section 3

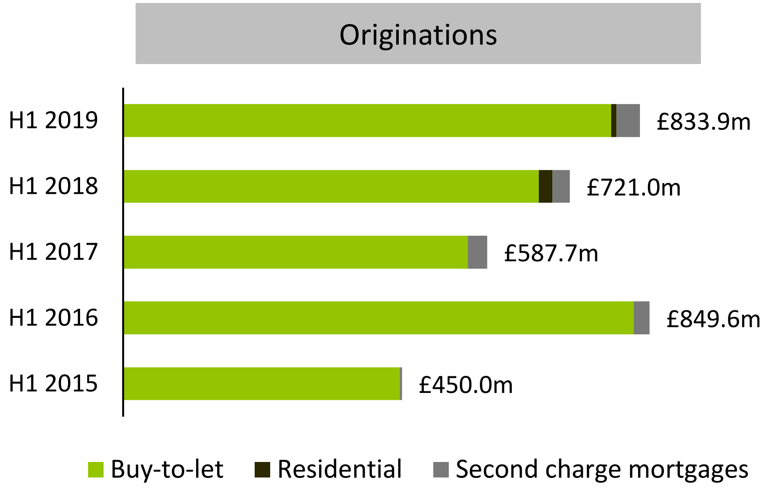
Appendix

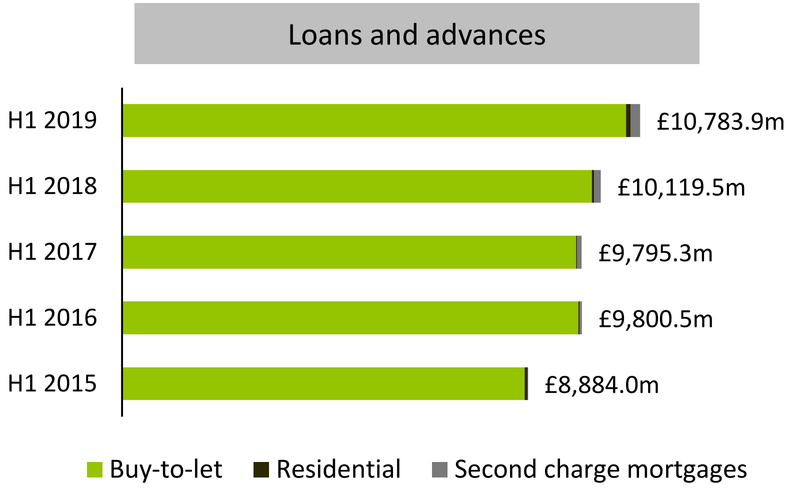
# Mortgages

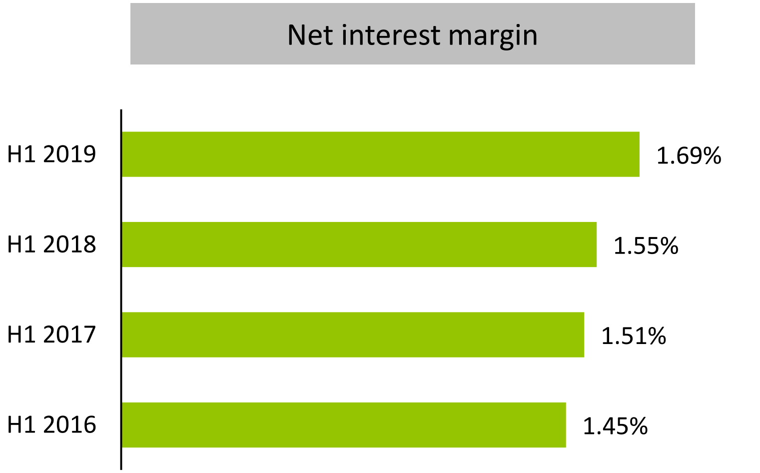


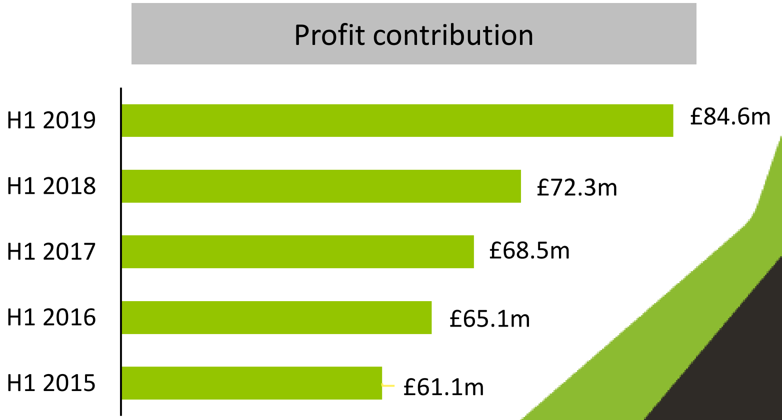
## Steady growth and strong margins

- Steady NIM improvement as legacy book amortises
- Net loan growth supported by lower redemption levels in first half of 2019

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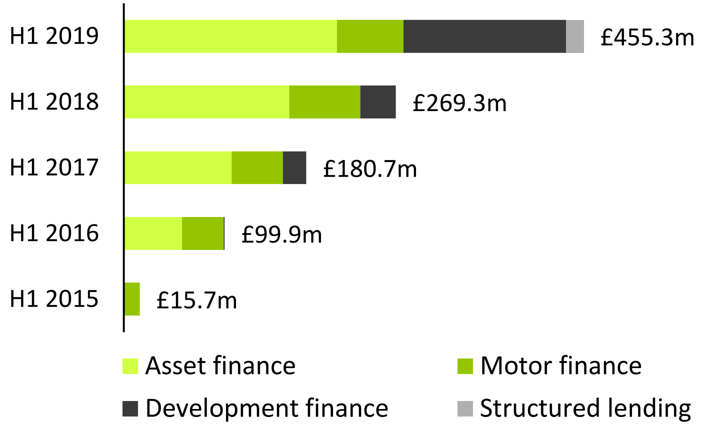
# Commercial Lending

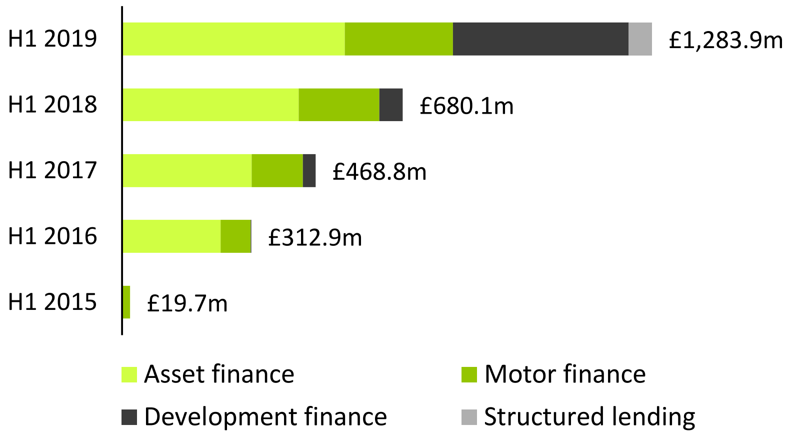
## Historic acquisitions underpin strong lending growth

- Purchase of Titlestone accelerated progress
- Acquired portfolio generated 83bp of period NIM expansion
- Like-for-like growth of 23bp in broader Commercial Lending division

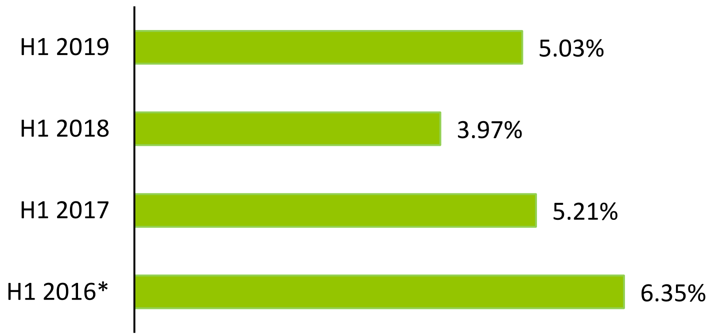
### Originations




### Loans and advances

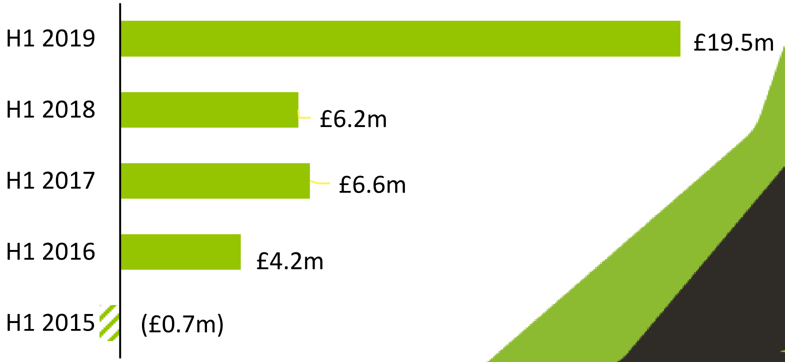



### Net interest margin




* Calculated over average monthly balances

### Profit contribution

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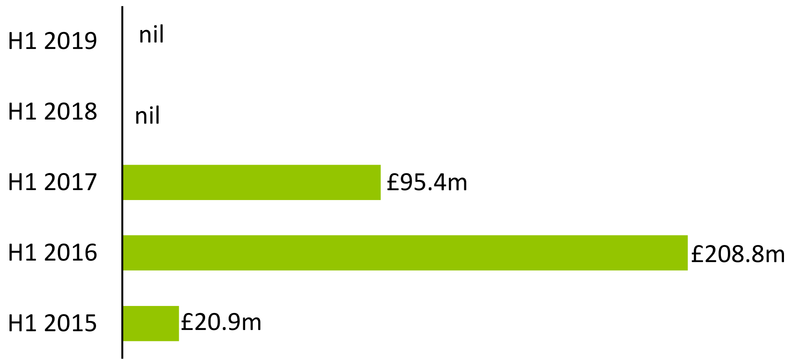
# Idem Capital



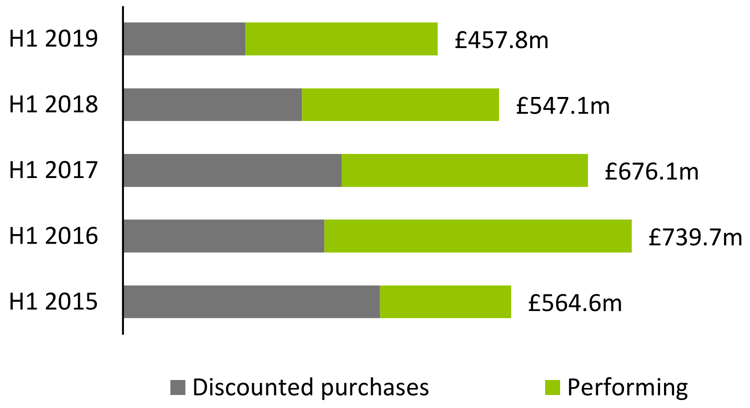
## Stable cash flow from amortising portfolio

- Profit contribution reflects natural run-off, portfolio sales in 2018 and normalised settlement levels in 2019
- Environment remains intensely competitive
- Activity reflects our strong discipline on risk and pricing
- EBA rules will restrict demand further going forward
- Asset sale in September 2018 evidences ability to recycle capital from low to high growth opportunities

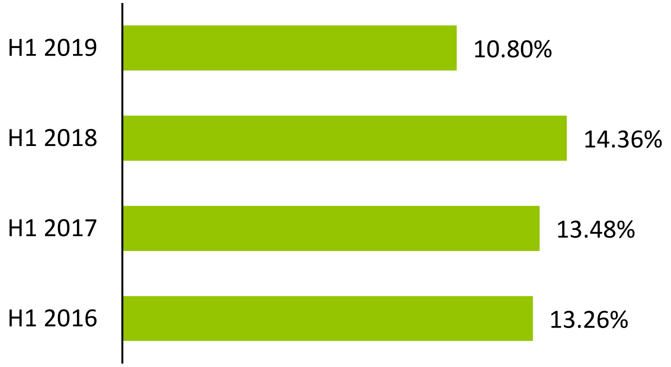
Investments



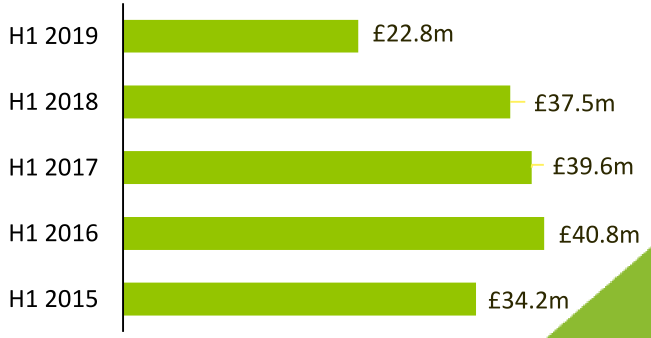

Loans and advances




Net interest margin




Profit contribution

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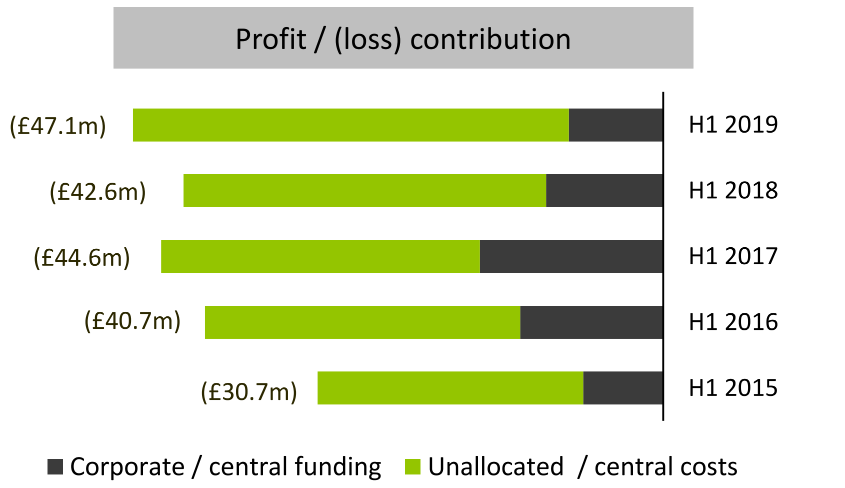
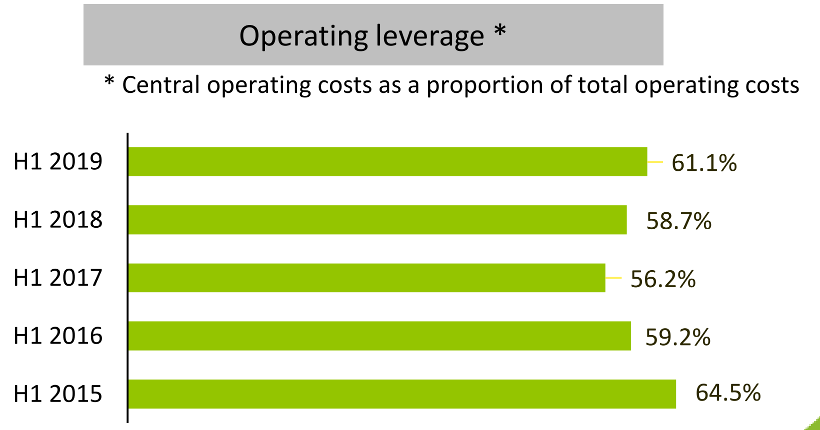
# Central

## Cost growth reflects IT investment and project expenses

- Full period benefit from TFS (H1 2018 only partial)
- Central costs included staff incentives for wider Group

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