Paragon Banking Group PLC
2022 Full year results
Transcript of presentation to analysts

Nigel Terrington, Chief Executive

Good morning and welcome to Paragon's 2022 full year results presentation.

The video we have just shown you shows how our purpose of "supporting the people and businesses of the UK in achieving their ambitions" is being delivered by our unswerving focus as a specialist bank and which will be evident to you throughout today's presentation.

We will of course, as normal, run through the financial and operational performance in detail, addressing our strategic priorities and the strength of our position as we approach a more challenging environment in the year ahead, but first I want to draw out five key messages from this year's performance.

Key messages

First, is that these results clearly show the value created due to our specialisation through the investments we've made over many years and ensuring we have a deep understanding of our markets, our customers and the risks we incur. We don't seek to challenge the large banks but we operate in focused areas where we can achieve strong and sustainable returns, achieving better margins with low impairment outcomes.

We see specialisation as a key element of our franchise noting that this year it has represented 97% of our buy-to-let lending and, whether it's the unique approach of employing our own in-house surveying team or the 600 million-plus pieces of data we access as part of our monthly customer behavioural scoring models or our highly experienced development finance relationship team, there is a consistent application of specialisation that is driven from our purpose.

Second, the balance sheet and funding structure is positively and deliberately geared to higher interest rates which has enabled further improvements in NIM this year alongside the existing long-standing diversification strategy's structural widening in margins as you have witnessed over many years.

We achieved good margins when interest rates were close to zero and we're achieving, and expect to continue to achieve, better margins at higher rates.

Third is the continued adherence to our prudent risk appetite, which has delivered another year of exemplary credit performance backed by a loan book which is 99% secured largely on property, all with low LTVs.

Notwithstanding this, we have further tightened criteria across the year, ensuring we positioned our origination flows dynamically in line with the changing environment. With the average LTV of the pipeline at 63%, we expect 2023 and beyond to continue to reflect our cautious risk appetite.

The fourth key message is the strong internal capital generation that has continued to support robust growth, as well as increased levels of capital distribution and repatriation. We completed a £75 million buy-back last year and have added a further £50 million announced today.

Since 2015 we have declared dividends and undertaken buy-backs which in total are in excess of £700 million, alone representing 65% of our current market cap.

With the RoTE targeted at over 15%, strong internal capital generation is set to continue and, with IRB making further progress, capital management will continue to be a core component of our strategic priorities.

And finally, our important digitalisation programmes are helping to improve customer and intermediary experiences. Good progress has already been made and we can see clear evidence of positive feedback leading to stronger new business flows and improved retention levels. Furthermore, there is still a lot more to come. Digitalisation is also improving efficiency and the cost income ratio is now below 40% which is where we expect it to stay.

These factors have helped us deliver our strong financial and operational performance over the last 12 months and which also enhances our existing strong foundations, enabling us to be well positioned to deal with the challenges in the period ahead … more of which later.

Financial and Operational Performance

As you can imagine, we are absolutely delighted with this year's performance.

Net Interest Income increased by nearly 20% with good loan growth and widening margins. Tight cost control helped reduce the cost income ratio to 39.4% and, not withstanding a cautious approach to strengthening provisioning, we delivered record Operating Profits of £226 million, leaving an underlying return on tangible equity of 16% and EPS growth at 17.9%

Richard will now run through the financial performance in detail and I will return later to discuss our strategy, the individual business lines and the outlook for the year ahead.

Richard Woodman, Chief Financial Officer

Good morning, as Nigel has mentioned the Group has delivered an extremely strong result for 2022. We leave the year with a strong pipeline, above trend margin growth, cautious provisioning and a high quality almost entirely secured, loan book. I'll start by looking at the overall income statement.

Income statement

The net interest result was up 19.5 percent on 2021's level, with growing volumes and margins that have widened beyond our normal 5-10 basis point accretion, reflecting the Group's positive gearing to higher rates.

Other Income has also outperformed recent trends, with leasing and activity-related fees elevated and higher than normal servicing fees as we near the end of a large third-party contract.

Operating costs were in line with expectations at £153 million when combined with the 19.5% increase in total income our underlying cost to income ratio has moved to 39.4 percent.

Pre-provision profits rose 24.2 percent from the previous year. Impairment charges increased, reflecting a more cautious economic outlook, harsher scenario weightings and continued judgmental overlays, inflating our calculated impairments by over 30 percent.

The disposal of our residual unsecured Idem portfolio generated a one-off gain of £4.6 million in the year and fair value gains which are linked primarily to the hedging undertaken on our buy-to-let pipeline totalled £191.9 million, taking our reported pre-tax profits to over £417 million.

My next slide looks at segmental performance.

Segmental results

The first thing to call out is that the sale of the Idem portfolio has resulted in the removal of Idem as a separate segment. The bulk of the remaining Idem assets have now moved to the Mortgage Lending segment.

Overall Mortgage lending operating profits rose by 4.2 percent, with impairments moving from a release in 2021 to a charge in the current year.

Pre-provision profits rose by 9.8 percent to £244.5 million.

Commercial Lending profits grew by 16.0 percent to £88.6 million, with pre-provision profits in the division increasing by over 20 percent to £98 million.

The central area benefitted from the funding environment, fwith higher income on cash balances more than offsetting the higher cost of central overheads. This left the central loss £5.3 million lower than 2021's position at £107.1 million.

I'll now move on to margins.

Net Interest Margin

For a number of years now we have discussed our structural NIM enhancement, with new buy to let assets carrying a higher yield than the back book and wider yields being earned on the Commercial Lending assets.

This underlying, favourable mix effect still holds. We are also positively geared to rising rates, with our net assets largely invested in interest earning assets.

The rising rate environment seen during 2022 has accelerated our normal 5-10 basis point structural enhancement to 30 basis points. However, some of this is a timing difference as savings rates tend to move gradually after a rate change, rather than there being a once and for all step.

We expect further rate rises during 2023 to underpin another year of outperformance, with NIM accretion to again be above trend. However, the outperformance is not expected to be quite as strong as 2022's result given a generally higher passthrough rate and catch-ups from previous increases still to be reflected. Our guidance is for a 20 basis point NIM enhancement in the coming year.

The Group actively hedges its mortgage pipeline, and this approach has resulted in a material fair value gain being posted in 2022, as detailed on my next slide.

Fair values

Our fixed rate mortgage pipeline includes both new business and offers for existing customers for switch products as they reach the end of an existing fix. These offers can be made up to six months ahead of the switch date and therefore require hedging to safeguard margins.

Until the swap can be matched with a completed mortgage loan, which is the point at which hedge effectiveness is achieved, accounting for the swaps used for this hedging uses market-based point-in-time fair values.

With the pipeline largely comprising five-year fixed rate business, the absolute greater scale and longer duration of the pipeline assets have required a doubling of the average hedge position and generated a very material gain in the year – magnified by a near four-fold increase in the change in swap rates when compared to recent years' performance.

Following loan completion, these fair value gains start to reverse across the remaining live of the swap (typically five years), while the cash flows from the swaps are unchanged and contribute to NIM.

The fair value movements are non-cash items that fully reverse, however, they do demonstrate the value of the hedging strategy – had the pipeline not been hedged, and instead loans were swapped at completion, the value of the fair value gain would instead have been reflected as lower net interest across the remaining lives of the swaps simply because the swaps at loan completion would have been written at higher rates.

Given the position reverses over time we exclude these fair values from our underlying performance statistics but they do get included in the Group's capital calculations, contributing around 2 percent to the 2022 CET1.

A final point on fair values – given these arise in the bank, they increase the proportion of the Group's income that is subject to the banking surcharge – increasing the Group's tax rate to 25 percent from an underlying 23 percent in 2022.

Moving on to operating expenses.

Operating expenses

I reported last year that our 2021 annual salary award was 5 percent. Given the inflationary environment and cost of living challenges additional support was given to our people during the summer.

Our year-end pay-round took effect from 1 October 2022, with an increase of 5 percent given to our people below the senior leadership group.

With continued investment in our digitalisation programme expected for 2023, further headcount growth, core wage inflation and inflationary impacts on core non-salary contracts, we expect 2023's outturn to be 2-3% higher than the current consensus of £165.5 million suggests – hence our guidance for the year is around £170 million for operating costs.

As Nigel has noted, in combination with our continued margin accretion,we expect our cost:income ratio to remain below 40%.

Moving on to the economic outlook.

Economic outlook

Our multiple economic scenarios have been updated to reflect the development of the outlook seen since the half year. In addition to generally harsher assumptions, we have also increased the weighting of our severe scenario – which now stands at 20 percent compared to 15 percent in 2021.

The scale of the change in the outlook is shown most clearly in the centre-bottom table on the chart, where our weighted average scenarios for 2023 see a 4 percent GDP decline, an additional 10.0 percent CPI increase, slightly lower unemployment reflecting a strong starting position and an additional 7.5 percent house price decline when compared to the assumptions made for 2023 this time last year.

As always, we show the impact of a 100% weighting for each of the scenarios as a guide to potential downside risk – despite the harsher economics the 100% severe scenario impact has declined from its 2021 level, in large part driven by the impacts of house price increases across the past year on potential loss levels.

The economic scenarios have generated an underlying impairment requirement of £48.5 million as summarised on my next slide.

Impairments

In addition to our modelled impairment, our Covid-related overlays have been written back and substantially replaced by a £15 million judgmental overlay. This judgmental assessment reflects the uncertain economic outlook and CPI levels that did not exist when our impairment models were calibrated. That gives a total provision of £63.5 million which - if you flip back to the previous slide - you'll see is £1 million more than the level we would need if we weighted 100% to the downside.

That downside scenario has peak CPI of 14 percent, a fall in 2023 GDP of 2.2 percent, a 6.3 percent peak in unemployment and a 14 percent peak-to-trough drop in house prices.

Including the overlays, the coverage ratio has fallen to 44 basis points from 49 basis points in 2021.

With the impairments skewed to Stage 1 and 2, the ECLs are largely precautionary in nature, reflecting the underlying strong credit performance of the portfolio. The net balance of Stage 3 loans was £95.9 million at the year end, this compares to £125.4 million in 2021 and £135.7 million at the much more benign 2019 year end.

We also continue to monitor the behavioural scores of our various portfolios. This gives a good early warning of credit challenges amongst our customers. We do this at a customer level and over differing time periods, but the year on year movement shown in the chart demonstrates a stable position at the year end.

The 3-month plus arrears total in the buy-to-let book fell from 21 basis points in 2021 to the current 15 basis points, again demonstrating the resilience of our customers.

My next slide shows the bridge in the capital position from 2021 to 2022.

Capital movements

Retained earnings include the fair value gains noted above (the after-tax value of these comprised 2.0 percent of the 4.6 percent growth on the chart).

Our net loan growth utilised 0.9 percent of our CET1 resources, the dividend 1 percent and the buyback a further 1.1 percent. Although the buyback wasn't completed until post year end our irrevocable instruction accelerated the recognition of the full amount into 2022.

Other movements include the capital required to support the actual balance sheet value of derivatives and hedging fair values – this is 0.4 percent of the 0.7 percent on the chart, partially offsetting the 2% value in retained earnings.

The table on my following slide gives a little more detail on the Group's strong capital base.

Group capital

The credit risk element in the table translates to the group-wide risk-weight density for the loan book that remained unchanged year on year at 44.3%. However, the higher cash balances and fair value adjustments mean that the aggregate risk weight of all our balance sheet exposures fell from 41.2% in 2021 to 39.1% this year.

As noted on the slide, all of the Group's Tier-1 requirements are met by equity, with no AT1 issuance.

The impact of IFRS9 transitions take the fully loaded CET1 ratio to 16.0 percent, which remains materially above our regulatory requirement.

As Nigel has mentioned, we have announced a £50 million share buyback for the year. The 2022 buyback was achieved at an average price of £4.92 per share, which compares to the £5.33 per share of tangible net asset value at the year end.

Since my interim update we have started to receive initial feedback from the PRA on Phase 2 of our buy to let IRB application – this constructive engagement is ongoing, and I will give more colour at the time we get invited through to the next Phase of the process.

Finally for this slide, the Bank of England published its long-awaited consultation paper on Basel 3.1 last Wednesday. Our initial view of the impacts of the Group in a Basel 3.1 environment in line with our initial expectations, with the Bank of England having stayed very close to the original Basel construct. However, the consultation includes important proposals on IRB, in particular the IRB accreditation process. It also proposes an increase in the Strong and Simple regime to cover balance sheets up to £20 billion, which would therefore include Paragon.

All in all, we see the proposals as a strong positive for the Group. We will contribute to the consultation over the coming months and will update the market as and when we get any tangible updates.

My final slide looks at dividends.

Dividends

Adjusting for the non-cash fair value items, but including the gain on the Idem Capital disposal, we are proposing a final dividend of 19.2 pence per share. This takes the dividend for the year to 28.6 pence, restoring the trend improvement in dividend levels as detailed on the chart.

I'll now hand you back to Nigel.

Nigel Terrington

Strategic Priorities

Our strategic priorities and pillars are the building blocks of how we set the bank up and how we've run it over the long term. It's the interplay between each discipline and how we calibrate them to reflect the external environment and risk appetite in a dynamic way that shapes the strategy, allowing us to execute our strategic plans while delivering for each of our stakeholders.

Operating Model Equilibrium

At the heart of what banks do day-to-day is the trade-off between Growth, Returns and Risk.

At Paragon we think about this a lot and we're always trying to strike the right balance, driving our strategic objectives whilst maintaining an equilibrium that works through-the-cycle, not just when times are good.

History shows that any single measure can be delivered in the short-term, but history also shows that taking a short-term view of things is dangerous especially when you're a bank.

It's why we focus on delivering consistent growth - not growth at any cost - and increased diversification, built on a strong prudential foundation of capital, funding and liquidity.

These are all wrapped up in a consistent application of a low-risk appetite that allow us to target, and now deliver, a greater than 15% return on tangible equity on a sustainable basis.

These attributes have never been more important than in the last few years – and it feels like they're going to be as equally important in the period ahead.

We are clearly mindful of the current environment, but we are well placed and, while growth is naturally likely to be tempered compared to 2022, margins are better and our position with our customers is growing stronger so that we can capitalise when the cycle turns, which inevitably it will do.

A key part of our customer proposition and franchise enhancement is being delivered through our digitalisation and sustainability strategies.

Digitalisation

Paragon is a specialist bank with a technology strategy targeted at delivering a better customer proposition through faster delivery with enhanced service levels, providing enhanced data to facilitate better decision-making, and enhanced cost efficiencies and increased operational leverage

We are undergoing a multi-year, multi-business line, cloud-based re-platforming programme utilising Open Banking and API technologies which will transform the way we engage with both the intermediary market and also with new and existing customers.

New digital technology is being introduced into virtually every corner of the bank with a prioritisation towards customer-facing areas.

The new in-house savings platform has helped support the increasing number of our third-party relationships, enabling us to increase deposit balances from these sources to £1.3 billion over the year - now representing 13% of all savings balances.

The SME front-end broker portal, launched during the year, is receiving positive feedback from the intermediary market and supporting good growth in our market share, and is a significant step-up in our operational capacity. Further upgrades will be rolled out this year to enhance our proposition even further.

A new end-to-end development finance platform was delivered this year which will provide significant benefits as this division moves into the next stages of our IRB programme.

There are numerous digitally focused new platforms to be installed in the future; one of the most significant being a digital mortgage underwriting and processing system, which will complement the existing broker portal and the new customer retention system delivered during the year and where we have seen improvements to internal switching levels, and this will become increasingly important in the provision of further advance facilities as our customers seek to upgrade their properties as part of their own sustainability requirements.

Turning now to sustainability.

Sustainability

We have been active in our broader responsibilities in our sustainability agenda.

Significant work has been undertaken using our advanced data analytic capabilities to measure the level of our operational and funded emissions, as well as the risks these bring. Alongside this, we are delighted to announce that we have signed up to Bankers for Net Zero.

We have also published today, our second Responsible Business Report, highlighting increased disclosure and public engagement. Additionally, ESG ratings have been achieved, confirmed or upgraded.

With regard to funded emissions, we've released product initiatives across our divisions designed to encourage our customers to invest in improving their own emissions on their properties or in their businesses, including a 43% increase in A to C rated properties in buy-to-let new lending.

We're also offering finance to support electric motor and commercial vehicles, a trend which will of course only grow rapidly from here. We have also offered a wide range of facilities to SME customers supporting their environmental plans.

A range of operational initiatives have also been undertaken which will continue in order to improve the emissions directly under our own control as we move towards our target of operational net zero by 2030.

We have also been conscious that the consequences of the inflationary environment are also likely to impact our employees. Consequently, we made a one-off payment in the summer to all non-leadership employees and accelerated part of the full-year profit related pay. The balance, which is an even distribution representing 1% of pre-tax profits or around £3,300 each, is also being paid this month again to all non-leadership, employees.

We're also conscious that our broader responsibilities are not just related to climate change, as important as that is. We have continued to actively support the communities we work with and, of course, our colleagues, particularly through the challenges of recent years as we have all learned to adapt to new ways of working.

Finally, we are particularly proud and delighted to announce that we were accredited Platinum status by Investors in People during the year - the highest possible rating which is held by less than 5% of those reviewed and less than 1% of all companies across the UK.

Turning now to our business lines.

Buy-to-Let

2022 has clearly been an outstanding year for Paragon's buy-to-let business and the wider market.

Our new lending has been strong, with advances up 18% year-on-year, and is more specialist than ever before as we continue to adapt to the needs of our professional landlords, who are themselves taking an increased share of the wider buy-to-let market as amateur landlords step back.

While the year to September saw good growth across the market, it ended rather abruptly as the markets reacted aggressively to the mini-budget, pushing interest rate expectations and swap rates up materially. The consequence was that the mortgage market temporarily froze … in some ways similar to what we saw in the early phases of the pandemic. However, we worked closely with landlords and brokers to ensure that the deals in the pipeline could be executed. And, we were able to do this due to our hedging policy, which we enhanced as rates started increasing from earlier in the year, and which allowed us to provide certainty and value to our customers at such a difficult moment whilst also protecting our margins.

As the external factors became clearer, rate expectations stabilised. Application flows are now back to where they were in the same period of 2021 and, with a good pipeline, we remain confident in our ability to support our customers' needs in 2023 and beyond.

In the triangular relationship I shared earlier, we will always prioritise risk and margin over growth and it will continue to be the same this year.

As we look into 2023 it would be heroic to assume that the market is going to be anything other than slower than 2022. While this is an easy prediction to make, the fundamental strength of demand in the buy-to-let market, coupled with the continued seasoning of 5-year mortgages coming up for refinance means that volumes are likely to be below 2022 levels, albeit only moderately.

We are well positioned in a market that is becoming increasingly complex and is therefore benefitting our specialisation focus.

Nevertheless, we have done a fantastic job retaining customers - 70% of which are our professional landlords - and that will be as important, if not more important, in 2023. The uptick in redemptions during the year is centred around our legacy book, which has additional amateur customers compared to the post-GFC portfolio.

Proven resilience of business model

Data analytics and technology have always been used extensively in our buy-to-let business over our history, which now extends to more than a quarter of a century, and this has been used extensively in supporting our IRB application as we employ methodologies to more accurately align capital allocation with risk.

Our buy-to-let credit performance has always outperformed the sector and this remains the case today. Arrears stand at just 15 basis points, virtually a third of industry averages, and, with average LTVs below 58% and only 1.4% of the loan book greater than 80% LTV, the asset backing of the portfolio is incredibly strong. As mentioned earlier, the average LTV of the pipeline is 63% and there is nothing above 80% LTV. When looking at this from the perspective of our landlords, their equity holdings in our buy-to-let loan book, now total in excess of £10 billion.

Higher interest rates always pose challenges for affordability tests, especially if they have not been vigorously applied in the past. We have always operated with conservative affordability tests whilst also applying an additional future affordability stress test … over and above regulatory requirements. Rental demand is very strong and is significantly in excess of the Private Rented Sector's available stock. Our further research directly with tenants and other market data points to continued resilience in their payment performance, providing confidence in the strength of our customers' cash flows.

Whilst 2023 will undoubtedly hold some challenges, our landlords and our buy-to-let business is very well positioned to deal with them. And, there will inevitably be opportunities as the competitive landscape will shift further towards professional landlord specialist lenders and to those lenders which have significant diversification of funding.

Turning to our commercial lending division.

Commercial Lending provides increased diversification

The graph at the top right of this slide shows the share of new lending in our Commercial division since 2018 which now represents 41% of the Group's volumes, reflecting our long-term diversification strategy.

The bottom graph shows that the pre-COVID growth trajectory has now been fully restored,continuing the trend upwards supporting the diversification of income and contributing to the Group's structural NIM accretion.

Turning to the various business lines within Commercial … first Development Finance.

Development Finance

Lending across the year in Development Finance increased by 24% to £632 million, taking the loan balances to just shy of £720 million, an 18.4% increase on a year ago.

The pipeline underpinning future facilities currently remains strong, which is likely to result in robust volumes in the current year as facilities draw down. However, through a combination of supply chain disruption and the uncertainty of the environment, the growth momentum is likely to slow over 2023.

Our typical development finance customer is a highly experienced SME housebuilder who has been through many cycles and where we have had a relationship for many years and, in many cases, decades.

We are highly selective of the developers we work with and they value our extensive experience and our ability to deliver, particularly in more challenging markets.

We undertook a series of credit tightening measures across the year and the portfolio is performing very well and we expect this to continue throughout 2023.

Now turning to SME Lending.

SME lending

Whilst market-wide SME customer demand in recent years has been disrupted by the CBILs and Bounce-Back Loan Schemes, we have achieved strong growth and outperformed the market, with new lending across the year approaching £450 million - a 32% increase on last year and the loan book reached £722 million, a 17% uplift on 2021.

Whilst this growth in new lending saw us taking market share, it is still only 1.5% of the asset finance sector and we believe there is a considerable opportunity to expand this division further over time, part of which is being delivered by the new cloud-based, end-to-end, re-platforming programme.

The new broker portal is already being used on over 70% of applications and has the ability to access over 4,000 pieces of customer data on every single application, including built-in online access to the customer's current account information as part of the underwriting process. This is a significant benefit for us and is data which was historically only accessible by the large banks.

The portfolio is performing well and there is no evidence of credit deterioration.

Turning now to the remaining components of the Commercial divisions.

Motor Finance & Structured Lending

First, Motor Finance which experienced a sharp slow-down during the pandemic and, for a period, operated at virtually tick-over levels.

However, following a review of its strategy, it relaunched with a more targeted approach in specialist sectors where risk reward could be better optimised.

New lending increased to £166 million across the year, a near 66% increase on 2021. New product launches commenced in the leisure markets and in the electric vehicle sector where we should naturally expect to see significant growth as the sector delivers and matures in the coming years.

And finally, Structured Lending, which provides asset- backed lending to non-bank specialist lending firms, has seen an encouraging recovery from the pandemic with an increasing number of facilities being added alongside an improved utilisation of existing credit lines.

Clearly good progress has been achieved across our Commercial Lending division. However, we are conscious that these asset classes are more cyclical in nature and that the environment could be more challenging in the year ahead.

All the portfolios are performing well and the combination of the tightening of lending criteria across the year, combined with the strong disciplined approach we've always taken in the past, will put us in good stead and will continue to be applied going forward.

Finally turning to Funding.

Funding

The deposit book is up nearly 15% year-on-year and now exceeds £10.7 billion. We've continued to strengthen our franchise, enhancing flows in the direct-to-market proposition and through our third-party relationships, like Monzo, Revolut and Hargreaves Lansdowne.

The higher interest rate environment has provided a tailwind to NIM with Savings rates delivering a sub-Sonia cost of funding.

Although the environment carries many uncertainties, we expect to see further NIM progression in 2023 with expectations of around 20 basis points above 2022 levels.

Technology is also playing an important role in our savings business. A new platform to support our third-party deposit relationships is effective and is working well, delivering improved efficiencies, strong operational controls and enhanced resilience.

The demonstrable success of our funding strategy has also been recognised externally with Fitch recently upgrading our long-term debt rating to BBB+.

Looking forward, Open Banking is becoming more embedded in the banking and payments sector. There are over £1 trillion of balances with the major banks earning modest returns, even after the recent base rate rises. New technology will reduce friction and should improve inertia. We are already seeing this today with £12.7 billion of new term deposit flows across the market last month, the highest ever recorded and the vast majority of which has left the large banks. There is a big prize here and we are seeking to exploit the opportunities that should emerge.

The Group has a long history and a strong presence in the securitisation markets and, whilst pricing is unattractive at present, it remains open to us to tap this funding source opportunistically.

Conclusion

So, in conclusion, 2022 has been an outstanding year in terms of our delivery.

Loan growth has been strong and our improved customer relationship management is leading to greater retention levels and supporting good balance sheet growth with margins widening which we expect to continue into 2023.

The strength of our profits and capital accretion supported last year's £75 million buy-back and a further £50 million for the current financial year. However, I am particularly delighted in seeing return on tangible equity on an underlying basis above 15%.

Basel 3.1 seems to be landing where we expected it to. IRB is inextricably linked here and the changes announced look positive. We are encouraged by the strength of our franchises and the growth prospects these can deliver over time. 2023 will hold challenges in growing lending volumes but we have always prioritised margins and the maintenance over low-risk appetite.

There is a significant cloud-based technology re-platforming programme underway across the Group, which will improve both our customer and market propositions, and improve our decision-making and cost efficiency, and much of it has the potential to help level the playing field with the larger banks.

The volatile market conditions have eased although the economic effects have yet to be seen in any material way. Our portfolio has been underwritten prudently and carefully managed over the years. We therefore expect that our business will perform resiliently, both financially and operationally.

We are well prepared for a weaker environment, both in the provisions already taken and with the quality of the loan book, and stand ready to support our customers in a more difficult environment, strengthening resources in our customer support teams in advance of any requirement.

Whilst the environment will create challenges, it will also inevitably create opportunities and we are well positioned to react to them as and when they emerge.

We will now be happy to take questions.

Q&A

Benjamin Toms

Morning. It's Ben Toms from RBC. Two for me, please.

Firstly, on the Basel 3.1 paper from last week, I think you'd previously guided that the impact could be somewhere between 75-150 basis points, depending on whether indexation was allowed and indexation is allowed, although not annually. So that kind of brings you to the 75 basis points if the paper was in line with your expectations, which you say that it was, and given that the small and simple regime which you now qualify for should be nicer than the full Basel 3.1 rules, can we therefore conclude that the impact from Basel 3.1 should be less than 75 basis points?

And then, the second question is around the buyback. £50 million announced today - when you had the discussions around whether it should be, say, £50 or £60 million, can you just talk about what stopped you from going further because it doesn't feel like it was capital, given that on an underlying basis, your CET1 ratio is probably mid-14% kind of level. Thank you.

Nigel Terrington

Okay. So Richard will give you his views on the relative value of the indexation point. I mean, first of all, we don't know what strong and simple holds because, so far, the PRA has only published a consultation on the scale, as in, the threshold, which was initially £15 billion and that's been, as you know with the latest CP, has been moved up to £20 billion. But we don't know yet what the capital consequences, or the other aspects relating to strong and simple, will be. So, it's actually quite difficult to judge the relative benefit or disbenefit until more details have been provided.

Richard Woodman

In addition to the previous expectation, there was also a slightly harsher treatment for HMOs in Basel 3.1, which probably takes the impact a few basis points above the levels originally showing, but there was still that broad mix and essentially the indexation, if fully allowed, would half the impact. So that position still holds. It'll be interesting to see whether that makes it to the end of the consultation. It does feel odd that the bulk of the UK mortgage stock falls under the IRB banks' remit where indexation is permitted as part of that piece. So, it just looks a little odd for that position to hold, but I'm sure it'll be part of the consultation pushback.

Nigel Terrington

I think the point we were making earlier is that you have to look at Basel 3.1 and IRB together. And, I think the PRA provided some acknowledgement of that by announcing changes to the IRB process alongside Basel 3.1. I mean, obviously there are output floors that will take effect, but not until, you know, phased in up until the point of 2030. But when you look at it, the fact is that whilst Basel 3.1 will add to your capital requirements, IRB pulls that right back. And Richard, I'm sure someone is going to ask the question more about how are you getting on with your IRB process and I'll leave that till then, but actually you need to look at those two things side by side because they are now more inextricably linked than probably ever before.

In terms of the buybacks, I think one of the issues there is - you can look at the capital in isolation and go like "you've got more, why didn't you do more?" - is we're all subject to a six month PRA limit as to how much their approval will last for and it's also then tied into how much we think we can realistically take from the market in any given period. If we see further opportunities to do further buybacks in due course, we'll go back and talk to the PRA again.

James Invine

Good morning. It's James Invine here from Soc Gen. I wanted to ask about the savings business, please. It's another strong year of growth and if you carry on growing at this rate, then you know you'll have all the deposits you need. So I was just wondering at what point you're going to kind of pivot, you know, away from growth and a little bit more to margin management. And then just how much difference will that make? I mean, I know the environment already is giving you a tailwind on that. But if you change from growth mode to just, you know, matching the loan growth, that could have another shift. Thanks.

Nigel Terrington

Okay, so the relationship between how much we want to fund from deposits and, or, rather other sources is, kind of, is part of a longer term strategy.

So, once upon a time, many moons ago, we were a wholesale funder and gradually we have not just met the growth in our balance sheet, but we've also refinanced our historic wholesale funding.

At the moment, there is a significant advantage towards retail funding versus wholesale funding. And, you know, we remain capable of opportunistically reacting if those relationships were to shift. But there's quite a gap, frankly, at the moment.

You, kind of, probably should look, the regulatory framework tends to point to a preference around no more than 30% of your funding coming from non-retail sources. Now, running right up against those limits is probably not ideal. So probably, you know, you might want to think of a level, a normalized, long term level, maybe around a 20% wholesale, 80% retail. However, you then move that around depending on where the relative advantages are. I mean, at the moment, there is significant pricing advantages. And, you know, if you get to the point where the evolution of our retail offering has got you to your 80% level and you are still seeing strong inflows because, you know, we are constantly looking at ways of diversifying our various platforms at which we target the fundraising. But then also if you get to that point, then margin management becomes a more active part of your life.

That being said, margin management is already, you know, the guys running our retail savings business are constantly - I wouldn't like to describe it like a frenzied dealing room - but they are constantly looking at various parts of the market along the yield curve, you know, because you can issue three year money and swap it back to sub Sonia. So you can look at various ends of the duration curve all against the relative, kind of almost like arbitrage value points along that line. So, margin management is already there. But, you know, if we constantly expand our addressable market, it will become a more pronounced and bigger opportunity we hope.

Perlie Mong

Hi, it's Perlie Mong from KBW. Just two questions. And the first one is on loan volume. So your guidance for next year suggests a fairly moderate reduction versus what you've done in full year 22. I'm just wondering what gives you that confidence because, at current rates, the rental yield is already below the mortgage rate. So have you seen or would you expect any of your landlords to sort of sell up?

That's one part of it. And the other part of it is what sort of rental cover, rental interest cover are you assuming in these numbers? Because I think previously, maybe last year, you were talking about something like maybe 200%, but at current rates, you would assume that some of that would have come down. So just wondering what you're seeing and what you're expecting. That's the first question.

And the second question very quickly, is the pipeline hedge? So, I would expect that to unwind over, you know, the next few years. But what sort of timeline are you expecting that unwind to take place?

Nigel Terrington

Okay. So let me deal with the first question, Richard, will be able to give you the details around the hedge.

So, I think if you look at the marketplace as a whole, you've got a component there of landlords buying properties and then a component of landlords refinancing. 2023 is going to have, market wide, more properties coming up to that, more landlords coming up to the end of their five year fixes in 2023 than there was in 2022. So first of all, the scale of the addressable remortgage market will increase over the next 12 months. However, I expect existing lenders will be more active in wanting to try and retain customers like we were very active last year. So that will all depend therefore on the competitive dynamics.

The question you posed is how do the landlords cope in this environment? The thing is, if you look at the rental yield in our pipeline, it's 7% - just a touch shy of 7%. And, if you borrow 63% loan to value against that, then you're weighted debt costs are basically providing you with a very strong margin for the landlord.

They are getting probably the full tax cover because they're doing this through a corporate structure so you don't have the same problems that some of the amateurs have. And so, the consequence is you're still generating a good margin for the rents. And part of that is because whilst interest rates have moved up, rents have been rising for quite some time. So, the landlords have benefited from rental growth and now are also benefitting from perhaps an easing from where interest rates were at their peak.

And it was interesting to note that when that kind of very disruptive period took place during October, the activity centred more towards the variable rate products rather than landlords wanting to lock in longer duration where, you know, the market just looked around at that point.

So I think landlords behave quite rationally, but I think you see the landlords, particularly the professional landlords, are achieving quite strong rental yields against their property.

Richard Woodman

Our year end fell at probably the most volatile part of the whole year. So, September saw a very, very material element of that £192 million adjustment.

Some of that will already have unwound because swaps have moved back to the still elevated - but at a slightly, slightly lower level.

There are two elements to the way the pipeline hedges unwind. Firstly, as and when the loans complete, the hedges, then get effectiveness and then the credit then unwinds through a debit for the next five years - given it's a five year swap.

But to the extent that they are still unhedged, sorry, unmatched actually, then you fair value the adjustments. So, my best estimate at this point would be around £100 million of amortisation for this year and then probably an average £25 million for the next four to take out that £200 million movement.

However, all it needs is a spike in rates one way or the other and, also, that only looks at the current pipeline - there'll be a new pipeline that's delivered along the way and, when there's volatility on rates, it could go either way.

But if you know, if all my planning is right and the market interest rates are correct, that's the sort of profile we'd expect to see from that.

Gary Greenwood

Gary Greenwood at Shore Capital. I've got three questions, please. So the first one on NIM and interest rates. You talked about how you are positively geared deliberately to rising interest rates and that's going to be a further benefit next year but I was wondering whether you can do anything to lock in those benefits as and when the rate cycle turns thereafter.

And the second one on credit quality, I think a feature of the entire industry at the moment is that actual arrears and losses still remain very low, and that's no different for you. But which of the areas of your portfolio are you looking most closely at at the moment in terms of risk?

And then the last question was on non-interest income. You mentioned that you had a better than expected year on non-interest income. So, if you could just talk about thoughts for 2023. Thank you.

Nigel Terrington

Okay. So the NIM, I think, is what you've seen is that NIM accretion has come around for a couple of reasons. One, over many years you've seen the structural NIM accretion as our business mix has changed. So less of the legacy buy to let book more of the post financial crisis book. You're getting old margins going off, new margins coming on. And you've also had the commercial business coming on where naturally it has wider margins. I think the other aspect, though, is the gearing effect you said with higher rates leading to the deposit beta, in effect, providing a move from above Sonia to sub-Sonia.

Now, your question was, like, can you lock the benefit of that in so obviously you're referring to the more structural hedges that the bigger banks have tended to use. And we will look at that. We haven't made any decisions about it yet about locking in or, you know, our return on our capital, in effect through a series of rolling swaps.

However, one of the things that has been historically used is that the reason we haven't done that is that as rates rise, it tends to be a credit negative, generally, not necessarily specific for any one bank, but generally, but also so which would see impairments rise.

So, if you're making an extra return, which historically we'd guided to, every 1% increase in base rates will add £10 million to the net interest income line. So, you can see that there is a hedge between net interest income and impairments on that basis. However, what we will be working on and looking at is to whether that is adequately modelled in this environment or whether it would be appropriate to look at structural hedges as an additional item to look at. So, no decisions yet. But it's being looked at.

Richard Woodman

On the non-interest income, with higher volumes, we see higher activity fees. So that's been just driven through naturally, that's been a small increase in the year.

The leasing business has done really well. We had a very good second half. And so that drives additional income.

But also a number of years ago when we bought the Titlestone development finance business, we only bought half of the portfolio. We've been managing that for a third party. The way that works is towards the end of the servicing contract, there's some higher earnings. And so, we have the first of those payments fell into this year. We were actually expecting it next year originally. So, there's a favourable timing difference there, but still a little bit more to come in 2023. That won't be repeated in 2024, but the absolute activity levels we're seeing should mean that the level is higher than the previous trend, but probably below 22 for 2023, if that helps.

Nigel Terrington

And so, the second question that you had was which of the portfolios do you keep more of a weather eye on in 2023?

So, you know, you'd start by looking at the buy-to-let book and saying it's very low LTV, less than 58% on the stock, 63% on the pipeline. It's demonstrably shown through many cycles over many years a more resilient outcome. I've tried to argue, maybe not necessarily successfully, that there is a countercyclical element to that because when the economy is weak, people don't buy, they rent for longer, so it increases demand and we've certainly got that at the moment.

However, so the commercial area would be regarded as more cyclical in its nature but, as I said earlier, as of today, we are not seeing any credit deterioration in any of those portfolios.

I would suppose the one that is the most cyclical is likely to be the motor finance division because, in effect, it is largely consumers there. It's secured against the value of the car, but that, you know, it is still a consumer exposure. That being said, we have been deliberately very cautious, very focused in the nature of that lending and tightening lending criteria there, as we have done everywhere across the year, pulling down LTVs across that product line, notwithstanding the increase in the lending that's been able to be achieved.

So, you know, we look at everything, we're cautious about everything at the point of underwriting. We are cautious about things the way we provide hence you've seen the approach that we've taken this year. We are very analytical, we download, as I said, 600 million pieces of data on our customers every single month so we try and see what's going on in their lives before a payment gets missed. And then we try and anticipate that reaching out to the customers to try and see what level of support we can provide. We're not seeing anything of significance come in through those early warning indicators either. So, it's all good. But we're very cautious, very conscious of the environment and we'll be there ready to support customers if that's what's needed.

John Cronin

Thank you. I have three questions. It's John Cronin from Goodbody.

The first one is on IRB. So, if you overlay the impacts of the expected reduction in risk rates you would see accruing from IRB accreditation to the revised Basel 3.1 standardised template, what are you seeing there in terms of potential benefit from a capital perspective?

The second question is on NIM, just looking at it further to one of the previous questions, just trying to unbundle that a little bit more for 23. So 20 basis points of accretion is quite strong and obviously your cost of deposits have remained quite low throughout H2 but have ticked up towards the end - and I think you did see a significant increase by period end - and I was just trying to understand what you're assuming in terms of deposit cost migration through 23, as well as asset rates and spreads.

And then thirdly, coming back to the point on credit quality, very clear, very, very strong message again on arrears and loan loss experience. And clearly, look, your provision bulk up is all through the form of overlays but I did notice that there was a significant pickup in the balances that have seen a significant increase in credit risk in the buy to let book and I'm just thinking about how comfortable you are with your provisions from a stage two loans perspective, particularly given they screen quite low relative to peers - although I appreciate as I'm comparing apples with oranges in many respects by drawing those comparisons, but just how confident you are in your in your coverage levels. Thank you.

Nigel Terrington

Okay. So let me just deal with the deposit side and then maybe you can cover IRB and the impairment flows.

So, on the deposit side, you can see that, you know, with a 30 basis points accretion this year - sorry last year - guiding to 20 for 2023, you know, we've allowed for an easing of that. And if you look at the relative rates, you know, we have passed on rates, you know, in a number of areas here to customers. Now, when you look at the phasing of these things and sometimes when base rates are moving like monthly and then you move and deposit rates move in the market, you're never quite sure whether it's playing catch up to the last base rate move, the one before or the one to come.

So, we all kind of want to see a dynamic here where markets peak, interest rates peak, we get some stability about where rates will be - and then you'll kind of get where terminal base rates will be and then you'll see the relative deposit relationship compared to Sonia or base rates.

Now I think when you look at that and actually because we've spent the last 15 years at near zero interest rates, then it's kind of difficult to look at recent history for a trend there.

So, you go back to the pre financial crisis when you know, life existed around 5% base rates, you typically had a healthy 2% spread on the deposit side to base rates. That's not, you know, it's a different world - it's a different dynamic, there's a different set of circumstances - so it won't be absolutely the same going forward, but what we see is that, you know, ignoring any short term dynamics between one competitor, suddenly having a flurry of activity, but trying to look at the longer term trend, is that we expect there to be further base rate rises to come.

Our view is that base rates will settle out at 4%, but that we will continue to see rates being passed on to customers. And so, the 20 basis points is a more cautious view of the accretion that we saw in 22 over to 23.

So, I don't think that the expectations are that all of this massive widening that has taken place in the sub-Sonia deposit rates is there and permanent to stay. I think there's a catch up still to come. And hence, that's why we've narrowed that deposit spread for 23.

Richard Woodman

We've been asked several times about the impacts of IRB. I think until we've got to the stage that we've cleared that with the regulator, we're not going to be able to give proper guidance.

The reason we're doing that, though, is not just to defray downside from Basel 3.1, but our basic IRB position would give a better capital outcome than the current standardised.

So, I think that's probably as far as we can take it at the moment.

There will be an interplay with the risk weight floors down the line on getting accreditation. There are some things that have been added into this next consultation that we still need to reflect in models. There's an element of a PD floor on some of the mortgages which we need to calibrate properly. But again, we're still expecting the IRB outcomes to be better than current standardised and I think that's the, in terms of if you like the downside risk of 3.1, that's probably the main takeaway.

Nigel Terrington

I think just to add to that point is if you've seen - if you're seeing - risk weight inflation coming through across the market for let's call it the professional landlords, multiple property landlords, then the significance of IRB has just become even more important.
So, one of the things is there is a question as to if you're a small bank and you don't see IRB as remotely achievable or affordable, then there's potentially a competitive disadvantage likely to emerge more as a consequence of Basel 3.1 than existed before.

Now, that may be alleviated under standardised, under strong and simple, but we simply don't know because there is no rules and guidance as to what will be included on the capital side for strong and simple. One thing you do know is regulators rarely give up capital. They only tend to add.

John Cronin

That's very clear on IRB but can I come back on one further question and I appreciate you don't want to be drawn on what the possible impacts would be but just in terms of how - so at the stage of introduction, so for argument's sake, if you were to migrate to IRB on the 1st of January 2025, at which stage the 50% output floor is applicable - do you think the PRA would, in a bid to try and minimise capital ratio volatility, look at maybe, and I guess there is a precedent for new to IRB banks carrying a slightly higher risk weight on their books relative to banks that have been using IRB for a long time - I suppose what I'm getting at is, look, theoretically you could see a substantive, immediate benefit as you move to 50% and then that partially unwinds over the course of the following five years as you move up to the 72 and a half percent output floor. Do you think the PRA would try and smooth that a bit?

Richard Woodman

I'm not sure that they'll necessarily try to do that overtly, but that's why we've not given guidance yet, because until we've been through exactly where our ratios are landing, it's hard to answer that question.

You know, we know where our models are looking and that still gives that favourable to standardised approach.

I think the bigger downside prize is that all firms who are currently standardised will be holding capital in case of Basel 3.1. I think if that threat is removed, even just the removal of that piece actually ought to give strong additional capital resources for us to grow the business, buy things, conduct more capital management - all the above.

And in terms of the SICAR movement, one of the key drivers of whether you - bit technical I'm afraid - but whether you actually describe something as having had a significant increase in credit risk is if when you put it through your IFRS 9 models, the PDs have gone up by a particular amount. So, the increase in SICAR that you've seen there is a function of the economic scenarios that we put in place. So that's the thing that has driven the increase in the balance and in that category. Not the performance of the portfolio, not the spot performance.

John Cronin

Then on coverage levels?

Richard Woodman

Yeah. And again, the driver there is LTVs. So, whilst you can see some movement on PD actually - back to Nigel's point - when you're starting with a 58% loan to value for the portfolio as a whole, there will clearly be a distribution within that but the vast, vast, vast majority of that is at sub- 80% so it doesn't translate through to crystallising losses at that point.

John Cronin

Great. Thank you.

Nigel Terrington

I think we’ve got time for one more question. Portia.

Portia Patel

Thank you. Portia Patel from Canaccord. Just two really quick ones, please.

Just on the NIM guidance, really simply what is your 20 bps accretion based on in terms of base rate expectation for FY23, ie it gets to what level and when?

And secondly, given what you mentioned earlier about increasing remortgage activity, how would you encourage us to think about redemptions in the mortgage book in FY23 and beyond?

Richard Woodman

Okay. Yeah. So we've got another, another percent from here, so up to 4% and assume that's from the summer next year in terms of base rates. So that's what would underpin that 20 basis points.

Nigel Terrington

So, on the remortgage side, so I mentioned earlier that 2023 there will be more market-wide, five year seasoned loans coming up for refinancing than there were in 22. That's a market wide phenomenon. The same is true for us. We have more coming up in the current financial year compared to last year.

What we also have is more within that - there are more professional landlords compared to the number of the component out of the total.

We will be more competitive in terms of our product offering with a professional landlord than we will be with an amateur. So, we are optimistic that we will have good retention levels in 23.

Portia Patel

Thank you. That's really helpful. And just a final one. The rule of thumb that you have, the 1% increase in rates is £10 million to PBT. Does that still hold at a 4% base rate level?

Richard Woodman

Generally, yes. The £10 million, 4% is in a steady state, so it won't be at the day you have it because there'll be lags and lead times in terms of the passing on of rates to certain customers and the savings customers. Steady state … at that level.

Nigel Terrington

Okay. So, thank you very much for attending this morning. You know where we are. We're happy to have conversations with you - for the analysts to discuss anything they want.

Richard has set aside a good amount of time over the next day or so. If you haven't got a meeting with him already, then please get in touch. We are around for a while so happy to carry on the conversation. Thank you very much.