2023 Half Year Results
Paragon Banking Group PLC

Nigel Terrington, Chief Executive

Good morning everyone. Good to see you and welcome to Paragon's 2023 interim results presentation.

Today we will run through the financial and business performance for the first six months of the year and provide you with our view on the outlook as well, of course, leaving plenty of time for your questions.

Slide - Strong performance and well positioned

But first, I'd like to start with five key messages which, for me, represent the key highlights from these results.

The first is that this excellent performance has been achieved despite the environment. The backdrop has certainly been challenging, with market volatility disrupting normal business patterns, interest rates reaching their highest level post financial crisis and the UK economy, whilst not in recession, has been weak throughout the period.

Therefore, it's particularly pleasing that we have delivered an outstanding and record set of interim results alongside a robust trading performance whilst continuing to deliver good progress in our strategic priorities.

Trading has been good in virtually all areas of the Group and better than our expectations, six months ago. Although all divisions have performed well, savings has been a stand-out performer, delivering good growth, broadening its addressable market and driving down the cost of funds to below Sonia.

There is also good momentum, with many early indicators pointing to further growth opportunities in the second half, giving us the confidence to upgrade our Mortgage Lending volume expectations and NIM guidance, the latter for the second time this year.

Our loan portfolios continue to perform resiliently and the widening NIM bears testimony to our approach to prioritise risk and margins over volume. This will remain important as we are clearly now in a further period of uncertainty.

Internal capital generation has been strong, supporting robust loan growth, the progressive dividend and the increase in the buy-back programme to £100 million announced today.

The final message is the growing importance of technology where we have made further progress this year, supporting improved customer propositions whilst achieving efficiency benefits. Technology is changing rapidly in almost every facet of business life. This is very true at Paragon as we transform every corner of our business to exploit the opportunities that the new technologies can provide.

Turning to the next slide we can briefly look at the key financial highlights.

Slide - Strong operational and financial performance

Operating profits stood at £129 million, up 22% on last year, driven by strong growth in the loan book and NIM 38 basis points wider than a year ago at 2.95%, resulting in our underlying Return on Tangible Equity reaching 18.7%.

Operating expenses are in line with expectations, delivering a cost income ratio of 38.1%. This results from tight cost management and some of the benefits of our digitalisation programme.

The loan book grew better than expected at 4.6% and savings balances, 94% of which are FSCS backed, grew over 20% year-on-year delivering an improved cost of funding and supporting the widening NIM referred to earlier. Underlying EPS is up 28% year-on-year.

As mentioned, we have today announced a further £50 million buy-back programme which we hope to complete in the second half of the year. Notwithstanding this, our capital base is strong, with CET1 at 15.6% providing ample capacity to continue to support our ambitious growth plans in the years ahead.

I will now hand over to Richard to run through the detail of the financial performance and I will return to discuss the business performance and our strategic priorities, as well as the outlook for the period ahead.

Richard Woodman, CFO

Slide - Financial overview

Good morning. As Nigel has just said, we've produced another strong set of results for the first half of 2023, and I'll run through some more details on the financials now and in the next few slides.

Slide - Income statement

Starting with the overall Income statement, both net interest and other income were up over 20% in the period – taking total operating income to £220 million, an increase of 21.2% on last year's level.

Operating costs grew by just under 12% to £83.8 million and remain on track to total around £170 million pounds for the year, in line with our initial guidance.

Provisions were higher in the period, with the impact of harsher economic scenarios being offset by a slight reduction in the overlays we held at the last year end.

These combined to take our underlying profits to £128.9 million, 22.2% up on last year.

As we discussed at the year end, the fair value gains we made in 2022 will all reverse to zero over time. Part of this has been accelerated into H1 23 with the rest expected to arise reasonably evenly over the coming five years, as the associated derivatives mature.

Underlying EPS rose 28% to 42.5p per share. This reflects the ongoing benefit of the share buyback programme as well as the increase in underlying profits.

Slide - Segmental results

On our segmental results, we sold the unsecured Idem portfolio in the second half of last year and moved to a two-segment disclosure last year end as a result. The figures on the table on the screen follow this approach, so the H1 22 comparative has been re-stated to reflect this change.

Pre-provision profits are higher in both core divisions, and we have also seen an improvement in central, where funding benefits have offset the impacts of cost inflation in the period.

Underlying operating profit for the Commercial segment now stands at just under 48% of that generated by mortgages, demonstrating the progress of the diversification strategy. This latter point also supports our continued NIM expansion, and I'll move on to that next.

Slide - Net Interest Margin

With the Group's margin having been on an upwards trajectory for some time, the chart clearly shows how NIM progress has accelerated in the higher rate environment.

We are positively geared to higher rates and have guided in the past to a circa £10 million per annum benefit, per 1% increase in base rates. This benefit has been augmented by savings pricing benefits and a continuation of our structural asset side accretion, which comes from the growth in the commercial division and the run-off of legacy buy to let loans.

There is more detail on divisional margins in the appendix, but it is worth noting that further growth in the Commercial division (which generates a 7% spread) will be an important element in maintaining margins above their longer-term trends when base rates eventually do start to decline.

On the liability side, at over 94%, our depositors are well covered by FSCS insurance. Of the balance, the majority represent term, rather than on-demand, deposits and you will see from our absolute deposit and cash balances that LCRs have risen over the year, with the average for the six-month period more than 20% up on the equivalent in 2022. The March spot position on LCR was higher still, reflecting the strong inflows seen in the period.

Slide - Operating expenses

Moving on to costs, as I mentioned earlier, operating expenses rose 11.9% from H1 22's level, as we continue to push on with our digitalisation plans. The increase also reflects the generally inflationary environment.

Core wage growth gets set from 1 October each year at Paragon - this was 5% last year - so the delta from that 5% to 11.9% reflects a combination of higher absolute headcount and non-headcount inflationary influences.

The Group's FTE headcount moved up 2.6% from March 2022 to this March, with the rest of the cost change arising from inflation and volume-related costs (the bulk of the latter relating to our savings activities, where costs grow in line with the deposit book size rather than having a direct inflation link).

When combined, our guidance for NIM and full year costs deliver a sub-40% cost to income ratio for 2023. Cost discipline and the delivery of operational efficiencies remain key priorities for the Group.

Slide - Economic outlook

Our economic outlook sees the key 2023 macro indicators being worse than the levels used when we undertook the exercise at the year end, with GDP trending lower and house prices softer. Across the scenarios, house prices are now assumed to drop by 12.5% in 2023, compared to the 8.2% we used at the year end.

We've maintained our scenario weights for 2023. If 100% weighted, the severe scenario, would add £21 million to our modelled provisions. The same effect last March was £41.5 million, with the difference largely due to the house price forecasts and their impact on the BTL portfolio.

Slide - Impairments

The multiple economic scenarios translate directly to our provisioning levels, with the recent reduction in house prices taking the buy to let portfolio LTV to 62.5% in 2023 compared to 61.2% at the 2022 interim, together with the softer outlook.

Despite the modelled provisions being higher, book performance and underlying collateral levels have remained strong, and we have trimmed the overlays we hold to £10 million compared to the £15 million we held at the year end. We still haven't seen the full impacts of the cost-of-living increases over the last year, so have not taken our overlays any lower. We will keep these under review to assess the degree to which our underlying models adequately reflect the impacts of emerging performance themes.

The coverage ratio at the interim is 47 basis points (40 basis points without the overlays). This compares to the Covid peak of 64 basis points and, as detailed in the bottom-left table, a level of 36 basis points had the environment let us move back to a more normalised MES weighting with no overlays.

We continue to monitor the credit performance of the book and as detailed on the right-hand side of the charts, our behavioural scoring outputs suggest a continued, stable outlook.

Slide - Capital movements

Our usual capital walk is shown in the chart. The main area of difference to the norm has been the impact of the fair value amortisation on the capital accretion in the period. Here, the underlying 1.3% growth has been offset by 0.8% of fair value charges, as the gains from 2022 unwind (in total these gave us a 2% benefit last year).

Distributions in the period totalled 1% and our period end CET1 stood at 15.6%. The total capital ratio was 17.6%. These March numbers exclude the extra £50 million buyback announced today.

Slide - Group Capital

Our attractively priced Tier 2 bond still has over three years to run and the Group is not impacted by MREL, so we have no corporate debt raising requirements in this period of elevated coupons.

On IRB we continue to engage with the PRA, where we have been reflecting their feedback and are nearing a position where our Phase 2 submissions will be ready for a formal panel review.

Phase 3 is ready to follow any successful panel review and we will update the markets as and when we get any tangible progress on the IRB side, but we continue to move at the pace dictated by the regulator.

We have seen the Basel 3.1 consultation paper in this half year. As drafted, it would have reduced our CET1 ratio by 2.3% from 1 January 2025. Any changes in the final supervisory statement should partially reduce this level and it would be fully mitigated by the Group receiving its IRB accreditation before the Basel implementation date.

We have also announced – as I've just mentioned - the additional £50 million of share buyback, on top of the 50 we've already done, taking the 2023 full year programme to £100 million.

Slide - Dividend per share

Finally from me, you will have seen that our interim dividend will be 11 pence per share. This is slightly above our normal policy approach (where 50% of the 2022 final would have been 9.6 pence), however, we have decided to restore a more normal relationship between interim and final dividends, following some material intra-year moves in the Covid period. Our total dividend policy remains unchanged at 40% of underlying earnings per share.

Nigel Terrington, Chief Executive

Slide - Business performance review

Thank you, Richard. Let me now turn our attention to how the business has progressed against our key strategic priorities and provide you with our view on the outlook for the period ahead.

Slide – Strategic priorities

We have shared with you previously how we focus on these priorities and how they are inter-connected and are supported by our strategic pillars of:

- A strong customer focused culture
- A passionate and committed colleagues
- Strong financial foundations

So, turning to the first of our individual strategic priorities.

Slide - Strategic priorities

You have seen that our new lending increased by 6.9% compared to 2022 and the loan book expanding by 4.6%. This is not just a one-off good year as the Group's new lending Compound Annual Growth Rate since 2015 stands at 16.6%. Furthermore, the specialist markets in which we operate are witnessing good underlying growth in most areas and offer excellent long-term prospects.

Our diversification strategy is an important ingredient in exploiting centralised operational leverage and broadening our sources of income. Commercial Lending typically delivers a Net Interest Margin materially higher than Mortgages but, with a highly experienced risk management team and a deep understanding of the sectors in which we trade, strong risk-adjusted returns can be achieved. New Commercial Lending represents 36% of the Group's volumes while delivering a £56.7 million profit contribution compared to just £13.7 million only three years ago. It operates typically in less mature sectors, where we have an underweight position, giving us market share growth opportunities and we expect this outperformance to continue for the foreseeable future.

Digitalisation transformation is now well progressed. 84% of our core and support systems are in the Cloud and we are systematically digitalising and transforming our customer-facing platforms across every corner of the Group, enhancing propositions, product delivery, flexibility, greater access to data and further improving cost efficiencies and operating leverage. AI is already being used in parts of the Group but it is early days and the opportunities for this exciting new technology are extensive.

Excellent progress has been evident in supporting the growth in SME new lending where the initial phase of the new platform has enabled us to broaden our customer reach and increase our addressable market whilst capturing extensive new data sources to support the underwriting process.

Internal capital generation is strong with 1.3% added to CET1 in the first-half, pre-distribution and fair value. As is well known, uncertainty exists on regulatory changes with IRB and Basel 3.1 in particular. However, such is our confidence that we have been able to increase our buy-back programme, bringing this year's plan to £100 million - our largest ever in one year - and taking the total since 2015 to £383 million, including today's announcement.

Finally, with regard to sustainability, we continue to make good progress in doing the right thing. The areas we can control, our operational emissions, have seen an acceleration towards our net zero objective by 2030, with a 39% reduction since 2019.

Our financed emissions are more difficult to deliver as we await a Government framework and policy directives. Nevertheless, we have extensive product offerings, with more in development across each of our business lines, offering customer incentives to support their own long-term sustainability requirements.

Turning now to each of the business lines' performances.

Slide – Continued focus on professional landlords driving loan book growth

The wider mortgage market is down year-on-year … including the Buy-to-Let sector. It was heavily disrupted at the beginning of our financial year when the so-called mini budget led to a wholesale freezing of the mortgage market, when the sector was effectively unable to price its cost of funds for a period of time. Given the wider economic backdrop, demand is therefore generally lower.

As we saw at the year-end results, our hedging was highly prudent and extensively applied … protecting our customers and our margins.

Consequently, there was a temporary, but significant, slowdown in new business flows and a step-up in conversion levels, thereby reducing the pipeline for a period of time.

Completions have been strong over the last six months at over £1 billion, some 19% up on the equivalent period last year. Due to timing and, as we guided in December, the second half will inevitably see a lower volume whilst the pipeline rebuilds. However, we now expect the volume for the year to be in the top half of the range we guided to in December.

The pipeline has rebuilt rapidly from its low point of £681 million in January and was £811 million at the end of March. It is significantly above this figure now and we expect the pipeline to continue to build further in the second half.

Whilst activity in the housing market has been weaker, we have also made further progress in customer retention - with 77% of maturing fixed rate customers choosing to remain with us, supporting the growth in the Mortgage loan book. The redemptions we are seeing are typically centred on the legacy pre-global financial crisis portfolio, where there is a larger cohort of amateur landlords.

Some amateurs have left the market, affected by tax and regulation which leaves further growth opportunities for professional landlords. To remind you, nearly 100% of our buy-to-let business is specialist in nature and to professional landlord customers. The buy-to-let market has been professionalising over a number of years and this benefits our customers so, it's not surprising that whilst the market has been weak, we are still achieving good levels of new lending.

Rental demand remains very strong and the supply shortages in the Private Rented Sector will only serve to keep our landlords' rental income firm.

Despite the robust lending volumes, we have not chased new business by weakening credit standards as is evident from our risk performance as can be seen on the next slide.

Slide – Proven resilience of business model through-the-cycle

We continue to use extensive data analytics in our buy-to-let business, supporting our comprehensive underwriting processes, in-life portfolio monitoring, as well as the IRB programme where the extent and depth of the data we hold is unrivalled in the UK - helping us to employ methodologies to more accurately align capital with the allocation of risk.

Despite the environment, arrears are just 10 basis points higher than the equivalent figure a year ago and remain materially below industry averages. Much of the increase is in the legacy portfolio where, as described earlier, there are larger numbers of amateur landlords. The average LTV stands across the portfolio stands at 62.5%.

We are conscious that affordability concerns have been in the spotlight in this higher interest rate environment. We have always operated conservative stress testing in this area and have applied it rigorously throughout, including employing tests over-and-above the regulatory requirements. Our current debt service ratio, the ICR, sits at around 200% even at current rates. Although loans coming off five-year fixes are typically seeing rates move up meaningfully, rents have kept track. Indeed, over the last five years their rents have increased by around 30%, meaning that the ICR is broadly unchanged. Furthermore, the ICR and LTV requirements are connected such that should interest rates rise without a compensating benefit from rents, our credit assessment will typically demand lower loan-to-values to adjust the position and therefore equalise cash flow coverage.

Nevertheless, rental demand has been strong, with rental growth running this year at an estimated level of 11% per annum. Our research and data analysis does not stop with our customers but includes assessing the financial resilience of tenants, thereby producing confidence in the strength of our customers' cash flow.

We now turn to the Commercial Lending lines.

Slide – Commercial Lending provides increased diversification

Commercial Lending has been the main vehicle by which we have been able to diversify our business over a number of years, in pursuit of our key strategic priorities. Whilst Commercial Lending represents 13% of the balance sheet, it is 36% of new business volumes and importantly 33% of income.

Additionally, Commercial Lending is not one homogenous product line but a number of different businesses providing further diversification in itself, and within SME there is a broad spectrum of customers, including SMEs, corporates and the UK Government, and a range of sectors from construction to logistics, from agriculture to education, manufacturing to transport and indeed many others.

So, turning to each of the Commercial Lending lines themselves.

Slide – Commercial Lending – Development Finance

As signalled at the year-end, we expected that Development Finance was likely to see weaker activity in 2023 due to the combination of supply chain disruption, cost growth and the uncertainty of the environment, including the outlook for house prices.

Consequently, our Development Finance lending division delivered a performance in line with those expectations. That being said, the loan book now stands at £766 million, nearly 14% up on last year.

As witnessed by the larger national house builders, there has been a modest recovery emerging in demand since the turn of the year and we have also witnessed an encouraging improvement in customer engagement levels and the pipeline is now growing again which, given extensive lead times in this sector, bodes well for 2024.

In line with our general credit standards, we have a high-quality customer base in Development Finance. We are highly selective of the Developers with whom we work, many where our experience of working with them goes back decades. The portfolio is performing well and we expect this to continue for the foreseeable future.

Now turning to SME Lending

Slide – SME Lending

Notwithstanding the economic challenges, our SME division has witnessed strong growth in new lending and a robust performance in the portfolio. Volumes for the six months stood at £220 million, 21% above last year, with the loan book now approaching £750 million.

This division has been a real beneficiary of our digitalisation strategy. Over 72% of our applications now pass through our new lending business portal, which assesses over 4,000 pieces of customer data with each application, including online access to the customer's current account information as part of the underwriting process. This is a significant benefit for us as previously this was only something accessible and available to the large banks. Further technology changes are being implemented in the second half of the year.

Even with the weaker environment and higher business insolvencies, the portfolio is performing incredibly well and there is no evidence of credit deterioration nor any concerns emerging from our early warning indicators.

Turning now to the remaining components of the Commercial Lending division.

Slide – Motor Finance and Structured Lending

First, Motor Finance which experienced a steep slowdown during the pandemic, has now witnessed another period of strong growth - despite the environment - following a more targeted approach to the specialist sectors.

New lending increased by nearly 14%, bringing the loan book outstanding to £286 million with stronger growth being achieved in leisure markets, LCVs and electric vehicles. As with SME lending, Motor Finance is also seeing a strong credit performance with no credit deterioration evident in the portfolio or in lead indicators.

And finally Structured Lending, which provides asset-backed lending to non-bank, specialist firms, has had a stable year in terms of new business flows, achieving good customer retention and delivering good profitability. New business pipeline levels are encouraging, and good growth is expected in the second half of the year. The credit performance in the portfolio has been exemplary.

Our Commercial Lending divisions are certainly more cyclical in nature than mortgages but have performed – as you've heard - particularly resiliently in this more challenging environment and, to date, the credit performance has been strong, reflecting the longer-term prudent approach to risk management applied across the Group. The environment may well get worse before it gets better but the business is well positioned to deal with these challenges and we will therefore maintain our cautious risk appetite, prudent provisioning coverage levels and continue to apply close, in-life monitoring across the various portfolios.

Turning to the Savings division.

Slide – Strong deposit growth with improved cost of funding

The Savings division has been a significant beneficiary of the rising interest rate environment, where our cost of funds has moved from around 100 basis points above Sonia to now being sub-Sonia. We have also seen a significant shift in customer demand with a material increase in flows into fixed term products, where there is now a meaningful return available across the curve.

Since September 2022, there has been a £53 billion switch from Easy Access and Personal Current Accounts to the term deposits market and we believe that this trend will continue. If you compare the position to pre-financial crisis, a time of comparable interest rates, term deposit flows should still expect to see significant ongoing enhanced demand for the foreseeable future.

Whilst it's clear there has been spread compression in many asset markets, it has been, for us, more than compensated for by wider liability spreads providing the opportunity to upgrade our NIM expectation for the year with our Quarter 1 results. However, the performance has been even stronger and we're now guiding to a 30 basis points increase in NIM to around 3% for 2023 for as a whole.

The deposit book is up over 20% year-on-year and now exceeds £12 billion. We have continued to strengthen our franchise, enhancing flows in our direct-to-market proposition and through our third-party platforms, like Hargreaves Lansdowne, Monzo, Revolut and many others.

New technology has already played an important role in the development of our Savings division and will continue to be a crucial driver to growth, helping to broaden the proposition in the future.

We can also, of course, access wholesale funding where the Group has a long history in the securitisation markets and, whilst pricing has improved, it still remains unattractive at present. However, it remains open to us to access this funding source tactically, as and when conditions improve.

Slide – Conclusion

So, in conclusion. The first half of 2023 has been an outstanding period in terms of delivery. Originations have been strong and our improved customer relationship management is leading to greater retention levels, supporting good loan book growth at the same time as margins are widening. The credit performance has been resilient, and operating costs are well controlled, supporting the strong growth in profits. However, underlying Return on Tangible Equity reaching 18.7% is particularly pleasing. Capital accretion is strong, supporting the first half buy-back and the additional £50 million announced in the second half.

Basel 3.1 is meaningful, perhaps a little more unhelpful than previously thought but IRB is inextricably linked here and will more than compensate for the additional capital requirements. And, we are very well positioned because of the extensive work already done with the PRA and the depth and quality of our data, somewhat unique in the UK.

There is a significant cloud-based technology re-platforming programme underway across the Group, capable of being transformational over time, and much of it has the potential to level the playing field further with the larger banks.

Our portfolio has been underwritten prudently and has been carefully managed over the years. We therefore expect that our business will perform resiliently, both financially and operationally.

It is clear that the environment will continue to have uncertainties but we are well prepared should a weaker environment emerge, both with the quality of the loan book and in the prudent level of provisions already taken and we stand ready to support our customers should it be required.

Whilst the greater level of uncertainty in the wider environment can create challenges, it will also inevitably create opportunities for further organic growth and potentially M&A.

We are financially strong and well positioned to react to opportunities as and when they emerge.

That ends the formalities of the presentation and of course would be now happy to take your questions

Q&As

OK let's start - front row and then we'll move across.

Yes, you need the microphone. Press … hold the button down I think.

Perlie Mong, KBW

Hello. It's Perlie from KBW. Thank you for the presentation.

Thank you for the new disclosure on Basel 3.1. I think you said you think IRB is going to more than compensate so, I guess, just the way you're thinking about it … is it going to be, you know, broadly offsetting or do you think there will be, I mean - I know it's hard to say, it depends on the regulators – but, do you think there's capacity for, you know, additional benefit from IRB for say capital distributions and so, I guess that's question number one.

And, the second question is on the stage two balances. So, from what I can see your economic assumptions have got more severe and I think in the report you've also talked about actual arrears increasing and stage three balances also increased by, I don't know, £30 million or something like that. So, I just can't really understand how the stage two balances fell so much - by 60% - and I think the text talked about model assumption inputs but given that your economic assumptions haven't got better so just wondering how that was calibrated? Thank you.

Nigel Terrington, Chief Executive

So, if you cover the second question about the impairment calculations.

So, in terms of IRB versus Basel 3.1, they are two separate pieces of regulation in effect. Basel 3.1, as you know, it's kind of industry-wide. It's going through consultation at the moment. We will find out in the last quarter of the year whether the consultation transforms itself into a policy statement in exactly the same form or what will get amended. So, there's a variable there. We don't know what the outcome is.

The second part is IRB. There is an extended and somewhat protracted process that we and frankly every bank that's going through this process has to deal with. But again, it is a case-by-case calculation by the PRA's specialist team on what your portfolio characteristics dictate the capital requirements can be. So again, that's another item that's a variable and it's a PRA decision both in terms of the capital requirements and the timing.

So, the reality is both of those factors, it's in the gift of the PRA and the Bank of England to be able to determine when that is and exactly what it is. So, to determine whether there is going to be - what it is exactly - it's impossible technically to say that but we've gone a long way through the process. We know, kind of, where we think the 2.3% in impact on the CET1

is based on the current estimated figures for Basel 3.1 and, if you kind of take that as a base case, the industry is kind of pushing back on a whole bunch of things, but you know let's assume that's the worst case, do we believe our IRB based on the level of information we have today will be equal to or better than that? Probably yes, but it's a PRA a decision not our decision and so I can't guarantee that number to you. But based on our experience, you know, we believe it's going to be at least compensating for the current CP increase in the CET1.

Do you want to cover the impairment figures?

Richard Woodman, CFO

Yeah sure. The stage two piece is really a combination of, if you like, journey and arrival. So, at the end of September last year, we were predicting a worsening economic environment.

You're right, we've seen some very modest increase in arrears. The models though were saying an awful lot more was going to happen.

Because that hasn't happened, you rebase at the new position and then put the increment in for the rest of the year. And, that's not as bad as from the start position that we were expecting. So, the performance of the portfolio has been so much better than was predicted by the models in the first six months, but the absolute level of stage two is lower. It's just following the maths through.

It's still a very large number relative to the arrears numbers that we're seeing.

Ben Toms, RBC

Morning, thanks for taking my questions. It's Ben Toms from RBC.

Firstly, just to follow up on Basel 3.1, the 230 basis points. I was wondering whether you might unpack that number slightly for us so then we can take a view on, if some of the measures get softened in the standard, what the benefit might be? I think previously you said indexing was worth … or no indexing was worth about half of the total. Are there any other bits that you might be able to unpack?

And then secondly, on the ROTE guidance, you've reiterated the greater than 15% guidance. It was 18.7% in the first half. I'm just wondering what the messaging is there to take away from that. I assume from everything you said, that you're not going to have a material reduction or ROTE in half two. So, is the point here, that just consensus don't get too carried away this year? It might not be an indicator for future years to come. Or, is it just that you're being super conservative.

Nigel Terrington, Chief Executive

Okay so dealing with those two.

I don't think we're going to unpack Basel 3.1. We're getting into too much granular information at this stage … but we are back in December for the full year update and the CP

will be turned into a policy statement we believe by then. So, what we'll do is we'll give you that granularity when we've got the outcome from the CP.

The second question … the ROTE. Don't read anything into the fact that, you know, we've got a target of equal to, or greater than 15%, and it's at 18.7%.

At the moment, one of the things is we've got two key elements that are recalibrating what the E is. So, what we'll do is once we have greater clarity on what the equity level is going to be for the business going forward, we'll re-look at that at that stage.

But, you know, we are currently above 15%, but I don't think we're going to reset any targets at this stage until we have greater clarity on what the E is in the ROE.

James Invine, Societe Generale

Hi, James Invine here from SocGen. I've got three please if that's alright.

The first is just on the legacy mortgage book. I'm guessing that the arrears there have risen by 30 to 40 basis points given what you said about the arrears overall and I was just wondering if you could give us please the interest cover and the LTV for that book specifically?

The second question was on your savings platform. So clearly, you're doing incredibly well there. I was just wondering at what point you start to pivot away from volumes and more towards margins and, on that thought, do you have complete control over the pricing on your savings platforms you know with Monzo and so on. Or, have you given any commitments to your partners on pricing?

And, the third one is just the comment in the release that in the structured lending business you're looking at moving into new asset classes and I was just wondering if you could give us a flavour of what you mean by that please?

Nigel Terrington, Chief Executive

I think you managed to squeeze four in there.

The legacy … I mean I don't have the exact details of those individual cohorts/sub-categories of the portfolio … I don't know whether you know it off the top of your head … but, it's likely that the ICR for these portfolios are going to be above the average just because they are highly seasoned. Those portfolios pre-date the financial crisis. Those customers are going to have been on the books for at least 15 years. They've had 15 years' worth of rental growth, 15 years' worth of house price appreciation as well.

So, you know we can get the detail for you but I don't have it at our fingertips but I suspect that's probably going to be the likely outcome.

Savings …you know, we we've grown our savings book very well. It's up to £12 billion. We expect to achieve good strong growth there. I think one of the things which I highlighted was the shift from easy access and PCA's to the term market. That I think has still got a long way to go. If you try and re-calibrate what that market should be because you've had 15

years of 0% interest rates where you were getting no benefit for extending the duration of your deposit and now you are. And so, we've seen £53 billion shift in the period that we've just reported on.

The current size of the term market is about 9% of the whole. If you go back to the comparable period, pre-financial crisis figure, it was 22%. So, that gives us the confidence to think there's a lot more traffic going to move from shorter duration to longer duration deposits and so that provides two opportunities. One is to provide stronger flows. Equally, it provides the opportunity to be a little more beneficial to the P&L on price as well.

In terms of the platforms, no there's no commitments. We make no commitment on price and we, you know, we always want to offer competitive products because that's, you know, one of the key points of differentiation for us … particularly from the larger banks … but there's no commitments that we make in that regard.

And structured lending. I mean structured lending is a small part of our overall business but the new asset classes … if you mentioned what structured lending does, it lends money to other smaller non-bank financial institutions secured against their portfolio of assets and it's using securitization technology in order to secure itself, and supported by the underlying cash flow of the assets that its financing. So, it can be anything right the way through from consumer receivables, right the way through to property, SME asset classes, bridging finance … a whole manner of things.

And so, there's nothing dramatic apart from an evolution of that. It's not like anything transformational that takes us into anything esoteric and weird and wonderful. So, just further extension. I think that's covered all those points.

Gary Greenwood, Shore Capital

Thanks. Gary Greenwood from Shore Capital. I've got three questions please.

First one on credit quality. I think the pushback sort of generally given by investors on credit quality is that we haven't really seen the full impact of rate rises on customers yet because they haven't come off their fixed rate mortgages yet and they're still rolling. Can you just give us a feel for sort of what proportion of your book has already rolled on to higher rates and of those customers that have rolled on to higher rates how those conversations have gone? What proportion may be struggling with that? What proportion are finding it, you know, readily absorbable and can continue?

The second one was on funding. We see your loan to deposit ratio has been coming down over time as you've grown that retail deposit book. Is there a level at which you're sort of targeting to get to in terms of optimising the mix of funding? How should we think of that?

And then lastly on capital. I think previously we've talked about a core tier one ratio target of around about 13%. Obviously, you have no AT1 in the stack at the moment – the AT1 market is probably a bit more difficult now than it has been in the past. Do you think about that 13% in tier one ratio terms as well? Thanks

Nigel Terrington, Chief Executive

So, in terms of the credit quality, there's about in the whole of this financial year, there's about £2 billion of fixed rate maturities and as you saw that we said that around 77% of those are being retained onto the book so there's a good level of visibility over their credit performance.

Last year, that number was £1.4 billion and the fact is that we highlighted that the increase in arrears that we'd seen was not on that those portfolios - it was on the legacy book.

So, you should take it from that, that that repricing effect has not had a significant impact on the credit performance of those loans that have repriced.

I think one of the things I pulled out in the presentation is that loans that refix from five years ago, there's been a broadly, broadly similar increase in the rents. So, what we're able to track is that if you looked at the pipeline today, the rents they received about five years ago was about 30% lower, so you've had that benefit to the cash flow and that's why the ICR is around 200% still.

Do you want to cover the loan to deposit ratio?

Richard Woodman, CFO

Yes, so we've been driving to a higher, a lower level of overall encumbrance within the balance sheet. I think we've gone through, well we've met our initial targets. Initially, we wanted to get our encumbrance numbers below around 30%. It's now sub that, very comfortably sub that level in terms of external wholesale funding.

You know, we've still got the TFSME facilities from the Bank of England.

My expectation is that we will carry on taking that gross 30 down but it is important that you have wholesale funding as part of the mix.

At the moment, it's unattractive in terms of price but at that point it was, you could easily add some more. So, I don't, you know, we don't have a hard and fast target. We're in that range and we'll try to optimise for available liquidity, having a diversified funding stack and the right price over the next few years.

Nigel Terrington, Chief Executive

I think the final question you had was around the CET1. I think what we'll be looking at is post IRB, we'll have a look at the CET1 targets then. But, what we won't know, is that when you go through the IRB process you should expect your Pillar 1 to come down, your Pillar 2 will probably end up with an adjustment as a consequence. So, once we know that, we can then make a better judgement as to what we think the kind of CET1 baseline is that we expect to operate from.

Gary Greenwood, Shore Capital

It was more around whether you think of the tier one and the CET1 ratios as being sort of similar targets on the basis you have no AT1?

Nigel Terrington, Chief Executive

Yeah, I don't think you want to sort of have one and not the other just because I think, quite rightly so, as we've seen the regulators in particular apply significant value to the quality of the capital … not just the absolute.

So, at the moment, we've not issued an AT1 and, you're right, it's not necessarily an attractive time to do so, but we wouldn't, at this stage, be planning to look at a core tier one target as opposed to a CET1 target.

John Cronin, Goodbody

It's John Cronin from Goodbody. Just a few follow up questions please.

Getting back to this question on the AT1, just thinking about your current CET1 ratio, the level of headroom, the buyback you've announced and potential future headwinds in the form of further fair value gain reversals. And with Basel 3.1 in mind, how likely is it realistically that you would creep below 14% or even 14.5% CET1 ratio at any point pre-2025?

Second question is just a small technical point on the development finance portfolio. Are you able to provide the debt service coverage ratio on that?

And then thirdly, a wider question on competition. Over the years, we've heard a lot of the other specialist challenger banks or mainstream challenger banks talk about professional but-to-let at various stages, HSBC most recently last June. Are you seeing any encroachment or developing interest on the part of other players in your markets, or do you feel that you are unlikely to see much in the way of a significant shift in the competitive landscape over the medium term?

Thank you.

Nigel Terrington, Chief Executive

OK. So in terms of competition, I would say probably there's probably a bit more competition around at the moment than there was a year ago. I think you've seen Kensington eventually got bought by Barclays last year – the process did take a while – and they've been utilising Barclays' strength in capital and liquidity. So, they've been a bit more active. And Starling through Fleet Mortgages have been a bit more active. As for the others though, I'm not sure there's been much difference. I mean the wholesale lenders, have largely not been there. There's been a few - one or two - who have been a bit more aggressive in terms of growth maybe because they're looking for strategic options in due course. But, I don't think the fundamentals have changed dramatically apart from those few. And HSBC, you mentioned them, we haven't noticed any activity from them in the marketplace.

Don't forget, I mean 99% of what we do is specialist in nature so it tends to keep a lot of the bigger players who are looking at more mass market products and less focused on those areas. So, it is a narrower competitive landscape there as a consequence.

The development finance debt service coverage ratio, we don't disclose that individually because I think it is significantly strong because that's what we set. But, it's also not just going to be about that. You're going to have a combination of factors to take into account ranging from the long term experience - I think as I said look around 60% of our business flow is for people we've already had relationships with over an extended period of time - so that's an important ingredient. You want to know, particularly more troubled markets, that these guys have been around the block a little bit. You also want to look at the gross development value but also how much cost is being contributed from the individual developers, as well as the level of guarantee coverage as well that comes into it. So, it's a far more holistic figure than just looking at the debt service coverage ratios, but they are strong because we just simply wouldn't do it otherwise.

And then finally, Richard, do you want to comment on what will happen with the unwind of the fair value adjustment. There's a big chunk of it has gone already in the first six months. The balance will go over the remaining four and half years, but you might want to talk about what what's happened this year.

Richard Woodman, CFO

Well probably fairly evenly from now. The bulk of the big credit that we had at the start of the year, those loans have now completed. So, there's either been the fair value adjustment that we booked in H1 or you're now amortising those remaining fair value items against the underlying derivatives. So, that’s fairly even over the next five years. So, £20-25 million a year for that portfolio.

Then that's going to be influenced by new swaps that we put in place and new volatility. In the couple of months we've had since the half year, swap rates have gone up, fair values will have gone up as well. So, that will actually be contributing back to the capital position rather than denuding it.

If you look at that 2.3% impact for Basel 3.1, with the gradual accretion that we have for underlying earnings, you probably would get down to somewhere in the mid 14s - if you were in a Basel 3.1 environment for your CET1.

Nigel Terrington, Chief Executive

So, one thing to point out is, we - as you would expect - we run stress tests. One of the stress tests we do is what if we never get IRB? We fully expect to but, you know, just for academic purposes what if we don't? What if Basel 3.1 is like it is today? And, can we therefore, do we have the capital even allowing for the regulatory requirements and then the management buffers above the regulatory requirements, therefore getting to the CET1 targets that we have publicly, do we have enough capital to then support the ambitious growth plans that we've got? The answers is yes, we have. So, there's nothing - the kind of worst case scenario that you can paint there about all those big regulatory changes not going in our favour, doesn't stop the growth plans.

Is there any more questions before we wrap up?

No, okay. So, I don't think there's any questions from outside either. So, in which case, thank you for your time and attention this morning. I know a number of you are going to have a chat with Richard. If you want to speak to us at any time over the next few days as you try and come up with other questions and things like that, please do so. You know where we are and we're very happy to engage with you.

Thank you very much for this morning and we'll see you soon. Thank you.