Virgin Money UK PLC Interim Financial Results 2023 - Call Transcript

<Video introduction plays>

David Duffy, Virgin Money UK PLC

That was a good start. Good morning, everyone. And I know some of the people normally in the room are on the call, and welcome to all of you are dialing in from Australia as well. Clifford and I, as you know, will follow the usual format and we'll update you on the details of our performance and then we will move to questions.

As we deliver the H1 results, I'm conscious that interestingly, we're halfway through the delivery of our three-year strategic plan at the same time, which, as you know, began in '21 as we came out of COVID. So, I thought it would be useful just to share an overview of where we are at this stage at the midpoint of our strategic plan, and then just drop into the H1 results with that as a background.

So, if we look at the first 18 months of our strategy, we're delivering against what is our stated strategy and ambition of building the best digital bank in the UK, and we've successfully developed our digital growth propositions to enable our acquisition of new customers, assets, and deposits, as more people are choosing to bank with Virgin Money. These digital products, you will have seen, include PCAs, BCAs, buy now pay later flexibility, travel insurance, and a digital investment and pensions proposition as well as the wallet. We have also delivered a digital transformation of our business bank, which is now acquiring record monthly new BCA accounts, and we have built a high-quality cards business and our next goal is to deliver a digital transformation of our mortgage business.

Our strategy to drive digital growth in relationship products, and particularly savings in the past 18 months, has also been very successful. And since 2019, we have increased relationship deposits from 34% to 53% of deposits. During this period, we have also delivered a reduction in our cost income ratio from 58% to 51%, and over the next 18 months, we will deliver a further reduction, bringing us to a cost income ratio of less than 50% in 2024, and that obviously helps us to underpin our target ROTE of double-digit returns.

Finally, we've also constructed a strong balance sheet with robust asset quality, really strong liquidity, and a capital base with a surplus of £1.2bn to regulatory requirements. Now as we look at the second half of the three-year strategy, I'm confident that we will continue to grow our assets and acquire lots more customers with our digital products, and as we accelerate our automation and reduce our costs, I think we will ultimately, we are very confident that we will deliver on our target of double-digit returns in FY24. As our strategy continues to drive this higher level of stronger capital generation, we're building a growing track record of capital returns and share buybacks, and that's supporting a much stronger return to investors, especially when you look at the next 18 months.

So, I thought it'd be useful to have that reminder of where we are on the journey in that context, as we drop into the H1 presentation. So, on that note, let me now turn to slide 4 of the half year presentation.

So, in the first half, the rate backdrop, and our strategy have continued to translate into good financial performance. We saw the benefit of our digital investment in our relationship banking model, as I said earlier, and that's come through both in terms of income and customer numbers as well obviously, in the strength of our balance sheet. Our previous investments in efficiency and automation of the customer journeys have delivered £93m of the £175m cost savings target that we set. In other words, half of the planned savings have been achieved half way through our plan. Whilst our costs are temporarily 5% higher in H1, and I'll come back to that, our cost income ratio has declined from 54% to 51% in the half.

I'm also pleased with the earnings momentum in H1. Our pre-provision profits of £456m are up by 16% year on year, and we have seen a strong performance in income growth of 10%. That's primarily driven by further expansion of our NIM which reached 1.91% for the half.

Given the recent market volatility, we've been very focused on delivering profitable growth. We've priced mortgages in that regard, tactically, given the margin compression with a 41% reduction in mortgage market volumes. We've also tightened our credit criteria in the unsecured area, unsurprisingly, whilst in the business bank, we've targeted growth in those sectors which we believe are delivering growth in the cyclical periods. And so, the growth strategy I think is proving effective in delivering improved margins.

In terms of the balance sheet, our funding and liquidity are really robust and we have strong deposit inflows, which grew 3% in the half, and our LCR is now up to 153%, with 72% of our total balances insured under FSCS, and our LDR has declined further to 108%. So, when we talk about provisions, the updated provision coverage already reflects the expectation that arrears will continue to increase from low levels. But the changes you're seeing today are model driven, we are catching up after our other peers did that in the last quarter. So, we've caught up with them, and the changes you've seen are model driven, not arrears. Now, we do expect them to increase but we haven't seen any material arrears in our portfolio and given the historical performance and the asset quality of our portfolio, I think 72bps coverage represents a very strong provision profile, and that for those who remember, remains above our pre pandemic levels. Our CET1 ratio of 14.7% is strong, and that also, by the way, includes the absorption of the 30bps for our latest view of hybrid models, and the completion of our buyback in H1.

As we look out over the remainder of the year, we now expect our cost income ratio to be in the range of 51%-52%. That reflects some temporary spending, we flagged customer service at the beginning of the year, to improve that customer service and a bit of a slower implementation of our mortgage platform. Now, as we reaccelerate our automation in H2, because we fixed those issues, those temporary costs drop away. So, we are confident in delivering our below 50% cost income ratio at the end of '24 as a result. So just think of it as, we look at the costs, we put them in temporarily, we get rid of them, so we have line of sight to where we're going.

So, in conclusion on that, we're upgrading our NIM guidance for FY23, and that's based on the strong margin performance during the first half. We now expect to deliver c.190bps level, which is at the top of the guidance range, as I said. Finally, given the level of surplus capital being generated, we'll continue to build our track record of returning capital to our shareholders this year, we're announcing a 3.3p dividend in H1. As we've previously guided, we'll make further announcements on buybacks later in the year, after the ACS process.

Let me now turn to slide 5 and the macro environment that we're operating in. So, our strategic delivery, as we would all know, has been delivered despite a muted economic backdrop, but we are seeing signs of an improvement in that backdrop; it's already starting. Inflation though, has remained stubborn, particularly in some areas of spending like obviously food. Though at the same time, we see offsets through lower energy pricing than expected and very importantly, a tight labour market. So when we look at GDP, it's modestly lower, but at the same time, the UK looks increasingly likely to avoid a significant recession. As the markets and the economic outlook start to improve, we've seen the rate curve flattening out, driving a lower outlook compared to Q1 and FY22. But even at lower levels, the rate outlook offers us opportunities in the refinancing of our structural hedge and I think that could be meaningfully higher, but Clifford will talk about that in more detail later in the presentation. Critically, we see that unemployment continues to remain low by historical standards, which is clearly underpinning credit quality. So overall, the more balanced outlook is setting the tone in our minds for a good development of the next phase of our strategy.

So, let me turn now to slide 6. And I think here it's important to say that it's encouraging for us to see that the investments we've made in driving strong customer growth have enabled us to add almost 70,000 active relationship accounts in H1. The investment in our business bank is starting to show as well, with 7% growth in BAU business lending in H1, which is material. Our Business Current Account growth is also strong, with 52% higher sales year on year, and we've now seen net BCA inflows for 17 consecutive months with a 5% growth in active accounts in the last six months. So, March, in fact, represented the highest ever level of acquisition of new BCAs in the business bank demonstrating the strength of that proposition.

On the PCA side, we're continuing to grow the book of relationship deposits, which I mentioned earlier and we've sold over 300,000 accounts since the launch of our digital Virgin Money PCA with 16% higher sales year on year in H1. The PCA proposition is very competitive, it's compelling, and it's rewarding for our customers. Across the PCAs and credit cards in total use, we have over 700,000 cashback users, and those users are receiving on average, 7% cashback on transactions. That's a market leading offering that really does build deeper and more enduring customer relationships.

In unsecured we've tightened our credit standards, as I said, given the weaker credit environment, however, we still attracted over a quarter of a million new account sales, with notable growth in the Virgin Atlantic affluent category of customers. Virgin Slyce, our buy now, pay better offering has launched and customer numbers and the use of the product continue to grow well there. If we look at other income propositions, we've sold 300,000 travel policies since the launch of our new digital proposition, and I'm delighted also that we've launched our digital Virgin investment proposition in partnership with Abrdn. We're excited about the potential in this particular area, as we have £3.6bn of assets under management from the existing business and see real potential to grow that business in the future.

So, turning now to our near-term investment on slide 7. As we've discussed at the full year, we experienced a significant increase in customer contacts across savings and mortgages. That was generated by the volatility, if you remember, from the mini-budget. Those service issues have now been resolved with outstanding complaints reduced by 80% and call waiting by 75%, and the non-recurring costs of fixing those issues are now being eliminated. So, I'm just being explicit there, 300 staff hired to fix that, contractors, 300 leaving. So, when I say non-recurring, it’s cost come in, costs go out. So, to ensure on the mortgage side that our launch meets the expectations of customers, we're going to take more time to deliver that new mortgage platform. Now, while that is a decision we're making for the benefit of the customer, that delay does not impact our business execution and we have a market share of around 5% of broker flows, which is consistent with the highs of the past.

We've continued to make good progress on the other strategic key initiatives that we have, such as our digital wallet, which has received overwhelmingly positive feedback from our closed user group working with Virgin Atlantic and the live app has now been launched, and the initial take-up has met our expectations. We are also continuing to work on the single app to bring together all of our offerings and are working closely with Virgin Group on enhancing the Virgin Red loyalty offers which will be part of that.

Finally, just a quick word on our flexible operating model, A Life More Virgin continues to drive a hugely positive brand outcome. Employee engagement is at a record 83%, turnover is down by 50%, and applications for each role are up by 200%, so it's hugely positive. We're now rolling out in support of that, an Agile delivery model which will help us to accelerate our execution of our restructuring activity.

So, overall, as we move into the second half of our digital strategy, the continued investment that we've described here in new products as well as our existing products, and the combination of that with our operating model and platform, leaves us in, I think an increasingly strong position to drive customer growth, which is what our ambition is, and that will drive income as well.

I'll now hand you over to Clifford, who will take us through the financials in more detail. Thanks.

Clifford Abrahams, Virgin Money UK PLC

Thanks, David, and good to see you all. You've just heard how our strategy positions us well in the current uncertain and volatile environment. I'm convinced that our consistent approach will deliver the full potential of our equity story set out here. We've managed our balance sheet prudently with strong funding, liquidity, provision coverage, and capital. Beside resilience, we continue to digitise the bank, delivering cost savings and launching new digital propositions. We're now growing relationship customers and targeted lending, despite the weaker credit environment. You can see our strategic progress translating into financial momentum on the next slide, 10.

The top left shows the growth we're delivering in our targeted margin accretive propositions. This alongside the rate environment has driven a sustained expansion in our net interest margin, top right. We're building a track record for sustainable returns, bottom left, and as a consequence, we're generating capital and increasing our distribution through dividends and sustainable buybacks, bottom right. We're confident in delivering our FY24 targets as we continue to execute our strategy.

Now turning to the details of our performance for the first half on the next slide, I'll comment first on profitability, then the balance sheet, capital and finally, our forward guidance.

I'm pleased to report here on slide 11, good underlying performance with continued top line momentum. We delivered good growth in income of 10%, reflecting our strength in deposits alongside higher rates. Costs were 5% higher reflecting wage inflation and short-term investment to safeguard customer service. Together, this further improved our cost income ratio to 51% from 54% this time last year, driving strong growth in pre-provision profit of 16%. Meanwhile, underlying profit was down year on year as impairments normalised from last year's lows.

Moving now to statutory profit on slide 12. I'm pleased to say the underlying earnings power of the group has translated into another period of solid statutory profit. Restructuring costs were £53m in the first half, modestly higher than last year, reflecting costs from reducing our office property footprint and digitisation. Following our service recovery, we expect to step up restructuring activity and related spend in the second half.

You'll see here that we're now reporting fair value movements arising from hedge ineffectiveness below the line. We're adopting this practice to give a clearer picture of the underlying trends in non-interest income following the significant rate volatility over the past year. We'll continue to report some other fair value movements above the line, relating to risk management products we sell to customers, however these are not expected to be material going forward.

Finally, you'll note that tangible net asset value is down 33p relative to year end ‘22, and this reflects the reduction in the cash flow hedge reserve, as swaps fell back after spiking around the time of the mini-budget in our September year end, as well as a lower pension surplus. These factors offset positive effects from statutory profit in the period and lower share count given our share buybacks.

I'll now talk through the key balance sheet items on slide 13. I'm pleased with the strength of our funding franchise, supporting both a robust balance sheet and our margin outlook. It's good to see our continuing growth in relationship deposits over the first half. In line with the market, we're also seeing higher flows into term deposits, reflecting the rate environment. We are actively participating here, which enables us to lock in term funding at pricing below swaps. Altogether we grew relationship deposits and overall customer deposits at 3%, outperforming the market and our large UK peers, and reducing our loan to deposit ratio to 108%.

In the first half, we successfully accessed wholesale markets, issuing €500m of MREL senior notes. We also repaid £200m of TFSME drawings in the period, and we'll continue to repay TFSME ahead of contractual maturity. Overall, our liquidity position is very strong at 153% LCR, and we now expect to issue towards the low end of the £1.5 to £2.5bn range of secured issuance that we communicated at full year and with no further capital issuance needs. The strength of our deposit gathering capability and our continued improvement in our funding mix leaves us well placed, despite recent turbulence, to support our lending growth and the refinancing of TFSME over the coming years.

Moving now to lending on slide 14. In lending, we traded well over the course of the half against the tougher backdrop. Overall lending finished flat, as growth in our business book was offset by a reduction in mortgages, while unsecured was stable. Mortgage balances were a little lower at just under 1% lower, a decent performance in a challenging market, as overall activity levels have slowed.

In particular, I'm pleased with our growth in business despite the slower market, reflecting the strength of our national and sector specialist franchise. In unsecured, we saw modest growth in credit cards offset by a small reduction in personal loans. Our card balances were up around 2% during the first half, a slower pace of growth versus last year, reflecting our further tightening of credit criteria, and our disciplined approach to profitability.

Looking forward, we expect total lending balances to remain broadly stable in the second half. In mortgages, we expect market activity to remain muted. In business, we expect a more moderate pace of growth through the remainder of the year. In unsecured, we will look to grow balances modestly further. So, overall, broadly stable.

Moving on to margins on slide 15. I'm really pleased with our net interest margin performance shown here, a major driver of the improvement in our income year on year. Following a strong performance last year, we've added a further 6bps to net interest margin, and the positive factors comprise improved deposit mix and spread, together with the benefit of our structural hedge rolling. More about these later.

Set against these positive factors, mortgages continue to be a headwind to margin, although the gap between front and backbook spreads has narrowed further, which means it will be less of a headwind going forward. Following the strong first half performance, we're upgrading our full year NIM expectation to around 190bps, reflecting base rates peaking at around 4.5%. So, we're expecting a relatively stable underlying performance in the second half of the year, reflecting ongoing tailwinds from higher rates, structural hedge reinvestment, and our high yielding asset mix, offset by headwinds from mortgage spreads, which we expect to remain tight, and higher deposit rates following a lag from the pass on of previous rate rises. So, a pretty balanced picture for the next few quarters.

I'll now talk through our deposit franchise in more detail on slide 16. The high quality of our deposit franchise has supported both our resilience and our margins. In terms of resilience, top left shows we've a diversified funding base with a large retail bias of around 75% of deposits, with business deposits weighted to SMEs with no outsized sector concentrations. Top right, you can see that we've continued to attract strong deposit inflows across the first half, demonstrating our deposit gathering capability and the strength of the franchise. Turning now to income. I mentioned in the last slide that our deposit performance has underpinned our margin performance. Looking back you can see, bottom left, that we've significantly matured our deposit mix, growing lower cost relationship deposits while reducing reliance on secondary savings. More recently, we've been active in the market for term deposits given the pricing opportunities available, and this demonstrates our ability to trade tactically when market conditions are favourable. This mix shift, alongside higher rates, has contributed to a material improvement in our deposit book spread whilst also delivering good value to our customers, as you can see bottom right. At this point in the cycle, we feel we're less exposed to rising deposit rates and deposit attrition than some of our larger peers, given the strength of our franchise, deposit mix, and customer friendly propositions. So, we expect to continue to grow deposits further into FY23.

Turning now to our structural hedge on the next slide and rate sensitivity, slide 17. We've set out here how our structural hedge is supporting margin, alongside our usual rate sensitivities. The hedge is a strong underpin to margin outlook. We reintroduced the structural hedge when the rate environment was significantly lower, and so now continue to benefit from materially higher reinvestment rates. You can see from the chart on the left how we expect the structural hedge to continue to support the net interest margin. Even before considering reinvestment, hedges already written will deliver gross income in FY23 higher than FY22. And alongside this, you should consider the reinvestment yield available on the current five-year swap rates at around 4% relative to an average redemption yield on our structural hedge in the second half of around 1%, so a pickup of 3%.

We expect the hedge notional of around £30bn to begin to reduce somewhat over the second half of the year, given the modest shrinkage of our variable savings book. However, this will have little effect on our net interest income given the shape of the rate curve; that's with SONIA broadly equivalent to the five-year rate. So, we have built in tailwinds. On the right we've set out our usual interest rate sensitivity using our standard pass-through assumptions and you'll know our rate sensitivity remains positive in year one, even in a 25bps down scenario, and this reflects prudent assumptions in product pricing from the more elevated rates today. So, overall, the combination of our structural hedge and rate sensitivity leaves us well positioned to maintain margins in the current rate environment.

I'll now move on to non-interest income on slide 18. Non-interest income was slightly lower during the period, down £4m year on year, excluding fair value and one-off gains. This reduction was entirely driven by business fee income, due mostly to lower merchant services income. This reflects the group changing its merchant services provider to Global Payments. Looking ahead, we expect growth in OOI to be muted in the short-term, reflecting that change in merchant services provider, but also changes to our current package account, our Club M account. Here we've made it easier for customers to select the individual benefits they wish to enjoy, while at the same time reducing their monthly account fee. But over time, we're targeting growth in OOI as we see contributions from the various initiatives we've set out on this slide, and these include Virgin Money Investments, which was recently relaunched as David mentioned earlier. We'll also drive additional merchant services income as we acquire additional merchants with Global Payments, our new provider.

Turning now to costs on slide 19. I'll first update on our cost performance and then on our restructuring costs. As a reminder, our primary target is to deliver a cost income ratio of less than 50% by FY24. Our underlying costs of £477m were around 5% higher year on year. Given our stronger income growth, the cost income ratio reduced further to 51%. On the left, we've set out the cost bridge from H122 to H123 and you can see our cost programmes are delivering savings as we digitise the bank. However, during this period, these savings were more than offset by higher staff salary costs reflecting wage inflation, and also the short-term investments that David talked through earlier, to safeguard service including strengthening our cost centre resourcing, as well as additional digital investment spend, mainly reflecting further investment in our digital mortgage platform. In total, we expect costs in the second half to be broadly stable on costs in the first half, resulting in a cost income ratio for this year of 51% to 52%.

We set out our multi-year investment programme at FY21, and as you can see on the right, we've made further progress this year delivering a total of £93m of cost savings on an annualised basis, at a cumulative cost of £135m. In the second half, we expect to increase the pace of restructuring activity and accordingly expect most of the remaining £140m of restructuring costs to be incurred in the second half. These initiatives will benefit our cost performance meaningfully next year, that’s FY24, as they earn through giving us further capacity to offset inflation. And at the same time next year, we expect to dial back the short-term investment the David talked through earlier. So, more cost savings, together with lower short-term investment, underpins our confidence to deliver a cost income ratio of less than 50% next year.

So, now moving to asset quality on slide 20. I’m pleased with the quality of our lending book, and we remain well positioned to manage through current risks and uncertainties. On the left, we've set out our ECL over time. You can see that during the first half, the increase in ECL was primarily model driven. We updated our macroeconomic scenarios at the half year, which reflect only now, the post mini-budget downgrade to the economy. Given the timing of our reporting cycle, it seems like a long time ago, but our macros are now broadly in line, and in fact, many cases, more prudent than the December reporters, who took most of that downgrade at their full year in their Q4s in December. So, alongside this, we've reduced our post model adjustments relating to the potential cost of living impacts as these risks are better reflected in the model outcome.

The net impact of all of this is that a headline level, total provisions have increased from FY22, resulting in a £144m impairment charge, and that equals an annualised cost of risk of around 40bps, modestly above our previously guided run rate. While our credit quality is resilient, we do expect to see continued normalisation of arrears, and that expectation is reflected in our provision coverage, which we strengthened further to 72bps. As you can see from the chart on the right, this coverage level is prudent and well above pre-pandemic levels, as David indicated.

Given the increase in our credit provisions in the first half, we now expect the cost of risk to be in the range of 35 to 40bps for the FY23. So, while our credit quality indicators remain benign, we're well positioned for uncertainty that lies ahead, given the strength of our provisions, which we've already booked.

I'll explain the resilience of our lending book on the next slide, 21. You’ll remember this slide from November, our full year and we've updated it here, and this shows the strength of our loan portfolio, and why we're comfortable with our credit quality and our underwriting. So, overall, our total portfolio is defensively positioned, with balances strongly weighted to mortgages, which reflect around 80% of total loans. Within mortgages, the book is a low-risk, prime book weighted towards owner occupied, originated within strict affordability assessments, and with only 6% above 80% loan to value and largely on fixed rates.

Our business portfolio is well diversified with strong collateral levels and skewed to lending to resilient sectors, with minimal exposure to commercial real estate, which comprises just over 8% of business lending or 1% of our total lending. This itself is conservatively positioned with an average loan to value in commercial real estate of around 50%. In unsecured, our underwriting criteria is prudent and we’ve tightened these further over the year to reflect affordability stresses on our customers. Virgin Money's unsecured customers are generally more affluent, and their retail spend has remained resilient over the past year and continues to be weighted to discretionary and luxury items. Their repayment rates remain stable, all indicators of credit quality.

Turning now to capital generation on slide 22. The Group remains very strongly capitalised and our capital generation continues to be strong, with 72bps of underlying capital generation. We announced today a 3.3p interim dividend, in line with our dividend framework, which is one-third of the FY22 total dividend of 10p. We were pleased to announce our £50m extended buyback in November, which was fully executed during the period, and that consumed around 20bps of capital. In the first half we also recognised a management adjustment reflecting the impact of adopting mortgage hybrid models. So, this resulted in an additional £400m of risk weighted assets and a modest increase in expected credit loss, taken together consuming around 30bps of capital and below what we originally expected. So, we've now absorbed the impact of industry wide changes to hybrid mortgage models. Altogether, this resulted in a 14.7% CET1 position, considerably above our target range, which I've set out on the next slide, 23.

Again, you'll recognise this slide from our full year, and our target capital range of 13 to 13.5% CET1 ratio. As we said in November, we expect to stay above 14% this financial year, given the economic uncertainties. So we currently have around £300m of surplus capital before future capital generation, relative to the 13.5%, and we have a surplus of around £170m, relative to the 14%, that's this year's aiming point. And we're committed to further sustainable buybacks alongside dividends as we target getting into our 13 to 13.5% range by the end of the next financial year. We expect to resume buybacks following the results of the industry-wide stress test to be announced in July.

Now finally, I want to conclude with our guidance on slide 24. I've summarised here our guidance for this year, FY23 on the left, and repeated our outlook for FY24 on the right. We've talked through the various details through the course of the presentation. Today, we're upgrading our full year NIM to around 190bps. We expect the cost income ratio for this year, FY23 to be around 51 to 52% cost income ratio. Following the increase in credit provisioning levels in the first half, we now expect the full year cost of risk to be in the range of 35 to 40 bps. Furthermore, we expect to resume buybacks after the results of the ACS in July, while maintaining our CET1 ratio above 14% this year.

Now turning to the medium term, we are committed to our double-digit target returns set out in November 21, supported by a cost income ratio of less than 50%. Finally, we expect to operate within our target capital range by FY24, enabling further buybacks. So, overall, our strategy remains the right one in the current environment, and we continue to make good progress during the first half, and our outlook is positive.

Now back to David.

David Duffy

Thanks, Clifford. You pointed at me when you said the outlook was positive! So, just to try and wrap that up. I think we have good momentum going into '23 and I think you've got plenty of detail there, which we'll cover in questions, but I feel pretty comfortable about the second half of this year. As I mentioned earlier, we're halfway through this three-year journey and I'm pleased with the momentum that we have, particularly in digital transformation and the success that this has created in acquiring new customers and assets and clearly deposits.

We're going to continue to invest in that digitisation and the diversification of those products and the propositions in the next 18 months, driving what we think will be strong, further profitable growth. So, given the momentum, I am confident, as Clifford just described, in reaching the '24 targets, and cost income ratio of less than 50% that underpins that. Clearly as that capital slide shows, this performance implies meaningful capital returns for shareholders, and we'll provide more details on our dividend and the buyback quantum as soon as we can.

So, I think that brings us to the end of the formal presentation and we're going to move to questions. I think Richard is going to control. We're going in the room first and there's going to be a mic in front of you. I've been told to say you can pull it out of the chair and you have to hold it to speak or else we can't hear you. And then we will move to online calls.

So, thank you. And over to you, Richard.

Richard Smith, Virgin Money UK PLC

Ben, do you want to go first?

Ben Toms, RBC

Morning. It's Ben Toms from RBC, thank you very much for taking my questions. Firstly, on the NIM, you've described the FY24 outlook as being resilient, can you just give a bit more colour on the puts and takes here, please? I think at your FY22 results, you described the dynamic for '24 for NIM as expansionary. Am I reading too much into the slight change in language?

And then secondly, on shareholder returns, can you just run through any potential headwinds to capital for the next couple of years just to ensure there's nothing out there that could eat into the excess capital that you mentioned in the presentation? Thank you.

David Duffy

Clifford, do you want to start on those?.

Clifford Abrahams

Yeah, on NIM. Look, we feel good about our NIM as I indicated, at half year and looking out to the second half of the year, that's why we upgraded our guidance. I didn't comment explicitly on FY24, that's next year, but we're comfortable where consensus is, which is around 192. I think what gives us confidence -- I ran through the details -- is some of our structural drivers. So, you've seen that given we are a smaller franchise with a real track record in deposits, we feel that's given us an advantage to navigate through the environment. So, we don't have this conundrum, which is do we offer good rates to customers, and then have to pass them on to our existing customers, or see attrition. Some of the very large banks have that conundrum. We're a challenger bank, and it's coming into its own. So we've been able to offer good rates to existing and new customers to grow our overall deposits at better margins. And we think we can do that going forward. I think our structural hedge -- all big banks have structural hedges -- we put our new hedge on at historically low rates. So that big, you see that big delta, I think that's bigger than some of the other banks because of the timing, so that 3% pick up gives me confidence.

And finally, our deposit mix. You've seen how we've grown our business deposits in a tougher market, and that -- look, we're small. So, it's the benefits of scale, we have a 2% market share. For us, to grow that, is frankly a lot easier than some of the very big institutions. Now set against that, we clearly have uncertainties in the rate environment, the mortgage market continues to be competitive. So, that means we're not guiding specifically to next year's NIM, but you can see we have some of those structural tailwinds; some reflect the environment, some reflect our strategy, that gives us confidence to upgrade our NIM guidance at this point.

Moving on to capital and buybacks, I think we flagged the hybrid model that's industry wide, I think we've been one of the latest banks to incorporate that. And we're pleased that we've done so at an amount lower than we previously expected. That's still subject to final PRA approvals, so it's not the final end, but we're getting more and more confident. We talked about Basel 3.1 at Q1, and we don't expect to see that as a challenge, at least in the short term. Generally, you know, you look at our capital intensities, they've been a bit higher than some of the bigger banks and that reflects bluntly the more basic approaches to models that we've adopted, the standard approach or the foundational approach, that gives us a bit more resilience going into a weaker credit environment. Now, we all hope we've seen perhaps the worst of the economic outlook, but we think that modelling approach provides some resilience and confidence around some of the surplus figures I talked about earlier.

Rohith Chandra-Rajan, Bank of America

Can I just start with funding, please? So as you say, you've got less, I guess, cannibalisation or migration issues than your bigger peers, but I'm just interested in the kind of the pass through that you're seeing. I think you showed 143bps average cost of deposits in the half, and I was just wondering if you could tell us what that would be spot today but including the current cost of new time deposits, and how quickly that would flow through. So, just to sense where the deposit cost is going.

And then the second one on funding would just be on TFSME. I think you've got about £7bn. You've started to repay that, if you could just remind us of the plans for repaying TFSME, that would be helpful.

And then I have a final one, please, if you don't mind. Just on the margin, I think at the full year, you were very clear in some of the assumptions behind your margin outlook. So, 100bp mortgage spreads and 400bp swap rates, just wondering what you're anticipating today to give you comfort in consensus NIM for next year. Thank you.

Clifford Abrahams

Yeah, so on deposit pass through, we have passed through around a third of rate increases to date. In our outlook, our assumption is to pass through more of the future rate rises, so around 40%. So a pickup, but not a dramatic pickup, and we're not expecting a, call it a step up, in that lag and I think it reflects the scale of business and how we go about financing it. So, you've seen in the first half, frankly, a bit of a switch from non-linked savings, so easy access savings, to term. Now all this deposit beta debate relates to easy access savings, right? Because you don't have beta on term deposits, bluntly. So, we've been able to manage the book given our scale and our franchise to be really quite competitive on term where we're funding below swaps, so, we're locking in one-, two-year, often longer, swap rates. We offer some of those really attractive term deposits to our current accounts. So, we have a linked rate ISA product where we're really competitive, so beta immune, and that enables us to be perhaps be a little bit more defensive on our non-linked book, so we're tactically targeting different groups. In each case, we're convinced we're offering good value to our customers. But what this does is it enables us given our scale, where we're meaningful, but not enormous, enables us to manage our deposits effectively, whilst also giving good rates to customers and that reflects the heritage of the group. We’ve had deposit teams who really know the market in place for the last 15 years, given the nature of the business.

Perhaps linked to that, your last question around margin and assumptions. I talked a bit about our rate assumptions. So, we're saying we expect rates to rise, peak at around 4.5%, there's obviously a debate as to whether it will go further, it's probably skewed to the upside now, given recent events.

But we're saying 4.5% on current swap rates, so swap rates as of today. I think around mortgages, just to give you a flavour, and I've seen what other banks have said, and you know, we're all operating in the same market, so, I think for us, we're seeing application spreads of around 70 to 80bps now. So, that's less than our book. Our book is a little over 100bps spread, that's our mortgage book. We were not as active as some other banks during the sort of “heydays” of COVID. So we feel we've seen a big chunk of the mortgage spread attrition already flow through, and whilst at current spreads it continues to be dilutive, it's moderated, and frankly it's good to see some of the issues that the other banks have talked about, because that might lead to perhaps a more normal environment where banks are making money on both sides of the balance sheet.

And lastly, on TFSME, there is a slide in the pack, page 34 and you can see we've set that out. Look, we have £7bn of TFSME so I would say it's about average for the sector. But I'm pleased to show there that it's quite nicely termed out, and given the strength of our wholesale funding franchise, deposit franchise, you know, we're comfortable with this and we’ll continue to repay it meaningfully ahead of contractual maturities.

Rohith Chandra-Rajan

Thanks. Do you mind if I just follow up on two of those things? So, the 143bp average cost of deposits in the first half. Could you give us a number in terms of what that is today based on new term deposit pricing and what you're offering on the other accounts?

Clifford Abrahams

No, I won't give more granular information on that. We'll obviously report at full year.

Rohith Chandra-Rajan

Okay, thank you. And then TFSME, so you've given us a sort of refinancing schedule, but typically, how are you refinancing, that? Is that deposits or is it wholesale funding, combination of the two?

Clifford Abrahams

I mean, it's a combination, we're really pleased with our LCR of 153%, we've let that drift up, reflecting the environment we think it's the right thing to do, it gives us flexibility. We've been very pleased with our ability to wholesale fund. I've got Justin, our treasurer, sitting in the back there, I think we've been able to tap the markets, again, given our size. So, we have a recognised brand, but our wholesale needs are not enormous so, we can step in quickly, and you’ve seen that with our MREL issuance, we're really pleased with that. And that together with continuing deposits means we'll take the opportunity to repay TFSME. We’re not desperate to do so, but we'll do that in a staged way to manage it down over time.

Ali Woods, Morgan Stanley

Hi, it's Ali Woods from Morgan Stanley. I just want to ask a bit about your deposits and what you expect for the future. So, obviously, you've talked about the pricing or taking advantage of term deposits. Is that a trend you expect to see, and do you expect to see further growth from those? And also, your current accounts are also growing, is that something else you expect to grow?

And then also on mortgages, you're talking about some of these headwinds coming to an end in terms of high-rate mortgages coming off, is this something we're going to start seeing from the next half? I know you said it's you didn't take as much on in COVID, when there were higher ones, is that something we're seeing soon or is that something more of a ‘24 and beyond benefit?

David Duffy

Maybe I'll just make a comment on deposits, Clifford, and you can pick up mortgages.

Just one thing that's interesting is the changes in the structure of the market on this. So, the bigger banks pass through is less. They're being written to by regulators about why and that's got mostly to do with the back book repricing, which is a material headwind for them. What we're seeing in behaviours on that, is their deposits dropping, or letting accounts go, or some combination of both.

So, we see ourselves as a beneficiary. So, if you look at the market dynamic, we see the opportunity to competitively obtain more current accounts at reasonable prices with our linked savings offers. So, that's been a really attractive part of building our deposit structure, so, we see that it’s being even more advantaged on a structural level in the next period of time. And I think we would always want to grow both term and the normal linked savings deposits, because it's a balanced structure in terms of your total exposure. So, we will see both growing I think, quite well.

And then on mortgages?

Clifford Abrahams

On mortgages, I think the total market is down 40% in terms of new applications, and you've got well capitalised, well-funded banks competing over a smaller pool. So, it's natural for us to perhaps be a bit more cautious in that environment. We're still in the market. I think for some propositions on some days, our market share moves up, you talked about 5% occasionally, other times it will be lower. So expect us to operate at that.

I don't expect or want the total mortgage book to decline materially and one thing we're seeing is a really good share of re-mortgages coming through the business. And whilst we have phased the delivery of our new mortgage platform, I think we're both really excited about the prospects of that. So, I think this year, we'll trade as we normally do, as that comes in next year, it will really open up us to the full intermediary market, the brand is well known, we'll be able to trade, perhaps with more agility, we'll be able to move up and down a bit more, because it will be digital end to end and I would hope that our mortgage share would tick up as a result, but only if the spreads are attractive at that time.

Ali Woods

Okay, thank you.

Richard Smith

Okay, operator, I think we’re ready for the first question on the phone line, please

Operator

Thank you. We have our first question that comes from Ed Henning from CLSA. Ed, your line is now open.

Ed Henning, CLSA

Thank you. A couple of questions from me. Firstly, just to continue on the NIM line, I just want to clarify something. With your second quarter NIM at 194, and that will trend down to see a broadly flat second half outcome from a higher quarter, you talked about reducing mortgage headwinds, is that what gives you confidence next year to maintain a resilient NIM roughly where consensus is with the offsets being hedge benefits and mix benefits, just with that reducing mortgage headwind in '24?

Clifford Abrahams

Yeah, look, we were pleased with Q2, 194 and are calling around 190 for this year, I think just reflects natural caution, and we've got more visibility on Q3 than Q4. So, we want to maintain our track record of prudent guidance and delivery on NIM. I think I didn't formally confirm guidance for next year, but just commented that we're comfortable where consensus is at this point. Personally, my view is rates will naturally move broadly where they are now, and I've seen brokers notes talk about 3 to 4% as the sort of sweet spot for rates and I think we can really leverage our deposit franchise well in with those sorts of rates, with the propositions that David talked about.

And I think the mortgage market has a prospect of normalising into next year. So, mortgage pricing is always a little bit stickier as rates are volatile and as rates stabilise, frankly, seeing how the bigger banks have seen deposit outflows and are perhaps needing to pass on more of the benefits of rate rises to their customers, will also be conducive to, call it a more orderly mortgage market, maybe looking out 12 to 18 months. So, as of today, we're comfortable with consensus for next year and we feel good about our net interest margin through the second half of this year, there's only five months to go for us.

Ed Henning

That's helpful, thank you. And then just on your guidance for FY24 ROTE, previously you were talking about 11%, and now you're talking about greater than 10%. What's driven the slight change in that? Is it the cost outlook or is it the revenue outlook, how should we think about that?

David Duffy

Yeah. Ed, hi it's David, and good evening, by the way. I think for us, it's really the rate cycle, and it's not the cost dynamic at all. As you heard me talking about the cost dynamic, I'm very, very comfortable with it, I pretty much have line of sight and I'd hope to even come in tighter in our range than we've talked about in the presentation. So, that's not the factor, it really is where the rate cycle settles. So, if you treat it as double-digit returns are our floor in a way, that's how we think about it, and depending on the rate cycle, it'll settle at a point above that. So, we will probably have a good line of sight by this year end on guidance on that.

Ed Henning

That's great. Thank you for that.

Operator

Thank you, Ed. We have our next question which comes from Grace Dargan from Barclays. Grace, your line is now open.

Grace Dargan, Barclays

Hi, good morning, thank you very much for taking my questions. If I could ask for a follow-on on costs, what's giving you confidence on your less than 50% into next year on the cost income ratio? I guess, in particular, what are the moving parts you're seeing falling away? What are the key drivers there and how much inflation are you capturing in that guidance? And I guess linked to that, I appreciate you don't give absolute numbers, but maybe you could give an indication of whether in absolute terms, you're thinking about a higher cost number in '24 than you previously were?

And then secondly, on capital. Appreciate the commentary around the buyback after the ACS. Is there anything to stop you announcing a buyback again at full year? I guess, how are you thinking about the phasing of that distribution? Thank you.

David Duffy

Hi, Grace. It's David, I'll start first. I think just on the cost dynamic, we do operate it in our heads as a cost to income ratio, clearly for the reasons that we're looking to grow the bank and fund that growth. So, you see even though the costs are up now, we're still 3% down on the cost income ratio in the half, but I think you should take it that we see costs in absolute terms as down in '24. So, if you do the math with that, you would see a decline in cost, but the cost income ratios, are therefore leveraged. So, I feel that the dynamics are there, we've absorbed the inflation Clifford talked about on staff costs, which are the material element and that's all built into the forecast. So, a below 50% cost income ratio with net cost reduction.

Clifford Abrahams

Shall I pick up? But maybe just to build on costs, because we talked about the short-term costs. We give a bit more disclosure in the IFR, and you can see, frankly, a step up in costs in professional services. So, in order to handle the capacity that we saw in our contact centres around the rate increases, we retained some of our own staff and as David said, we had contractors, we had third parties dealing with calls and dealing with customer issues and we've got very good line of sight on that, and that was the £20m that I flagged earlier and so, we're confident that that will get dialled back next year. So, that's a sort of built-in improvement underpinning that cost reduction.

I think around savings, look I'm pleased with the cost savings, the £93m, but we are really looking to accelerate that. So, we haven't shrunk our store footprint, for example, for 18 months and that reflects some of the traffic that we've seen post COVID, but you can see that we have a really good line of sight on our restructuring programs that will re-energise through the second half of the year, and that'll earn through next year.

So, I think inflation, it's clear that inflation is coming down. We're hopeful that it gets back to within the Bank of England's range, but I think that's probably not my best estimate for next year. My hunch is inflation will prove a bit more durable than others, but at the same time that interest rates remain a little bit elevated, and in that 3 to 4% sweet spot that I talked about.

And so, we've got a good line of sight on our costs; on the net interest margin, I talked about the confidence in the net interest margin for next year and in terms of balance sheet, you can see even in a difficult half year we've managed to keep the business stable and we've got the growth drivers in our unsecured, our business book and then on mortgages as and when the platform delivers through next year, so that underpins our confidence around the cost income ratio.

I think around the timing of buybacks, we do want to see the ACS results that will be in July. Clearly buybacks need regulatory approval, there's a process around that. I mentioned I expect that we do the buyback by full year but we're not going to wait so, if we see an opportunity, and we follow the necessary process with the regulator, we would do a buyback ahead of that, subject to close periods, and so on and obviously macroeconomic conditions and the Board's view at the time, but we won't wait to do that necessarily, for full year. And you've seen that's been our practice last financial year where we've seen opportunity and follow the processes, we've done it outside of formal results.

Grace Dargan

Okay, thank you very much.

Operator

Thank you, Grace.

With our next question comes from Guy Stebbings from BNP Paribas. Guy, your line is now open.

Guy Stebbings, Exane BNP Paribas

Hi, morning, thanks for taking the questions. The first one was on the stress test, and I just had two points of clarification. So, on the stress test, what from the exercise are you and the rest of the Board are looking for to get comfort coming out of that to support distribution plans and operating back down in the capital range, is it the headline ratio you print in the stress test? Is it the size of the drawdowns? Or is it more simply just what the PRA tells you behind closed doors on performance and the greenlight for buybacks off the back of that?

And then the two points of clarification, I think you referenced that you expect the hedge notional to fall slightly, I don't know if you can size that for us at all? And then the mortgage hybrid model change, I believe that's an anticipated number, but can I just check you've got complete conviction that that's the sort of right number that you've got in, or complete clarity and visibility there. Thank you.

Clifford Abrahams

Okay. This is like Mastermind, isn't it? We've got the chairs. So, on stress tests, it was interesting, a very big bank announced a buyback earlier in the week. They have particular circumstances, despite stress tests being ongoing. I think for us, we were really pleased with our stress test first time, we're going through it again together with the industry, for the second time. So, we think it's important not to prejudge it both as Virgin Money and we want to go through the process with the PRA, I wouldn't read anything untoward in that.

I think in terms of the results of the stress test, there's again nothing untoward to comment on there. I think it's just not prejudging stress tests or pre-empting the regulatory view, I think the regulator has a right to have a view, we make our submission alongside other banks, the regulator has views, we get into a dialogue on those. We feel that our capital target range 13% to 13.5% is robust, we struck it prudently, we struck it in consultation with the regulator and you can see notwithstanding, we're not systemically important, it's a robust target. I think it's serving us well in the current environment, so I don't currently expect that to change. But I think that's all I would say around stress test. I mean, it's fairly imminent now isn't it, July's around the corner.

I think around hedging amount, the figures we've disclosed previously have been I think £32bn, we've talked about that hedge, and it may come down a couple of billion, and that reflects our relationship deposits have been maintained really quite well, but our non-linked secondary savings you saw we've dialled that back. So, I think in common with some of the other banks, we're seeing that come down, but the whole game of call it, terming out, getting the benefit of the upward sloping yield curve is actually gone now, isn't it? Now the yield curve is flattish so I don't expect that to change in the short term so that gives us confidence that it's not going to be material indicator from a net interest margin perspective.

And then finally, on the hybrid mortgage model, to be super clear, and I think it's set out in the notes to our accounts, we have made a submission regarding our hybrid mortgage models, in common with other banks. That process, for us and others is in dialogue with the regulator. So, it's not a black box that you're putting it in. If we make a submission, then that reflects our views, so, we need to book it, which we have, and so the £400m reflects management's best view of the new hybrid models. Those models are subjected to final review and a formal approval by the regulator, it's possible they have other comments. However, I would say I think we’re one of the last banks to do this. So, clearly, we don't analyse from the outset all the other banks, but there are enough advisors and the PRA has a view, that there's a consistent approach or a fair approach being adopted across the market reflective of the various books. So that gives me confidence that we are there or thereabouts, but there's always the possibility that the regulator has a view, as there is, frankly, in any other aspect of our model landscape, which will continue to evolve over time. So, that's probably beating that topic to death, but that gives you an idea of how we're thinking about it.

Guy Stebbings

Okay, that's helpful. Thank you.

Operator

Thank you. We have our next question comes from Joshua Freiman from Maquarie. Joshua, your line is now open.

Joshua Freiman, Macquarie

Hey guys, thanks for the opportunity to ask the question. Just one from me, actually. On your consumer credit, or your cards on slide, I think, it's about 14, you actually state that the moderation and growth reflects a disciplined approach to credit and profitability. I’m conscious you've raised your impairment and I just want to check, the other statistics that you guys show on your cards book highlight quite a high-quality book. If you're moderating growth because you're taking a disciplined approach to credit and profitability, what are you seeing in your books that's concerning you or causing you to raise provisions here?

Clifford Abrahams

So, a few things. So the bulk of the raising of provisions reflected the models that David talked through earlier. We're also seeing an increase in credit bureau scores, customer indebtedness, and that flows through to our staging, so, I would say they're more technical factors, we are seeing a modest pickup in arrears, we've set that out in the slide at the back. So I think they're not spiking, but they're more normalisation, which you'd expect at this point in the cycle. So those are arrears and impairments.

I think the points around moderation of growth and profitability are a little bit separate, obviously related, a little bit separate. So, when we talk about underwriting criteria, when, for example, utility bills go up, that affects the affordability for our customers, even well-off customers, so, we tighten our criteria so, we plug that into our models, and that will naturally reduce the amount of new business that we're getting. So the way we talk about it, we might have a 10% reduction in our underwriting criteria, that means where we took on 10 customers, now we're going to take on nine, because some customers just drop out because they don't meet our affordability needs. Now as utility bills start to come down, that will unwind. So, that's one factor.

I think around profitability, what we've seen, we're active in the balance transfer market. When interest rates are very low, all banks, including us, can offer quite long balance transfer periods, up to 30 months, and still earn decent returns. Now as five-year swap rates have gone from one ish, to 4%, that erodes returns, all other things being equal. So we have been, I think, one of the leaders in dialling back balance transfer periods, so, our leading balance transfer period is less than 30 months now. We've also increased our go to APRs, so the rate that we will pay after the balance transfer period has ended. Now, some institutions have maintained quite long balance transfer periods of 30 months or more and what we've done, is we've let growth moderate, so, we've slipped down the ranking in terms of proposition attractiveness, because it’s a business, frankly, so we want to earn our target returns, and we'll only write business if we can see a way to do that. So those two effects are not a direct function of arrears performance. Does that give you…

Joshua Freiman

Understood, it seems like it’s more of a -- yeah, that makes sense. It seems like it's more of a serviceability question for future growth in balance transfers –

Clifford Abrahams

Yeah, and we’ll grow. We -- I think David talked about Slyce and some of our other propositions. I'm really excited about the prospects of profitable growth there at the right time and now is not the right time.

Operator

Thank you. With our next question comes from Chris Cant from Autonomous. Chris, your line is now open.

Chris Cant, Autonomous

Good morning, thanks for taking my question. If I could just come back on cost, please. So, during the Q&A you referenced you would expect costs to be sequentially lower in ‘24 versus ’23, obviously, the guidance today would imply consensus costs for ‘23 are a bit too low. What's your view on ‘24 costs? Would that be down sequentially enough? Or do you actually see room to potentially beat ‘24 cost expectations of about £940m? I think your guidance implies about £950m for this year.

And just in terms of your gross cost savings target, the £175m, and the pacing of delivery of that. You talked about accelerating the restructuring efforts during the second half of this year, and I guess into 2024, so, presumably, the fruits of that effort will be building as we go through 2024. But 2024 itself, we don't necessarily see the full impact, so, would you then be expecting potentially costs to be lower again into 25, as we see the full effect of those cost efforts, assuming a moderation of inflation? Thank you.

David Duffy

Yeah, thanks, Chris. I’ll let Clifford give you three-year guidance, I'll steer away from that, but seriously, the first step in the cost reconciliation, which Clifford can do for you, is that acceleration in the second half, and that's the key element because we paused a bit of it, you know, branches, that type of initiative, whilst we dealt with the customer service issue, so, we were very focused on getting that right. So, we had cost built to solve those issues and costs not cut, as we didn't want to impact the initiative. So, on both fronts, you will see the acceleration in the second half. So, picking up what we had planned to do before at a faster pace, and then removing all the costs that we put in place to solve the problem and that momentum going into next year with the plans we already have gives me the confidence on the run rate to actually get to a lower cost number next year. But I don't know if you want to add on the reconciliation?

Clifford Abrahams

I think that's fair, we made some effort to pivot to cost income ratio, because we think that's right for a growth business. Our view is costs will be lower next year in absolute terms and we see consensus has costs of around 50% next year, we think it's going to be lower than that, for the reasons David ran through, that's based on our current expectations. We're really committed to our 10% ROE target floor. We think to do that our cost income ratio needs to be below 50% and we'll manage the business in that context, and as we get closer to a full year, we'll guide more specifically, but I think, our view is more ambitious than costs set out in consensus next year.

Chris Cant

Just to follow up on that, you indicated you're comfortable with consensus NIM of 192, I guess the balance sheet growth in the first half was a little bit better, so presumably you're comfortable with consensus NII or potentially think you might see some volume related beats there, and then, therefore, the overall revenue picture, presumably you're comfortable with for consensus, the sort of circa £1.9bn. So, implicitly, you’re then saying you expect to beat in terms of costs of 940 to get below the 50%? Is that a reasonable summation?

Clifford Abrahams

Well, the short answer is yes. We're targeting as I think you've heard from both David and I, a commitment of 10% plus returns. So I think we've been consistent when we talk to you and investors, who've pencilled in 8%, I think broadly speaking for next year? Some of the deltas; so there's a delta around costs, and we've given you the rationale as to why we're confident. I also think the street doesn't have us moving into our target capital range at the end of next year.

Now, none of us has a crystal ball for next year, all the pluses and minuses, but the way we run the business is we really want to deliver that 10% plus, and we'll manage the business to deliver that, whilst doing it in a safe way, within credit risk appetite and so on. So, that's the rationale for our confidence in those figures.

Chris Cant

That all makes sense, I guess part of the reaction today is probably around costs, and I’m struggling to remember the last quarter where we had objectively good news on the cost front, hence the question. Just coming on to the sort of delivery phasing of the £175m, do you expect to be delivering the majority of that £175m by the time we get to end ‘23, in terms of the run rate benefit?

I'm just trying to get a sense of how much that cost base delivery is still progressing as we go through ’24, because it feels like something that may be relevant as we think about 25 and I appreciate you might not want to give us specific figures on 25 costs, but obviously consensus, you're saying consensus is probably too high in absolute terms for ‘24 and consensus has costs up again into 25. So, just trying to understand how you're thinking about delivering that £175m.

Clifford Abrahams

Look, it's fair, we recognise that. We can go through the quarters, but I think we've been consistently transparent around costs and the service recovery that's now done. I think we flagged that at the full year and Q1. So, I don't think this is a surprise, although we've clearly given some figures around it. I think the way we've quoted cost savings, we do it in two ways. One, we talk about run rate, cost savings delivered, that's the £93m and we also give an indication on the bridge of how much is that earning through. So what we've seen, I'm really pleased actually that we've spent £135m, so we spent just under half the £275m, but we've delivered just over half the cost savings at £93m. So, they're sort of broadly matched. So, I think you can assume that we'll only spend the money if we think it's going to result in business benefit and as we will spend most of the remaining £140m during the next six months or so, you can expect that we will deliver most of the remaining annualised cost savings and those will earn into FY24.

David Duffy

Chris, just to add something there, because I listened to some of the commentary around the cost side. In 18 months, we've taken the cost income ratio down from 58% to 51%. Not many have. We're looking at taking it down to below 50% in the next period. And as a smaller firm we are subject to more volatility as we grow and transform, so, I look at that trend and then I look very carefully at the volatility, which you're obviously referencing, and there's a difference between cost-out fail and cost management of events. So, what I was pointing out today was that we were dealt an event around the mini budget, which created hundreds of percent of increases in calls into every aspect of the bank on mortgage rates and savings rates, which drowned us in volume, which we had to respond to and I made the decision. I wasn't too worried about what the quarterly or half number was going to be, I was much more worried about what the right answer for the business was, so I spent the money.

But I'm saying equally at the other side of that, that I'm taking the cost out. So, for me, where we were before today, and where we are after today is exactly the same answer as it was before to quote the Talking Heads. I just want to frame it that way, because that's how we think, the cost income ratio is about both sides of the cost income ratio. We will have volatility from time to time, but the most important statement is, do I believe we will deliver below 50% cost income ratio in '24? Absolutely. And do I have line of sight of that? Absolutely.

Chris Cant

Great, thank you.

Operator

Thank you. The next question comes from Edward Firth from KBW. Edward, your line is now open.

Edward Firth, KBW

Yeah, morning, everybody. Could I change the subject slightly and talk about tangible book? Because if I look at where that came in against the consensus that you sent us, it was about 26p lower, which is quite a big delta and I obviously get the movements around cash flow hedge reserves, but I guess the key difference looks to be the pension adjustment. If I look at last year, you've got slide 45 showing the bridge, but on the sort of Truss budget, etcetera, the pension increased by about 5p of tangible book and it's now down 20 in this half. So, could I just ask you just tell us a little bit more about what's going on in the pension in terms of the surplus or deficit etcetera and how we might expect that to evolve?

And then secondly, in terms of what's left in the cash flow hedge reserve, could you just tell us, it's probably in the numbers somewhere, I haven't seen it, but roughly how much is still in there? And is it -- I think you said in the past it would be about three years for that to amortise; is that still the sort of headwind we should be expecting on the tangible book? Thanks very much.

Clifford Abrahams

Yeah, I'll pick that up and refer to page 45 in the presentation. Around pensions, we have seen some really sort of odd behaviour. I mean, our period end was September and I think you'll know, and it's disclosed, that effectively it was credit spread spiking that's the real issue, because that's the discount rate for the liabilities, more than rates per se. So, rates should really hit both sides of the balance sheet, but effectively, we had a high discount rate September that's unwound. I also think that surplus is always quite leveraged, it's the difference between two large numbers coming out.

When we look at it on a, kind of an economic basis, or a pension trustee basis, we're really pleased with the resilience of our pension fund. You saw that we de-risked the pension fund to longevity, actually we announced that a couple of days ago. So, I think we feel in good shape, I would say have a look at our disclosures around pension fund, we can pick that up with Richard afterwards.

I think on page 45, around the cash flow hedge unwind, it's broadly as we expected. I mean you'll recall some of that had already unwound by the time we met at our full year results and we've unwound now down to about £400m, and we expect that to unwind another £100m. So, we've seen I would say the large part of the accelerated run off, it's now stabilising into '24 and I think has another couple of years left to it. So, it should be less of a factor as we head into…

Edward Firth

Great. Can I just go back on the pension fund. Is this the sort of volatility that you would expect? I mean, it feels looking at you versus other companies, that's almost, what, 5% of your 4% tangible or something is moving around around your pension deficit or your pension surplus? I mean are you comfortable with that or are you looking to try and reduce that and try and reduce the volatility in that or is that something that you feel is reasonably normal?

Clifford Abrahams

I think it reflects the abnormal environments we've been in, the spiking up of rates and credit spreads. I'm comfortable with the pension surplus and I think we have a good relationship with our pension fund trustees. The asset side is substantially de-risked now. We're going through our annual process, we'll see how that pans out but I think the longevity exercise that we've just gone through is an opportunity for people to crawl all over the pension fund and gives me confidence that we're in good shape. The pension fund is one of those issues that all institutions need to manage through. It predates my arrival a couple of years ago, I think the pension fund is in good shape and you can see we've not made capital contributions for a little while, reflecting that surplus.

Edward Firth

Great, okay. Thanks so much.

Operator

Thank you. Our last question comes from Jonathan Pierce from Numis. Jonathan, your line is open.

Jonathan Pierce, Numis

Yeah, hello both, thanks for taking my question. I just wanted to come back to the delta between consensus ROTE expectations for next year and your own guidance. I mean, it's clear within the underlying P&L I think where you see the deltas versus the market, it sounds to me like it's interest earning assets and maybe costs. I wondered if you could talk a little bit more though to some of the other moving parts. Cost of risk for instance, I think there's some moaning this morning about increased guidance for cost of risk this year but as far as I can tell, the genuine stage three default charge is still running at 20bps, which is well below where consensus is for next year. So, I'm wondering if there's a bit of a delta in your budget there?

I'd also like to get a sense as to where you think the below the line items next year will be. Consensus has still got a fairly chunky number in there, restructuring charges in particular, could be somewhat lower than consensus has got to?

But then the denominator, unless you're going to tell us that there could be further movements in the pension, which I guess is very difficult to predict at this point, I suppose the only real delta versus consensus may be on buybacks, so I was hoping you could just remind us exactly how the buybacks feed back through to TNAV, because I think in your case, quite a lot of the announced buyback hits TNAV on day one, so that would probably help the RoTE number next year as well. So, just a little bit more colour really on the deltas between the market and your own budget for RoTE next year would be helpful?

David Duffy

Yeah, I'll make one comment just on the arrears again, because I just want to be sure everyone is following it clearly. We're sort of out of cycle of the other firms who all did their macros, so when we come in and do our macros now, that's actually what our provision change is. So, it's not arrears. So, just if that's the point you're making, and Clifford, you can cover the underlying points, but the principle is there that we were behind the curve in terms of our year ends versus other year ends and half years, so, this quarter, we're updating, that drives the macros, that drives the increase, but it's not got any correlation to arrears in fact, so.

But Clifford, do you want to –

Clifford Abrahams

I'll make a couple of other points, I think we're covering it. I think on impairments, the point of IFRS9 is to accelerate impairment recognition going into a down cycle and so, I think bluntly, we feel we've picked up the mini budget and frankly, looking at other banks, a number of other banks have upgraded their macros from December reflecting the good work that Rishi and the team have been doing to stabilise. So, I'm not pre-empting full year, but we think we're catching up and that's not a past catch up, but that's a look forward catch up. So, if I look at consensus, consensus has 37bps for cost of risk next year, and that will be outside our through the cycle cost risk of 30 to 35, and I think at this point my best estimate is 30 to 35 for next year, because we think we've included all available information on our current balance sheet, so we should be reverting to the mean next year.

So, I think that's one delta and I think you put your finger on it, which is on CET1, where I've guided to overall surplus, consensus has just under 14% next year. We think our target range is appropriate and prudent and we're targeting getting within that range by the end of the year, and the phasing will reflect dynamics at the time and the recognition that you refer to.

Jonathan Pierce

And the TNAV implications of that are, what, about half of the buyback as it is announced comes out of the TNAV, you don't have to wait for the actual buyback to the executed?

Clifford Abrahams

Yeah, that's right. But you've seen our practice, which is I would say, call it, phased sustainable buybacks, so don't expect very large one-offs. That's not been our practice. I think our challenge over the last period has been inaugural stress test, and then changes in terms of the stress test timetable. So, what we'd like to do is to do sustainable kind of medium-sized buybacks, which I think is best for all stakeholders.

Jonathan Pierce

Yeah, that's great. Thank you very much.

Richard Smith

Okay, that brings us up on time. So, David, pass back to you for any closing comments.

David Duffy

No, just to say thanks, and I think the picture I'm drawing is probably slightly outside of the half year and I'm recognising that, but I am looking at the half year and the halfway point in our strategy and even with the lag effect of execution and actions, I'm thinking of those and I'm saying over the three-year period, we'll deliver the targets and that's what's in my head and so we're dealing with today, cost events that were taking cost out, so, we're comfortable with that and a macro model driven provision rather than anything else.

So, when I look at where we are, I feel pretty comfortable and that's why I tried to make that point today and be clear on that. And then I look at the distribution for our shareholders, that's a key part of what we think about and Clifford has gone through the numbers, and I see a huge opportunity over the next 18 months on that front as well.

So, the combination of those factors, you know, I would be as CEO the optimistic one of the two always, but I do see the next 18 months as a momentum play for us, with rapid increases in execution on all parts of the business and a confidence level around what we'll deliver and a substantial delivery for our shareholders in terms of distribution.

So, I'll close on that happy, upbeat note, and we'll see you all again soon. Thank you.

[ENDS]