

**Virgin Money UK PLC Full Year Trading Update Fixed Income 10 November 2021 – Call Transcript****Hosted by Justin Fox (Treasurer) and Richard Smith (Head of Investor Relations)****Justin Fox, Virgin Money UK PLC**

Hello. Good morning, everyone, and thank you for attending this call. You have myself, Justin Fox, Group Treasurer. And I'm joined by Richard Smith, our Head of Investor Relations, Matthew Harrison, our Head of Treasury Debt Capital Markets, and Gareth McCrorie, our Debt Investor Relations and ESG Manager.

As you're aware, we have made the decision to accelerate our Digital First strategy following our observations of market trends emerging in the post-pandemic environment. We recently issued an RNS indicating that we were executing a material reduction on our branch presence. In recent days, we have completed our Digital First strategy analysis, and have agreed the financial outcomes with our board. Given the launch of our new strategy with updated guidance, we felt it was appropriate to communicate these outcomes as soon as possible, and so released an unaudited, full year Trading Update last week. Following on from this, we've published some fixed income slides on the financial results section of our website, which Richard and I will walk you through.

Overall, we believe full year 21 has been a transformational year for the Group, which I hope you will see reflected in the slides. We have a robust capital position, which has improved over the year. We have simplified our funding programme structures, reviewed our structural hedge methodology, and delivered on our Tier 1 regulatory requirements with the submission of our first Bank of England Stress Test and Resolvability Assessment, both of which were expected to demonstrate the group's simple and straightforward business model and its resilience to potential vulnerabilities, thereby providing comfort to investors.

First off, we will do a brief review of our unaudited financial performance for full year 21, we'll walk you through our key elements of our capital, funding and liquidity position, our issuance plans for next year, and a few other key things emerging that we feel are worth sharing. At the end, we'll open up for Q&A. I'll now hand over to Richard to walk you through our unaudited full year 21 results. Richard.

**Richard Smith, Virgin Money UK PLC**

Thanks, Justin, and good morning, everyone. Starting on slide 5, as you can see, the bank is performing well. We've delivered a statutory ROTE of 10.2 percent and a statutory profit before tax of £417 million. Our balance sheet mix continued to evolve, with NIM increasing to 1.62 percent for the full year, and with an exit rate of 170 basis points in Q4. Our relationship deposits have grown 19 percent year on year, and our cost of deposits have declined 37 basis points compared to a year ago. Our costs have declined 2 percent year on year, and very importantly, our integration and rebranding of the bank is now substantially complete. This is a major achievement given the operating environment in the past two years. We've delivered strong growth in our established digital propositions. Our Virgin branded PCA sales have increased 95 percent compared to last year. And our new cashback proposition on Credit cards supported good growth in Unsecured volumes. Our Virgin card book has performed very well, growing at 4 percent against the market, which contracted by 6 percent. Across our portfolio, our asset quality has remained resilient and we've maintained strong provision coverage of 70 basis points. Our cost of risk for the year was a credit of 18 bps. And finally, our CET1 ratio has improved to 14.9 percent, demonstrating a strong TNAV progression as well.

Finally, as we announced last week, the board intends to recommend a dividend of 1 pence per share. We understand the importance of the dividends to our shareholders, so it's pleasing to be in a strong position to signal the restart of the dividends. However, it's worth stressing the outcome of the Solvency Stress Test remains a key milestone to consider ongoing dividend policy. So watch this space and we'll provide more details within the first half of the financial year.

Let's move onto slide 6 and I'll talk a little bit about the economic backdrop and how we're positioned. On this slide, you'll see that we've set out the latest macroeconomic indicators from our third-party provider, Oxford Economics. Overall, as you are no doubt aware, the backdrop in the UK has continued to improve over the course of the second half of the financial year. This improvement in the economy has seen GDP expectations improve further, with a recovery to pre-pandemic levels now expected in the final quarter of this year. Unemployment forecasts are also supportive of a growing economy.

The most significant change since we reported our half-year numbers has been the recent sharp increase in inflation, which is expected to continue to rise through the remainder of this year and into the early part of next year. And although the MPC have recently voted to maintain the base rate at 10 bps for the time being, we have seen the swap curve steepen through the second half of the financial year, and this has been beneficial for our structural hedge. Justin will take you through our rate sensitivity and gearing to an improving rate environment in more detail in his section.

So moving now to the lending and deposit base, we've prudently navigated through the course of the year in terms of our lending balances, with overall balances remaining broadly stable. In Mortgages, we entered the year cautious on HPI and prioritised margin amid strong market conditions. In the second half of the year, increasing competitive pressure saw us compete tactically, and balances contracted marginally. Going forwards, we continue to participate tactically, focused on maintaining strong overall returns and growing in targeted high-yielding segments where we have an established specialism. Business lending balances contracted as expected, with weaker BAU demands due to government lending scheme usage. In the second half of the year, government-backed lending balances became eligible to make payments for the first time, resulting in balances contracting slightly to £1.3 billion. And for those businesses choosing to use Pay as You Grow for Bounce-Back loans, we've seen the majority extend their loan term from 6 to 10 years. We're now targeting a return to growth in the business lending book, supported by the rollout of our M-Track proposition. Finally, we're very pleased with the performance of our personal lending book, where balances increased by 4 percent. A strong performance given the subdued backdrop that we've seen in the market. We are seeing consumer spending now back above pre-pandemic levels, well placed to benefit from the recovery with customer propositions that now include cashback and instalments. Looking ahead, we're targeting further market growth in high-yielding segments, including Personal and non-government Business lending. In Mortgages, we'll continue to participate tactically and look to maintain our market share.

Turning now to the asset quality of the book, we're pleased with the quality of our lending book, and are well positioned as government support is fully withdrawn. Credit quality was robust throughout the year, with Stage 3 loans remaining around 1 percent. Arrears and default levels remain low across the portfolio, and forbearance levels are stable. Charge-offs also remain low, with around £100 million of write-offs net of cash recoveries, less than in FY20. During Q4, we reflected updated economic scenarios from Oxford Economics relative to our Q3 assumptions. These include higher GDP growth, lower unemployment in the short term, peaking at 5.4 percent. We still retain conservatism within HPI, though now factor in a less severe contraction in 2022 of 6 percent. All of this drove a reduction in Stage 2 balances, resulting in around £200 million of lower modeled and individually assessed ECL provisions relative to the first half. We are conscious that the outlook remains uncertain, so we

maintained around £200 million of post-model adjustments. Overall, our final ECL provision of £504 million represents a reduction of £231 million from the FY20 level, resulting in portfolio coverage of 70 basis points, which remains above the pre-pandemic levels. This produced an income statement release of £131 million, equivalent to a cost of risk credit of 18 basis points. We expect the group's cost of risk to rise through FY22 towards the 'through the cycle' levels.

Finally, I want to finish on guidance and outlook. We've given guidance on KPIs for FY22 throughout the presentation, and we set this out on the left-hand side. We are making good progress in terms of driving the key pillars of our strategy with clear road map to statutory double digit returns by FY24. The assumptions that we have baked into that are realistic, and to recap, we incorporate general inflation of around 2 percent per annum. We have a prudent view on base rate rises through to FY24. We have assumed front book Mortgage spreads which are lower than stock in FY22, before seeing some recovery from FY23 onwards. And we have taken a prudent approach in terms of cost of risk and capital requirements. The double-digit statutory return targeted in FY24 will be supported by net interest margin expansion as we target growth in high-yielding segments, a higher contribution to total income from non-interest income, and a sub 50 percent cost income ratio and lower below the line charges, which we think have peaked in 2021. I'll now hand back to Justin to take you through the funding, capital and liquidity position of the group in more detail. Justin.

### **Justin Fox**

Thanks, Richard. As you can see on slide 11, we are pleased with our IFRS9 transitional CET1 ratio of 14.9 percent. This does, however, include the benefit of software intangibles of 53 basis points. Total underlying capital generation of 212 basis points in the year was driven by 216 basis points of underlying profit, 19 basis points benefit from lower RWAs, offset by 23 basis points of AT1 distributions. Exceptional items consumed 108 basis points, while there were 6 basis points of accrual for expected dividends and 11 basis points of other impacts, 15 basis points of which relate to a £35 million payment to our Defined Benefit Pension scheme to settle in full all remaining outstanding Deficit Reduction contributions owed. This is an important step in our strategic aim to continue to reduce pension risk and the capital set aside for that.

Looking into the next year, we expect continued capital generation from ongoing statutory profit but with a number of headwinds to net capital generation. The reversal of the CRR2 software benefit will reduce CET1 by around 50 basis points next year. We also expect RWAs to grow, reflecting both increases in volume and density as we target growth in higher risk weighted Unsecured and Business lending segments. While RWA pro cyclical to date has remained low, we remain cautious about the future outlook. Our full year '22 RWA expectation does not include benefits from the move to IRB for our Credit card portfolio and the adoption of hybrid mortgage models. Both of these depend on regulatory approval, with hybrid models expected to take effect from full year '23 and Cards IRB transition the year after. We are pleased that the board intends to recommend paying a dividend and remain committed to establishing a sustainable, growing dividend going forward. Overall then, we expect to CET1 to reduce somewhat next year, but remain comfortable on the outlook. Clearly, the next important milestone for us in the capital space will be the publication of the Solvency Stress Test results in December. We'll then provide further updates, as Richard has outlined in our interim results in May.

Moving on to slide 12, our capital position remains robust across all metrics. As disclosed last week, from the 4th of October, our Pillar 2A CET1 requirement reduced by 50 basis points to 1.7 percent. A lower Pillar 2A requirement means our CET1 minimum requirement, or our MDA hurdle, has also reduced to 8.7 percent, giving us a meaningful £1.5 billion of CET1 management buffer on top of the half billion of on balance sheet provisions. Total capital of 22 percent and the UK Leverage ratio of 5.2 percent both remain strong, and at 31.9 percent we remain comfortably ahead of our expected 1st January 2022 end-state MREL requirement of 24.6 percent.

Turning now to the breakdown of our total capital stack on slide 13. Compared to others in the market, we have a very straightforward capital structure. All of the Group's regulatory capital and MREL is issued by our holding

company, Virgin Money UK PLC. It is fully eligible from a CRDIV perspective, so there are no issues about grandfathering. There's also no FX exposure in the capital structure, providing stability during periods of market volatility. As you can see, we have excess total capital of 8.4 percent over our regulatory minimum. During the year, we took the opportunity to optimise our capital stack, increasing Tier 2 via the £300 million transaction in May and reducing AT1 through the recent £230 million call. As I've mentioned before, we don't have a target level of AT1 or Tier 2 per se, but we aim to maintain headroom over and above the regulatory optimum amounts to cover potential RWA increases. Over the medium term, we will continue to look to manage these buffers in an efficient manner through potential redemptions and any refinancing activity. In an attempt to pre-empt any questions about the £450 million of AT1 that is callable in December 22, I'd say this - we're fully aware of it, and it's clearly in our thinking and we get reminded about it a lot, but I think it's far too early to give any indication as to our thinking. As a reminder, our call policy remains unchanged. Future capital call decisions will be assessed a broad economic basis, i.e. balancing factors including the relative funding costs, current and future regulatory capital and MREL value, rating agency treatment and wider wholesale funding needs. And, of course, calls are subject to PRA approval with whom we have an active dialogue.

Turning to our MREL position, as I've already mentioned, following the successful issuance this year, our MREL ratio of 31.9 percent comfortably exceeds our expected end state requirement of 24.6 percent of RWAs. So in terms of what this means for our capital and unsecured issuance plans for 2022, don't expect incremental capital issuance given where our Total Capital ratio is. Any issuance will be broadly limited to refinancing. And we have no HoldCo Senior issuance plans, again, given our comfortable MREL position and the fact that we do not have any HoldCo Senior redemptions until 2023.

Now turning to funding on slide 14. We're pretty pleased with the work we have done to reduce our overall funding costs this year across both retail and wholesale channels, benefiting NIM. While total customer deposits were stable in the period, we improved mix and repriced, delivering a sharply reduced overall cost of deposits to 53 basis points. Our successful new current account proposition, together with customers holding higher average balances, resulted in a 19 percent increase in relationship deposits. At the same time, we reduced more expensive term deposits by 29 percent. In wholesale, we reduced overall balances and managed mix as there was no need to replace maturing secured funding. Looking forward, one point to note is that following the improvement in our wholesale funding spreads, the cost differential between incremental customer deposits and wholesale funding is now quite finely balanced, which allows us to be agile when thinking about refinancing wholesale funding and minimise our cost of funding within our LDR guidance.

On TFSME, when the scheme closed in October, we had drawn our full initial allowance of 7.2 billion, effectively refinancing our TFS drawings. We were eligible for £5 billion of additional capacity; however, we chose not to draw this given what that would have done to our future refinancing profile. £7.2 billion TFSME represents about 8 percent of total lending, which feels like the right balance between supporting additional lending to the real economy whilst not increasing refinancing risk. As with FLS and TFS, we plan to repay TFSME about one year ahead of contractual maturity and are using the time to simplify and improve our wholesale funding capabilities. With the closure of TFSME, our secured issuance is expected to normalise through 2022. We anticipate £2 - £3 billion pounds of issuance, but this will be subject to deposit flows and relative cost.

Quickly on liquidity, our LCR was stable at 151 percent, comfortably exceeding both regulatory requirements and more prudent internal risk appetite metrics, ensuring a substantial buffer in the event of any sudden outflows and significant potential to support any increase in lending as the economy recovers.

Moving to slide 15. When we last spoke at the half year, we noted strong outperformance in our secondary spreads during our first six months of trading. We're pleased to see that this trend has continued in the second half of the year, and we have continued to close the gap to larger peers. In May, we issued £300 million of Tier 2 debt, which was priced 300 basis points tighter than where we priced the same trade in September 2020. The same month we issued our second Euro HoldCo senior transaction, which attracted 35 new European investors – a positive sign that our name is maturing and our investment proposition is compelling. However, there's still

room for improvement. As of today, market pricing for VMUK has significantly improved across AT1, Tier 2 and MREL senior. Hopefully this continues. Improving cost of funds helps us internally with discussions on the relative cost of retail versus wholesale, which is good discipline. More broadly, it helps us make important contributions to financial performance through NIM and CET1.

Moving now to our issuance structure on slide 16. As I mentioned on slide 13, we have a simple vertical issuance structure. All external regulatory capital and MREL is issued by Virgin Money UK and we don't have legacy or grandfathered capital securities. All Virgin Money UK's external regulatory capital and MREL instruments are downstreamed internally to our main operating subsidiary and ring-fenced bank Clydesdale Bank PLC, meaning the capital structures of the two entities are aligned. All secured issuance is from Clydesdale Bank or SPVs consolidated as part of Clydesdale Bank. We continue to work hard to rationalise our secured funding footprint across both the old CB and VM heritages. In September, we obtained consent from holders of the only remaining bond outstanding on our Old Covered Bond Programme to transfer it to the New Covered Bond Programme. This process was completed in October and the Old Programme was subsequently unwound on the 2nd of November. The simplification improves our collateral management and reduces the operational risk and cost of running two programmes. Going forward, future secured issuance will therefore be from our New Covered Bond Programme or Lanark RMBS Master Trust. Worth just noting that as part of the covered bond consent, holders agreed to amend the rate of interest that would apply in its extension period from LIBOR to SONIA. This means we have successfully transitioned all of our debt securities -- secured, unsecured and capital -- from LIBOR to alternative rates, ahead of the regulatory deadline at the end of this year.

Moving now on to the structural hedge on slide 17. We have now fully reinstated our structural hedge. You'll recall that we reintroduced the structural hedge towards the end of the first half, having unwound the previous program back in 2020. At that point, we were focused on recommencing it on the same basis as before. Over time, we would look to optimise based on an updated review of customer behaviors. Also, we were more concerned at that point about the prospect of negative base rates. Now, we're more focused on the prospect of rising base rates. At the end of Q3, the group had reinvested with balances at £25 billion. During the tail end of Q4 we increased the size of the position further to around £26 billion.

During October, we expanded the structural hedge further after concluding a methodology review and an updated assessment of rate sensitive balances and the behavioral life of deposits. This now takes the size of the total hedge to around £32 billion.

In terms of the financial impact, contribution from the previously hedged position that was unwound in FY20 remains the same; that hedge was around £24 billion of notional and has been locked in at circa 80 basis points since Q3 2020. 1/60<sup>th</sup> rolls off each month, so therefore the 2021 contribution was around £150 million, will be £120 million in FY22, and is gradually reducing out to FY25.

The new £26 billion pound hedge, which was reinvested through May - June 21, was executed using swaps with an average duration of two and a half years and an average yield of around 32 basis points and contributed around £30 million to gross NII in FY21.

Given the shape of the yield curve and the higher hedge size of £32 billion, we estimate structural hedging contributions to income will be meaningfully higher in FY22 relative to this past year on a gross basis, with £6 billion of additional capacity invested at recent higher rates.

In terms of what this means for interest rate sensitivity, based on the higher hedge size of £32 billion pounds, we estimate a one-year sensitivity to a parallel shift in rates will deliver around plus £20 million or minus £10 million for a 25 basis point parallel shift, either up or down in base rates. This is down relative to the year-end position, given the additional value we were locking in from the upsizing the hedge with the reduced ongoing exposure to rate changes.

I'll now move on to slide 18 to discuss our regulatory deliverables this year and next. One thing I don't think is fully appreciated is that after bringing the two banks together, we became a Tier 1 bank for regulatory purposes, which means we are subject to exactly the same enhanced governance and oversight requirements as larger UK peers. Therefore, 2021 has been a very busy year of firsts for us. We participated the first time in the Bank of England's Solvency Stress Test, with the results now due in December. We believe we acquitted ourselves well and demonstrated the group's strength and resilience to stress. However, the outcome remains a key milestone in considering our future capital framework and dividend policy, of which will provide more detail at the half year. Along with larger UK Banks, we submitted our first Resolvability Self-Assessment. In case you aren't familiar with the Bank of England's Resolvability Assessment framework, certain firms are required to perform an assessment of their preparations for resolution in which they identify any risks to successful resolution and the plans in place to address them, submit a report of that assessment, and publish a summary of their most recent report. This is designed to make resolution more transparent, better understood and more successful should it ever happen. The Bank of England said it intends to make a public statement concerning the resolvability of each firm in scope in June 2022. We will also be required to publish our own assessment alongside those of larger peers. Again, we hope to screen pretty well on this compared to larger, more complex peers, and we will publish more information about this in June 2022.

Moving to our credit and ESG ratings on slide 19. All the group's ratings are now back on 'Stable' outlook, having navigated the COVID 19 pandemic with no rating downgrades. In January, S&P affirmed Virgin Money UK's ratings and upgraded the long-term rating of Clydesdale Bank by one notch to A-. The upgrade reflects the Group's improved additional loss absorbing capacity following Virgin Money UK's MREL issuance, which provides additional protection for Clydesdale Bank senior creditors in resolution and now exceeds Standard and Poor's threshold for the additional notch benefit. In June 2021, S&P revised the outlook on Virgin Money UK and Clydesdale Bank long-term ratings to 'Stable' from 'Negative', reflecting their stabilising view of the UK economy, coupled with the Group's improving asset quality outlook, conservative risk appetite and robust positioning. In July 2021, Fitch affirmed the long-term ratings of Virgin Money UK and Clydesdale Bank and revised the outlook to 'Stable' from 'Negative'. This follows the revision in Fitch's outlook on the United Kingdom's AA- long-term ratings to 'Stable', reflecting their improved expectation for the UK's economic recovery and subsequent reduction in downside risk to the Group's asset quality, capitalisation and strategic execution. Also, in July 2021, Moody's upgraded Virgin Money UK's long-term rating to Baa2 from Baa3 following revisions to their 'Advanced Loss Given Failure' framework. At the same time, Moody's reaffirmed the 'Stable' outlook on all the Group's ratings.

We've also had good news on the ESG front, with rating improvements in every one of our benchmarks in the last 12 months, with a notable one notch upgrade from MSCI to 'A' from 'BBB', which is reflective of the hard work and progress made over the year. One of the main challenges going forward really is going to be managing the increasing myriad of rating requests from third parties and agencies in this space. And we're pretty conscious that the market is looking for a 'show not tell' approach and hopefully our updated ESG disclosure that we will release as part of our Annual Report and Accounts on the 24th November will provide evidence of that. However, we are also ambitious, and we realise that this is not a 'one and done' exercise and that we must evolve as the market evolves.

That said, let me move on to slide 20 to discuss our ESG highlights for the year. We made good progress in FY21, building momentum and continue to embed ESG within our business, with responsibility for success shared across the leadership team. In terms of highlights across our ESG goals, as I mentioned last time we spoke, we have switched the biogas saving estimated 9 tonnes of carbon per day, reducing our Scope 1 market-based emissions by 80 percent. We have a range of product developments this year, including our sustainability linked loan and green mortgage launch, that incentivises customers to own more energy efficient homes by receiving discounts when purchasing EPC A or B rated new build properties. We won the 'Financial Inclusion' award for the new M account by increasing the value we're giving to longstanding customers and aligning it to the value proposition offered to new customers. And finally, we will publish TCFD reporting in our Annual Report and Accounts, have expanded the ESG measures for the 2021 LTIP and have rolled out ESG training across the organisation.

Looking forward, our focus in full year '22 will be to further understand emissions from operational -- so premises, travel, and indeed home working -- and financed activities in mortgages and customer lending, alongside setting science-based targets in line with our recently signed net zero banking alliance commitments. This, alongside keeping pace with compliance requirements, should keep us busy across new financial year.

Finally, as can be seen from what I've just described, we are doing a huge amount of work to embed ESG strategy across the business, and the Annual Report and Accounts should give you an even greater sense of that progress. In terms of our green funding plans, it is something we're continually looking at, but for the time being we are focused on further improving our data and disclosure and demonstrating lending against our new ESG products. This will drive the funding need and enable us to develop a truly customer driven ESG funding solution.

So, to quickly conclude on slide 21, overall, we believe full year '21 has been a transformational year for the Group, which I hope you see reflected in the slides. Asset quality remains robust across all portfolios, with no significant specific provisions and little evidence of asset deterioration. Capital, funding, and liquidity all remain strong. We're building momentum across a wide range of ESG initiatives, which is being reflected in improved ratings. Our legacy issues are behind us, we have completed our rebranding and integration activities, and we have built unique product and proposition capabilities. And we're confident the Bank of England Stress Test results and Resolvability Assessment public disclosure will demonstrate the Group's strength and resilience to stress and provide comfort to our investors that we have a simple and straightforward business that they can have confidence in. In my mind, that all makes a pretty compelling investment proposition, especially given we are still trading wide of peers in debt markets, but I'll let you be the judge of that. We will now open up the line for questions. Juan, please go ahead.

### **Operator**

Amazing, thank you. If you would like to ask a question, please press star followed by one on your telephone keypad, now. For those who have joined us online, please press the flag icon. When preparing to ask a question, please make sure your phone is unmuted locally.

And our first question comes from Yi Qian from Atlanticomnium. Please, Yi, the line is now open.

### **Yi Qian, Atlanticomnium**

I just have a quick question on the deposit side. The run rate as disclosed in the last week's earning call, it's already at 43 bps. I'm just wondering in 2022, how further down it can go? And then in terms of the term deposit trend, I'm curious, do you have an expectation of how much further the cost of your term deposit book can reduce in FY22? Thank you.

### **Justin Fox**

Richard, can I point that one to you to begin with.

### **Richard Smith**

Yeah, sure. Absolutely. So I think you're absolutely right, in terms of pointing that we've had a significant improvement this year, and the exit rate is substantially better. I think in terms of 'Where does it go from here?', we do still see some benefit in terms of our thinking around NIM in our c.170 bps of guidance, but it is far more limited. You're right to call out the term deposit book, obviously it's been coming down over the course of the year. And we're pleased with that mix shift as a driver – and the substantial 19 percent growth in terms of our relationship deposits, and corresponding reduction in some of the more expensive term deposits. When we look

at the Term Deposit book that remains -- and we'll give more detail around this in the Annual Report -- it does still remain at an average cost north of 1 percent. So as those term deposits roll off on to more market level rates, they are still coming down a bit and it does represent a tailwind to us. But it is more limited.

I think when you look at the drivers that we set out in terms of NIM more generally, the elements that are certainly going to be helpful in terms of our thinking into next year, deposits are the lesser tailwind, but we do have more benefit coming through in terms of the hedge year on year, and we've got a stronger contribution in terms of growth in higher yielding segments. Offsetting that, we are cognisant of continued pressure in terms of mortgages. But that's the way that we've thought about the drivers as we look at that c.170 basis points guidance for next year.

**Yi Qian**

Thank you.

**Justin Fox**

I'd also follow up -- one of the things that we've been looking at in the last few weeks is what's been happening with TFSME. There seems to have been quite an extensive back end drawing to the scheme. The size of the scheme is actually now higher than then TFS was. That will also have some bearing on what sort of activity we expect to see going on within the deposit market; certainly, over the next 12 months.

**Yi Qian**

Understood, thank you very much

**Operator**

Thank you. Our next question comes from Guillaume Desqueyroux from Sanlam. Please, Guillaume, the line is now open.

**Guillaume Desqueyroux, Sanlam**

Hi. Good morning. This is Guillaume Desqueyroux. Hi, thanks for the call; very appreciated.

A few points from me, if I may. You've talked about the pension risk that it seems to be something that you want to get sorted. Can you remind us the amount of stakes for the DBS? And do you consider, you know, options out there like buyouts, this kind of thing? Secondly, on RWAs -- on the different buffers that you have on Tier 2 and Tier 1, you said that you want to keep some headroom with RWA increases potentially - away from Basel IV and those things, do you have additional question marks on this trend that you could share with us? And last but not least, on your structural hedge, you said that you moved the outlook from concern over negative rates to more higher rates. But I was more interested in the highest saving rate that you can see still in the economy and how does that impact your deposit behavior and your thinking about the quantum for your structural hedge, if it makes sense; do you have enough visibility or are you still taking a prudent step before hedging too much and not enough? If you can just articulate a bit of your structural hedge thinking, that would be, I think, appreciated given the environment we are in.

**Justin Fox**

Okay. So let me deal with pension risks to begin with. So Defined Benefit pension schemes do consume capital, they consume capital under Pillar 2A, under the methodology outlined by the PRA in their ICAAP review. They can also consume capital through the modeling that is done through the stress test cycle. So that two ways they can impact capital. Clearly, all banks have been taking steps towards reducing the risk they see from their old schemes. We've made a lot of progress on our scheme. This time last year, we told the market that we just completed our triennial evaluation and the IAS 19 accounting surplus had clearly risen as a result of that. I think what you'll see when the Annual Report comes out later this month is that trend has continued. So the decision that we made was, we have been making monthly contributions that will go out to 2023. Given our stronger capital position at the end of this financial year, we made the decision to basically prepay that contribution. What we're now doing -- what we are looking at -- with the pension scheme is the forward-looking strategy, as we move towards self-sufficiency. So we're in conversation with the trustees about what that may or may not do. More will come out when we publish the Annual Report. Hopefully, that that gives you a sense of where we are in pension risk. In terms of RWAs, I think you're right, I think there are two things that we think about. One is the natural path of RWAs given our corporate plan over the next five years, and we've already said that we think our RWA density will increase as we increase our exposure to Unsecured and Business lending, which is consistent with the strategy we outlined back in 2019. We do look at and think about Basel 3.1. We had a lot of discussions this year about modeling the impact, and then clearly we are somewhat subject to the broader dynamics that are going on around the timing of that. So we keep an idea and we do look at that. I don't think specifically we have talked about any specific inclusion of RWA uplifts because of Basel 3.1, but that goes into our thinking. And then on structural hedge, you're right. I mean, one of the things that we have been looking at over the last six months is how has depositor behavior changed in our book throughout the pandemic. In part that will be driven by the wider inflow of customer deposits that we have had, but also for us, the switching towards growing our current account business. So, we have not fully hedged our position -- we are mostly hedged, in terms of that and we continue to look at that on an ongoing basis. Richard, I don't know if we've mentioned what the size of the expected hedge was last week, I can't remember off the top of my head.

**Richard Smith**

No, we mentioned where we were up to today, around the £32 billion level. I mean, overall, I think, you are right in saying Justin, less to go after, in sort of an increase.

**Justin Fox**

Less to go right now. But I think we continue to watch this as our book changes. So that will evolve over time, particularly as we grow the current account base. So I hope those answers your three questions, if that's ok.

**Guillaume Desqueyroux**

Yes, thanks for that. May I just sneak a fourth one? Just on the mortgage developments, I think you said that 2023 should be slightly better, but I still see like a very crowded marketplace with still a lot of small market players. So can you give a bit of the reason why you would see this as a positive trend?

**Justin Fox**

Richard, can I ask you to cover that one, please?

**Richard Smith**

Yes. Sure. So you're right. It's still a very competitive market spreads have come down and, currently, front book is below back book. What we were flagging was two things really. Firstly, it's still early in the year as far as we're concerned, so we don't assume any benefit in terms of spreads expanding materially this year. As we look out to next year though, two things we are already seeing. More increases in terms of customer rates going through from peers, so you are seeing the swap curve pickup that we've had over recent weeks starting to flow into customer pricing across the sector, which is good. Typically, customer pricing lags movements in terms of rates both on the way down, but also on the way up. So, we have very good spreads over the backend of last calendar year as swap rates fell, but we see more pressure on the way back up more recently. We are now starting to see the market respond to that which is positive. We are also targeting growth in some more specialist segments, in the new business that we've been writing, given we've got established specialisms in terms of buy-to-let, and we'll be doing more there. We also have established specialisms in high-yield, and particularly high-yielding segments which are large ticket size, and also higher LTV space. So, we'll be doing a bit more across those and sort of dialing up those as a proportion of flow. We'll also be delivering, over the course of '22, straight through mortgage processing, which will give us additional speed, in terms of processing those, which again is helpful in terms of supportive to pricing more generally. But for us, as I say, we've been pretty prudent in the thinking for '22 around what spreads look like with some benefits starting to play through some of those areas in '23.

**Guillaume Desqueyroux**

All right, thank you, very clear; I'll drop the mic, thank you.

**Operator**

Thank you. As a reminder, to ask any further questions, please press star followed by 1 on your telephone keypad now. And the next question comes from Marc Sanchez from Credit Suisse; please, Marc, your line is now open.

**Marc Sanchez, Credit Suisse**

Hello, good morning, Marc Sanchez from Credit Suisse. First of all, thank you very much for this presentation, very useful as always. My question is on M&A; we've recently seen headlines regarding M&A in the UK midsize banking sector. We wanted to ask you about your views regarding M&A at what role could Virgin Money play here?

**Justin Fox**

Oh, Richard, that one is definitely for you.

**Richard Smith**

Yes, of course, no problem. So, look, we've obviously just come to the end of the last integration that we've done between CYBG and Virgin Money. Having done the rebranding, what we've laid out last week in our minds -- gives us a great organic opportunity. I think you're right, there is increased noise across the sector around what peers are thinking and may be looking to do. We feel like we have adequate scale and a strong organic opportunity. 'Are there areas where we could look at sort of tactical infill in terms of capability'? Yes, it's possible. But ultimately, I think where we are at the moment is, large-scale M&A, where there is significant restructuring, doesn't feel like something that we particularly need to do unless it's incredibly compelling. From our perspective, we've got a pretty strong organic strategy, and that's our primary focus at the moment.

**Marc Sanchez**

Thank you very much, Richard, very clear.

**Operator**

Thank you. The next question comes from Lee Street from Citi. Please, Lee, your line is now open.

**Lee Street, Citi**

Thank you. Thanks for the call and morning. Thanks for taking my question. Really just one question with two parts. On your returns, when I look at your return on tangible equity for a statutory basis is expected to be double-digit in full year 24. I am just trying to understand, obviously it's the restructuring charges, why it takes so long to normalise it? It just feels as though it probably should be happening sooner? And, I suppose, linked to that, when I look at your business and the makeup of your loan book, I just feels like it's right at the higher end of returns that we actually see, and yet it never quite delivers. So, thoughts on ROTE as we look ahead - those are my questions, thank you.

**Justin Fox**

Richard, would you like to take those?

**Richard Smith**

Sure, absolutely. So, in terms of restructuring, you're right, in that I think where you're going with the question there Lee, in the sense that it is frontloaded, and we have flagged we are targeting to take more than half of those in FY '22. So, you will see a normalisation come through over the outer years. If I flesh out some of the other building blocks just around how we think about ROTE, we flagged as well as part of the Trading Update, in the near term, tax will gradually rise towards a low '20 type of level by FY '24, which is in part driven by the recognition of deferred tax over the course of that period. The key component, though, and I think maybe this is where you were going with the question as well, the cost income ratio where we highlighted less than 50 percent, and really the strategy in terms of how we think about what we laid out is two-fold. We will both take costs down in nominal terms overall, but also it's about growth and really targeting growth in high-yielding segments and in fee income driving businesses, and that's really what some of the elements of the investment that we're doing will deliver. So, there is definitely a delivery point where we need to show the benefit of those returns and really drive stronger underlying profitability, and then it's about closing the gap between statutory and underlying, and really that's how we see the sort of double-digit returns coming together.

**Lee Street**

Ah right, fair, thank you.

**Operator**

As a reminder, to ask any further questions, please press star followed by 1 on your telephone keypad now. We currently have no further questions. I will now hand over to Justin Fox for any final remarks.

**Justin Fox**

Just to say thank you all for dialing in today. As I mentioned, to begin with, the call happened a little sooner than we planned, but the reasons we announced last week hopefully provide an explanation for that. We do very much appreciate your ongoing support and dialogue. The team are here to answer questions, so if you think of something post this call that you'd like to learn a little bit more about, don't hesitate to get in touch. The next important milestone for us will be the 24th of November, when the Annual Report and Accounts will be published, and again, that will also include our first enhanced ESG disclosure. All that saves me to say is thank you very much for your ongoing support, and we'll speak to you all soon. Thank you.

**[ENDS]**