CYBG PLC Interim Results – Analyst Call

Hosted By: David Duffy (CEO) and Ian Smith (CFO)

David Duffy, CYBG PLC

Good morning everyone in London, and good evening to those of you joining our webcast from Australia and welcome.

With our Capital Markets Day only a few weeks away, today's presentation will be a little shorter than usual and will focus on the positive progress of the combined business for the last six months. We will share a little bit more about the future opportunities and the strategic outlook on the 19th of June and I hope that many of you will be able to join us then.

Today I'll briefly take you through the highlights of the first six months, and Ian will then talk through the detail of the financial results, and then we will open up to Q&A on the financials at the end.

Okay. Having completed the Virgin Money acquisition in October, we're pleased with the strong progress we've made in our first six months as a combined business and I'm optimistic about the opportunities we can see for the new business. I will therefore use the session today to comment on the two areas that are my primary focus: financial performance and integration.

Firstly, financial performance, I don't want to steal too much of Ian's thunder here, but I do want to highlight that we have delivered a resilient underlying performance in the first half. Our income has remained resilient over the past six months. Underlying costs are reducing and we remain well capitalized and are therefore very well-positioned going forward. As expected, impairment charges have increased, as they have normalized a little from an abnormally low year in 2018.

The initial cost synergies are being delivered, as expected, with around £33 million of annual run rate synergies realised to date. And as you know, we've have been able to increase our expectations of the total annual run rate cost synergies from £120 million to a minimum of £150 million. We will talk in more detail about the broader cost opportunity in June.

While our underlying profit before tax is slightly lower, year-on-year, due to the impairment increase, it is up on the second half of 2018, and we have delivered a double-digit underlying ROTE of 10.4 percent. You will also have seen, from some of our peers, just how tough the market conditions are at the moment and Brexit uncertainty continues to undermine confidence as well. As other results have shown, the market more generally is seeing SMEs defer investment and fewer people buying homes, which of course is combined with, as you know, the strong levels of competition across the mortgage market. So in that context, it is actually pleasing to see how resilient the underlying business performance has been.

As we guided to previously, and consistent with expectations, we have incurred upfront acquisition costs which have impacted the statutory profit during the period, but with these costs now largely behind us, we have a clear path to future statutory profitability, and Ian will talk through that in more detail later.

While, overall, I am pleased with the group's first half performance, there are always some things that disappoint. One of those was the outcome from our bids for a grant award from Pool A and Pool B of the RBS Capability and Innovation Fund. We're very surprised at the outcomes, given our reading of the eligibility criteria in particular. However, given our strong existing position in the SME market, we remain very well-placed to deliver on our plans to disrupt the status quo in SME banking, and we will talk more about that in June. And I think you'll see from the results today, we're doing quite well, in any case.

Secondly, let me now turn to integration. We are of course just six months into a three-year program, but I am pleased with the progress that we are making. We have focused initially on addressing duplication in the first two layers of senior management, which inevitably requires tough decisions, but the vast majority of headcount reductions have been achieved through natural attrition and voluntary redundancy.

Colleagues across both heritages are very engaged about the future opportunities for the group, despite this being a period of change and personal uncertainty for some, so I'd like to thank all of our colleagues for their continuing commitment, and I look forward to seeing what more we can achieve together. I am particularly pleased that the transaction has enabled us to deepen the strength and capability of our management teams, with Virgin Money leaders representing around 40 percent of the next management level of the bank and both cultures are integrating very well.

Completing the FSMA Part VII banking license process is the key to the next stage of integration, and I'm happy to say we're making good progress on that and still expect to achieve it by the end of this calendar year. I'm also excited about the opportunities that we believe exist with the Virgin Money brand, and also with the wider Virgin Money group companies. And we will obviously say more about these on Capital Markets Day, but the early engagement we've had reinforces our view that there are some tremendous opportunities to create a unique and differentiated proposition in the U.K.

I will sum up by saying that everything that we thought was possible at the time of the transaction we still believe now, but with even greater confidence.

In simple terms, we have an iconic national consumer champion brand, the full range of products, a national distribution network, an integrated open API platform for six million retail and SME customers, and a proven track record of cost management.

So, we're now at the stage where we are ready to take our next strategic step to deliver on our ambitions and I look forward to sharing our thoughts in more detail with you on those ambitions in June. Thank you, and let me now hand you over to Ian, who will talk you through our combined group financial performance over the past six months. Thanks.

Ian Smith, CYBG PLC

Thank you, David, and good morning. It's nice to see the usual friendly faces out there today, and good evening to those following this in Australia.

As David mentioned, the focus of today's presentation is very much on the financial results for the last six months, but we will be updating you on the longer-term strategic plans at the Capital Markets Day in June.

Before I start, I want to clarify the basis of presentation for the numbers I'm going to talk to. It's a bit more complicated due to the timing of the completion of the acquisition. The acquisition completed on the 15th of October last year and so, from a statutory perspective, the financial results will only include the contribution from Virgin Money from that date. However, to make for a more helpful discussion of the results, and for ease of comparability, we've prepared pro forma financials, which assume the transaction completed on the 1st of October 2017. And it's this pro forma basis that that I will talk to today, but of course, the statutory details are in the appendix and in the detailed interim financial report.

So, starting, as is customary, with the underlying pro forma financials that represent what's going on in the business day to day, I'm pleased to report that our operating profit, prior to impairment losses, is up 4 percent year-on-year and up 7 percent compared to the second half of 2018. This has been driven by broadly stable total income, which is pleasing in the challenging environment, and I know that that's something our peers have commented on over the last few weeks, combined with continued progress in reducing our absolute cost base.

Underlying profit after impairment losses is down 5 percent year-on-year, but this is due to an expected increase in impairments following an abnormally benign year in 2018, and with a cost of risk of 21 basis points, more representative of the current environment. It's pleasing to note that underlying profit was up 2 percent compared to the second half of 2018.

In terms of KPIs, our net interest margin was 171 basis points, down year-on-year due to margin pressures we saw in 2018, but stable on the second half of 2018, and slightly above our full-year NIM guidance. We continued to improve the cost-income ratio, which now stands at 57 percent, with positive jaws of 3 percent in the period. And our underlying ROTE was a creditable 10.4 percent.

Now, the key takeaway from this slide is that our core business performance is solid, despite the challenging environment.

Turning to our pro forma profit before tax, we incurred substantial costs -- £214 million, to be precise -- in relation to the acquisition. I'll step through the detail in the following slide, but it's worth nothing that £127 million of this charge was capital neutral.

Other costs include a small conduct provision top-up of £33 million, £30 million of which is PPI and largely relates to increased processing costs, owing to a pick-up in speculative complaints, and again, I'll talk through the detail later.

Included in "other items" is an £11 million one-off charge due to the equalization of pension benefits for men and women in relation to historic guaranteed minimum pension arrangements.

So, this means a small pro forma profit of £9 million during the period. However, a good chunk of these costs is not expected to recur after this financial year, and as I say, going forward we can see a clear path to statutory profitability. Just for completeness, the statutory profit after tax was £29 million on a reported basis -- i.e. with the acquisition having been completed on the 15th of October.

So turning now to some of the detail of these acquisition costs. I want to talk through the moving parts, given their scale, and give you a sense of what you might see, going forward. The first of the two ongoing costs are integration costs. And that includes the synergy costs to achieve and rebrand costs that we guided to at the time of the transaction and we'll talk about those two together going forward.

So, as a reminder, the costs we expect to incur are around £240 million of costs to achieve, for annual run rate cost synergies of £150 million and the spend will be split broadly evenly over three years. There's also around £60 million in rebrand costs over two years, so £300 million in total. And we've incurred around £45 million in total in the first six months, so, pretty much in line with expectations.

The other ongoing charge relates to acquisition accounting adjustments -- principally IFRS3 fair value unwind, and the IFRS9 impact on acquisition. Now, you'll recall from our Quarter 1 update that we said there was approximately £300 million of accounting adjustments that need to be unwound over the next three to five years and after some more work, we've refined this estimate to £270 million. The unwind was £67 million in the first half, and slide 26 in the back of the pack guides to how we expect the balance of those acquisition adjustments to cycle through in future years.

Now as you'd expect, we've been through the acquired balance sheet in some detail and we've also worked to align the accounting policies and practices between the two heritages and this has given rise to two further acquisition-related adjustments, and these are one-time adjustments. We've cleaned up the intangible asset registers, identifying items that don't have a future in the enlarged group, and either accelerated the depreciation of these assets or written them off, taking a charge of £127 million -- which is capital neutral. The largest single item was Virgin Money digital bank, and that accounts for £70 million of the total.

Accounting policies and practices across CYB and VM were largely aligned. One exception was the treatment of income earned in the period customers spend on SVR at the end of any fixed-rate product. In common with the rest of the industry in the U.K., Virgin Money included this income in the effective interest rate attributed to the mortgage line; CYB did not. The CYB and VM accounting practices have now been aligned and we've recognized a net asset on a prudent basis of £80 million, relating to a catch-up in EIR and that is across a £25 billion mortgage book.

So, a longer P&L explanation than usual. But in summary, we're pleased with the resilient underlying performance in a tough environment, but it was clearly somewhat messy, in terms of statutory profit and the large list of exceptional items. However, as many of you will know, this is fairly common in the early stages of a transformative acquisition.

So, turning to business, the funding platform is in good shape, with deposits ticking along nicely and a busy time for wholesale issuance over the past six months. The key issue we've had to manage and that we continue to manage, is pressure on cost of funds. To that end, while growing our deposit volumes, we've been focused on managing the mix, prioritizing savings ahead of term retail and pushing ahead where we can in the current account market. We've seen some growth in current account balances, driven primarily by business deposits. Retail PCA balances are pretty much flat over the last six months. But to my point about managing mix, there's some solid progress going on behind the headlines.

Now, we've talked before about the importance of relationship deposits in both retail and business banking, and we'll say more about that on Capital Markets Day. But I want to illustrate, with some detail, some data on the retail PCA book, where we focus on growing the current account base with linked savings accounts. This is a much more engaged customer base, higher and stickier average balances and a lower blended average cost and that accounts for about 80 percent of the retail current account portfolio and 50 percent of the total current account book. Over the last two-and-a-half years, we've successfully grown balances in the retail linked account base by 4 percent every six months. The real star of that story and the driver of the growth has been B, where we're now approaching 300,000 customers and £3 billion of deposits.

The blended average cost of deposits is up 11 basis points in the half, all related to the base rate increase, as we've managed mix to defray the pricing pressure that's evident in some corners of the deposit market. As we've said at the time of the transaction, we now have a higher blended average cost of deposits -- nearly double that of the CYB heritage, and this presents us with a significant opportunity going forward, as we look to deploy the Virgin Money brand into the current account market and build on our success with B.

We'll also grow low-cost business deposits, both organically -- where we've got a strong track record -- and through the RBS incentivized switching scheme for SMEs, and we'll talk more about the strategy and the action behind that at Capital Markets Day.

We've been busy in wholesale funding markets, issuing term repo, Tier 2, RMBS and covered bonds during the period. And we've also embarked on TFS re-financing, of which £150 million was repaid in the period. The 34 basis points' increase in the blended average cost of wholesale funding is really half-and-half mix and rates.

So, before I move off this slide, I wanted to touch briefly on the RBS incentivised switching scheme. As you know, we invested in building a strong capability to switch customers, but it's still early days in a scheme that is expected to run until 2021. Now we're restricted on what detail we can provide until the switching customers transfer to us, but what I can say is we're seeing strong interest in our switching offer on the RBS website and we continue to think we'll be an attractive new home for Williams and Glyn customers, offering a good deposit and lending opportunity for us.

So, looking now at asset growth. Overall, a good six months of asset growth across our key lending segments, despite the challenging conditions. On mortgages, we came into 2019 with a strong pipeline, which has supported the above system growth that we saw in the first half. However, as we've said at Q1, our strategy is very much to moderate volume in order to preserve margin, but we won't see the full impact of this strategy until the second half of the year. I would therefore expect us to grow below market during the remainder of the year.

In SME, net lending growth of 1.1 percent is somewhat below our usual growth rate, but this actually masks what was one of our strongest six months in terms of origination and I'll talk to that in more detail on the next slide. But net lending was impacted by higher redemptions, mainly from customers selling their businesses.

Finally, unsecured lending grew strongly at 4 percent, with continued growth in our Virgin Atlantic Airways credit card proposition. And also, improvements to our personal loans application and fulfillment journeys, which has driven better conversion rates through our IB platform.

So, with a strong pipeline into the period, we saw gross mortgage origination of £5.8 billion. In terms of the mix of front-book lending, the story is very similar to previous periods, with customers continuing to prefer fixed-rate products, so 98 percent of origination during the period, but interestingly, the proportion of five-year fix-rate products is slightly lower than a year ago at 35 percent of origination, and that suggests customers' expectations for future interest rate rises have tempered somewhat.

In SME, as I said, a strong six months in terms of gross lending, with £1.1 billion of new business drawdowns and £1.2 billion of facilities originated, notwithstanding the economic uncertainty. Our origination in the period is well-spread across sectors, with a particularly strong performance from those areas where we're investing in sector expertise, such as hospitality, healthcare and business services and we have a good pipeline going into the second half.

So, turning then, to what we're seeing on yields, in mortgages, as expected there was a decline in the average book yield, reflecting the continued competitive front-book pressures we've seen over the last 12 months, and lower SVR balances because we're much more proactive in customer retention. But as you can see, that impact is moderated compared to the second half of 2018, reflecting more recent stability in front-book pricing. In SME, the average book yield continues to increase. This reflects increases in the LIBOR or base reference rates, and a little bit of margin widening, but the high-yielding business is clearly beneficial from a mix perspective.

On unsecured, the dip in the second half of 2018 was due to an £8 million EIR asset reduction that Virgin Money made as part of their first half results. So, it's pre-acquisition, but it falls into our pro forma comparatives and this cost around 50 basis points. Absent that, and reflected on the year-on-year increase is the benefit from the maturing card portfolio and a reduction in the proportion of balances on zero-rate products. So, about 35 percent of credit card balances are now post-promotion, and we've seen the bulk of the growth in our cash yielding Virgin Atlantic credit card proposition. So, the takeaway from this slide is that our strategy of improving the balance in our asset portfolio by growing in SME and unsecured will be margin beneficial. Now clearly, this does require a strong focus on risk management, but this is something that we're good at.

So, we thought it would be helpful to try and break out the moving parts of the NIM situation so that everyone's clear on what's driving it and I hope you'll find this new disclosure is a useful addition. The 2018 story should be fairly familiar to you all, but just to recap, what we saw was significant pressure from mortgage margin compression during the period, with back book refinancing most acute here. In the first half of 2019, we've seen a smaller impact from mortgage pricing, down four basis points in the period and that was offset by six basis points of positive NIM contribution from high-yielding SME and unsecured. The wholesale liquidity and other includes five basis points of adverse impact from wholesale funding costs, but that was offset principally, by lower swap costs and other rate movements.

We continue to expect to be within our NIM guidance range of 165 to 170 basis points for the full year, which reflects our expectation for sustained mortgage margin pressures, including substantial refinancing in the second half and funding cost headwinds.

So another new disclosure here, really, is just breaking out what's going on in the non-interest income line a bit more, and there's only a couple of things I wanted to explain. Retail fee income is a bit lumpy due to a couple of one-offs, but absent these, it's broadly stable. SME has seen consistent fee income growth through business current account fees and our treasury solutions for clients, and it's a clear opportunity for further growth that we'll talk about at the Capital Markets Day. And then finally, investment income is down in the period, principally due to our decision to reduce the annual management charge to make our products more competitive in the marketplace. Now, we still expect to complete the Aberdeen Standard Investments J.V. by the end of June.

So, turning to costs. As David has said, the integration is well underway, and I'll just remind you quickly of how we expect things to unfold. Until we complete the Part VII transfer and bring the business under a single banking license, there's not much we can do by way of rebranding, bringing together the customer platforms and optimizing the branch network. So, in year one our focus is on reducing the senior management layers, improving supplier contracts, eliminating some properties and squeezing discretionary spend. We've delivered £33 million of annual run-rate synergies in the first half with an in-year impact of £21 million. By the end of FY 2019, we expect to have delivered annual run-rate synergies of around £45 million, with an in-year impact of £40 million. We're very much on track.

These synergies, together with the remaining project Sustain benefits, have helped to drive down the absolute cost base and deliver positive jaws in the second half -- in the first half, beg your pardon. We are reaffirming our underlying cost guidance of £950 million for the full year. However, I want to caution -- particularly those that have followed us for some time -- against expecting significant out-performance on cost in this financial year. As noted, there is a limit to how much integration we can do before Part VII, and as ever, we're managing a series of cost headwinds, as are all businesses at the moment. Having said that, we have a reputation for delivering on costs, and we feel very confident about our upgraded synergy targets of £150 million net and we'll take the opportunity at Capital Markets Day to set out the medium-term trajectory for the group's cost base.

So, turning now to impairments. Our net cost of risk has increased to 21 basis points in the half, up from 15 or so basis points over the last three halves, but still very low in absolute terms. And let me unpack what's happening in our loan portfolios to help you understand what's going on there, and really demonstrate that normalization is not a euphemism. It's really all about SME and unsecured. The mortgage book continues to see negligible losses and that's consistent with the rest of the industry. In SME, what you can see is a return to more normal levels of gross cost of risk, after an unusually benign 2018, where we had very low specific provisions in the SME book and indeed some material recoveries.

Our SME portfolio continues to perform well, notwithstanding a more uncertain economic environment. Categorized loans -- so, our watchlist, if you like -- increased to around 10 percent of the portfolio, up from 9 percent a year ago, but flat on 2017. And in addition, the proportion of SME lending in stage three, the impaired book, has remained stable year on year.

Now, the gross cost of risk and unsecured has increased by 91 basis points over the last 12 months, and there are several contributors here, but none of them are any cause for concern. Unsecured lending growth in the last 12 months has been heavily tilted towards cards, as opposed to PLs, and cards attract a higher cost of risk. We've also seen a seasoning of the cards book over the last 18 months or so, as new business rolls through into more mature cohorts, and then there's the IFRS9 effect.

IFRS9 was implemented in the VM book at the start of 2018, and in the CYB book from the first of October 2018. Now, IFRS9 as you know, accelerates the recognition of provisions, especially in unsecured lending, without changing the overall lifetime losses and this acceleration effect is magnified in a growing book. We estimate that more than half of the increase in unsecured cost of risk stems purely from the implementation of IFRS9.

Now this is where I get my risk colleagues nervous, but broadly speaking, unless there's a specific driver in the outside world or there's a change in the portfolio, the gross cost of risk in the unsecured portfolio should level out from here. We are where we expected to be, and we also compare well to our peers where disclosure permits comparison, both in terms of cost of risk and asset quality, as measured by the proportion of the book in stage three. So, taken together, all this says that we should expect a similar group cost of risk around 21 basis points for the remainder of the financial year.

Turning to PPI, I shan't dwell too long on this page, as it does feel as though we're in the final stages of the PPI episode, but unfortunately we do need to take a small top up of £30 million to the PPI provision. Around half of this reflects an increase in processing costs relating to a surge in speculative PPI complaints from claims management companies. Now clearly this is frustrating for us, as the majority of these are spurious, but cost us to process. And I did note that one of our peer group commented on something similar a couple of weeks ago, suggesting it's not just us being impacted by this. And the FCA's regulatory oversight of CMCs from April this year, should help mitigate some of that behaviour.

In terms of complaint volumes, we're planning for a slight increase in volumes relative to our previous provision, between now and the time bar and this really reflects our experience over the last six months. This accounts for the other half of the provision top up. As you can see from the weekly complaint graph, the monthly average hides the volatility we see on a weekly basis, which just shows why it's so hard to accurately forecast volumes, but we remain comfortable with the remaining provision based on what we know now and, at the time we set it, with five months to go.

Now, there's always a risk of further costs. We may see a spike in complaints. Actuals may turn out different from our forecast assumptions, although the April numbers were absolutely consistent with our projections. And I won't rule out a small clean-up at the end of the process, but we shouldn't expect that to be material, again, based on what we know now.

So, turning to capital. As David says, we remain strongly capitalized, with a 14.5 percent CET1 ratio, which is unchanged compared to December 2018, with a significant capital absorption having largely come through in Q1, as you already know. We delivered strong underlying capital generation of 114 basis points in the first six months, but as you can see, this was absorbed by a variety of items in the period. RWA growth of 56 basis points comprises two factors: firstly, the lending growth in the period, which accounted for around 35 bps, and secondly, there was around 20 bps of non-recurring IRB model calibration adjustments in the period. As you'll recall, we provided an estimated IRB impact at 30 September, having only just received accreditation, and we've now finalised implementing those models.

Investment spend and AT1 distributions you're familiar with by now, so I won't dwell on these. And then, as I've already talked about at length, there's a significant exceptional cost, including acquisition integration costs, legacy conduct, and the other bucket primarily comprises ongoing defined benefit pension contributions. Finally, you'll be aware we recommended an ordinary dividend in respect of 2018 of 3.1 pence per share and with this being a post-balance sheet event, it wasn't accrued, meaning the cash payment is a deduction from capital during the period. Just on dividend, I did note some market commentary on the potential for an interim dividend. We haven't paid one before, and it hasn't featured in our plans for 2019.

Finally, in terms of the second half, I'd expect a similar trend of strong, underlying generation being largely absorbed by growth, investment, and the acquisition integration costs. So, I don't expect much change in our capital position over the next six months -- before any dividend decisions, of course. I'll talk in more detail about the longer-term capital trajectory at the Capital Markets Day, so, I'll leave it there for now.

The group is off to a strong start. We've posted a resilient underlying operating performance in a competitive market, with a statutory profit impacted by the upfront acquisition costs as expected. We're reaffirming our guidance for FY 2019, with a net interest margin of 165 to 170 basis points, and underlying costs of less than £950 million. And the integration, while only six months in, is going well, with our run rate synergies being delivered in line with plan.

The Capital Markets Day on the 19th of June is the opportunity for us to discuss the group strategy and to lay out the exciting plans that we're developing. You can expect to see clear -- three -- sorry -- clear strategies for our three business segments, an overview of the significant opportunities we see from the powerful brand that we have, and the partnership opportunities with the wider Virgin group. We'll provide a detailed update on the integration program and we'll also set clear, medium-term strategic and financial targets for the group.

So, as David mentioned at the start, today's focus is just on the interim results and you'll forgive us if we keep our powder dry for just a few more weeks on a lot of the forward-looking detail. So really, that's the summary of today's results, and hopefully noting the progress that the group has made. We'll turn now to Q and A, starting with people in the room, and we will also no doubt have some questions on the phone.

David Duffy

Okay. We've got -- we'll bring the mics down to the front here. There's about four people. Okay. We'll start here and then go back across.

Robert Sage, Macquarie

It's Robert Sage from Macquarie. I was just interested in terms of your asset growth outlook. You've been very clear on mortgages. Just in terms of the sort of various conflicting factors, SME is quite subdued against the incentivised switching scheme sort of kicking in -- would you expect to see positive growth coming through on SME balances in the second half of the year? Is that a sort of a sensible assumption? And likewise, on the unsecured book, you know, quite good growth I thought, better than I was expecting. I was just wondering, in terms of whether that momentum should be carrying through into the second half?

David Duffy

Sure, maybe I'll pick up and Ian will follow on. On the SME business, I think the -- we have a three-year, £6 billion model, which we've been deploying. And what you've seen is this year is nothing different. That has been consistently delivering against the ambitions we had in respect of those targets. The six months that have just passed have seen our strongest drawdowns in that cycle. So, we are competing very well in that space. And so, I would expect, you know -- that number is a little softer in its appearance due to a lot of sales of customer businesses, which are good for those business. But I would expect us to compete well for the rest of the year and to see the net growth there. The switching process is one which probably won't feature massively in this year's numbers because it -- of the timing it takes for that to happen in terms of RBS, et cetera. So, our core business showing net growth is what I would expect, and maybe -- Ian, on unsecured?

Ian Smith

Yeah, I mean, I think unsecured is pretty steady. You know, it grew very strongly, particularly, in the Virgin Money cards book a couple of years ago and the growth we've seen has been very well-balanced in the last couple of periods, between sort of regular customer growth and balances relating to Virgin Atlantic customers. So, I would expect to see something similar in the second half, all other things being equal.

David Duffy

I think we're in the second row here.

Aman Rakkar, Barclays

Morning, it's Aman Rakkar from Barclays. Thank you very much for taking my questions. I've got one very predictable question on NIM, unfortunately. So, you know, resilient print in the half -- note that you stick with your full year guidance to suggest quite a material step down in the second half. I think we're probably talking about funding costs as quite a material headwind, as you've alluded to some kind of mortgage margin pressure -- a bit more color on both of those?

And actually, on the funding cost point, could you -- you've got this AT1 from Virgin Money that's coming due next month. I'm going to assume that you're going to call it. I don't know -- any color you can provide there, but how does that affect your plans for MREL issuance in the second half of this year, potentially next year -- would be really useful?

Ian Smith

Okay. That's a very detailed question, Aman, thank you. So, if you take some of the moving parts -- on mortgages, although we've seen a bit of price -- I guess, front-book price stability, and indeed, a slightly better outcome on swap rates over the first half -- but let's hope that continues. We're going to see significant redemptions on fixed-rate products coming to the end of life in the second half. So, that refinancing is, you know, going to have a dampening effect on the margin. And similarly, you know, we've done some -- as you've seen, some substantial wholesale issuance in the first half that will feed through into the second half.

Now, set against that is, you know, I think a continued strong performance on SME and unsecured. But broadly speaking, that's applying some pressure for margin expectations in the second half.

In terms of where we are on, you know, capital instruments and quasi sort of capital issuance, I don't think you can expect us to do anything odd in relation to AT1. And MREL we've consistently talked about, you know, building our MREL stack over the years, through to 2022. We are -- we do have plans for, you know, issuance of about £750 million a year across the two businesses. And so, we'd expect to do something later in the second half on MREL.

David Duffy

Great, thanks. We'll just pass it along. It's coming from your left.

Shailesh Raikundlia, Panmure Gordon

Morning, it's Shailesh Raikundlia from Panmure Gordon. Just one question, actually -- a follow-up on NIM, actually. On the unsecured side, the credit card side -- interesting movements in the yields. I was just wondering if you could recap those movements?

And also, as you said, 35 percent of the credit card book is now post-promotion. Just wondering how that sort of plays out for the rest of the year, and you seeing -- would you see further improvement in yields on the credit card book going forward? Thanks.

Ian Smith

Yeah. Thanks, Shailesh. So, as I said, there as a one-off hit to unsecured rates in the second half of 2018 that was in the old Virgin Money heritage, in the EIR asset adjustment. As we said all along, you know, we acquired the credit card portfolio after a bit of seasoning, which means that, you know, you'll have a higher proportion of the book that is cash yielding. And we expect that proportion to increase over the second half of the year as customers come out of the promotional period.

It's more valuable in our hands because, you know, we get a chance to reset and look at expectations for the cards book from the date of acquisition, and to, you know, to take in that proportion of the book that's cash yielding at the cash rate. Whereas VM on its own, we're locked into a much lower EIR from initiation. So, we always thought that this was a, you know, a beneficial impact for us in terms of unsecured yields, and that's what you're seeing going through.

A sort of move to cash on the stuff that's in its promotional period at the moment isn't going to have a significant impact on us because we're locked into a prudent EIR rate on those balances. So, you know, the step up you've seen over the last six months or so, you shouldn't expect to see repeated. But what I like about this book is it's more and more cash yielding.

David Duffy

Is there one back here? And then, we'll come back to John.

Robert Noble, RBC

Morning. It's Rob Noble at RBC. Just on the capability and innovation funds, did they give you any feedback at all as to why your bid wasn't accepted? And then presumably, you had a -- you presented investment plans on what you were going to do with the money? And you didn't get the money. I presume you are still going to do those investment plans and does that factor into higher costs, or higher investment spend, over time?

David Duffy

Sure. Ian can cover the investment plan in a little bit. But, just in terms of the approach and where it -- the feedback came from -- we didn't get really structured feedback. It's plain vanilla superficial feedback. I think the reading -- the disappoint for us, or perhaps, more surprise, was that when you look at what the instruction was, or what the published request was, it was to allocate funds to an existing player in Pool A, existing players who could achieve real market competition versus the incumbents in the 5 to 8 percent range. So roughly, that market kind of level, which would be real competition.

And so, we would recognise ourselves -- and, maybe, one other -- who could reasonably do that in the timeframes prescribed. And, I think, based on public information, what I see is the cumulative promise would require all the major banks, themselves, to step away, for five years, from the market. So, there seems to be a bit of irrationality there. So, beyond that, that's all I can say because we haven't had more structured feedback. That's our analysis of it.

So, we step back, and say we have, nevertheless, a very strongly performing business. And we will continue to build that business. It would have been nice to have the additional funds to accelerate the technology and the support of that build. But if I just -- Ian -- maybe make a comment on the investment profile in I.B?

Ian Smith

Yeah, I can't resist being a little bit caustic. I think, to meet those market share targets, you would require the banks that know how to do this to shut their doors for three years. And, then, you guys will need to go out and open a business current account, every day, for the next three years. But that being said -- and I'm not pissed off about it, at all -- [laughter] -- the investment plan is an interesting one. We'd always kept it off to the side because of you know, it was a contingent outcome. So, we had some plans for how we would deploy the investment. And, you know, we still think that we can do an awful lot in growing our SME business. It might be at a slightly different pace, in a slightly different order. But we're still absolutely committed to that.

And we think it's a real differentiator and, you know, an enhancement to our returns. But we had never incorporated that into our plans. As I say, it was off to the side. So, when we come back at Capital Markets Day and explain how we expect to grow SME, we'll talk about the cost of that and how that feeds through.

Robert Noble

Thank you.

David Duffy

Moving across into John here. And, then, we'll come to you.

John Cronin, Goodbody

Hi, guys. Thanks for taking my questions. The first one was a follow-up on the credit cards book, just to check, are the retention, are the retention assumptions that you made as part of your assessment at acquisition, holding muster in -- with respect to those balances that are transmitting across to cash from zero balance?

And, then, my second question is just on the fixed-rate tailored business loans. We've heard you before make very strong remarks in relation to the level of work you've done to support your views, in terms of provisioning adequacy. We have seen recent media commentary around a claim being -- papers being filed in the High Court. Any further comments you could make on that, at this point, would be helpful. Thank you.

David Duffy

Sure. Just on the latter part -- and Ian can talk about the retention assumptions, the -- nothing has changed, in terms of our views of any of the claims on the TBLs. I think what you're referring to is some recent noise around certain other customers and some case filings that have been advertised. The short way to look at this is we've had three cases filed. So, after multiple years, and claims of extraordinary amounts of numbers of customers, we've had three filed. So, I would put it in that context and, probably, just add to it that there is no change in our assumptions about the defensibility of our position on a small number of these that are out there, absolutely no change.

John Cronin

And am I correct in saying on that that, you know, Augusta Ventures was first in the media in July 2017 or, potentially, earlier, in terms of its -- the noise it was making?

Ian Smith

Sorry, could you say again John?

John Cronin

Yeah, I think, if I remember correctly, I think it was July 2017 when we first learned of potential claims in that vein, unless it was, perhaps, earlier? It seems like a long time, in any event, I would have thought.

Ian Smith

Yeah, that's right.

David Duffy

The point there was that we were saying that nothing has changed since we first started talking, back then. If you recall, those early days were very big numbers and many customers, and it keeps getting smaller and smaller. And two years on, we've had three cases filed recently. So, I think we are -- and nothing's changed around our assumptions, or logic, around the defensibility of any of the matters involved. So, that's -- hopefully, John, that gives you a good answer there. And just on the retention assumptions?

Ian Smith

Yeah. So, absolutely line-ball, in terms of customer performance. So, no divergence there, at all, and so, we're very comfortable. And we've, also, you know, as you know, we've been pretty prudent, both in terms of the period over which we project cashflows, and the rate that we use to recognize income, so, I feel very comfortable about how we're managing the risk there. But customer behavior is exactly spot-on.

John Cronin

Okay, thank you.

David Duffy

All right. Just to your left.

Chris Cant, Autonomous

Hi. Good morning. It's Chris from Autonomous. If I could come back to your slide eight and you flagged up this mortgages EIR adjustment, positive £80 million. So, I may be getting this back to front, but it looks like you've aligned to Virgin here, rather than vice-versa, from what you've said, Ian? And so, when I think about your NIM bridge for the period, presumably this has effectively increased your back-book yield in the period, versus the prior period? So, how much, how many basis points of benefit have you got from moving to an EIR assumption on your Clydesdale back book in this period versus the prior period, please?

Ian Smith

So, you're absolutely right about the direction of travel there. So, this was an addition to the CYB mortgage asset. It has had a negligible impact on back book rates and, indeed, the net interest income during the period. It was really just bringing the opening position into line with Virgin Money's approach.

Chris Cant

Okay, very clear. Thank you.

David Duffy

Okay. Just pass it along to your right.

Georgi Gunchev, Bloomberg Intelligence

Hi, Georgi Gunchev at Bloomberg Intelligence. Just a quick one from me. Obviously, your customer deposit balance growth has somewhat lagged lending growth. Do you expect any pickup in customer deposit growth in the second half? And, also, do you have any appetite of, maybe, going above 120 loan-to-deposit ratio in the near term? Thank you.

Ian Smith

So, yes, is the answer, we expect to see continued progress in deposit growth in the second half. We're, kind of, unrestricted by volumes, particularly in the, sort of, Virgin Money savings machine. They've been -- they're both very good at retention and also, winning new business on savings. So, we feel absolutely fine about volume. So, we've been managing for cost really, there. So, you should expect to see, you know, continued growth in the second half, perhaps, a little stronger, proportionately and that'll help to reduce the loan-to-deposit ratio. But that's -- it's well within limits -- our LDR at the moment.

Georgi Gunchev

Thank you.

David Duffy

Are we ready to go to -- if there are no more in the room, we'll go to the phone. Is there? Okay. Can we take the first caller on the line then, Andrew?

Operator

Our first question today is from Ed Henning calling from CLSA. Ed, your line is now open.

Ed Henning, CLSA

Hi. Thanks, guys. A couple of questions from me. Firstly, the NIM response you gave earlier, Ian, wasn't quite clear on the call. Can you just run through what your assumptions are for your guidance on the swap costs, and the SME, and the unsecured rate? So, you're assuming all the levels hold steady, in your guidance for the full year?

Ian Smith

So, what we're assuming Ed, is we'll see some pressure from the mortgage side, more through, you know, back book redemption and refinancing than front book price pressure. And we'd offset some of that with, you know, improvement in sort of, mix through SME and unsecured, but net, we expect to see, you know, further margin pressure in the second half and that's what brings us back within guidance of 165 to 170.

Ed Henning

And what about swap costs, are you assuming they hold at the current levels?

Ian Smith

Yes.

Ed Henning

Okay. Second question: in slide 31, you mentioned scope to optimise your capital requirements. Can you elaborate on that?

Ian Smith

Hang on one second, Ed, I'm going to have to remember what was on slide 31. Yeah, so this is -- this really refers to, sort of, ongoing discussions at the moment, on capital levels with PRA. You know, we had -- and really, it's a subject of the ICAAP that we submitted a little while ago, and they're currently reviewing.

So, if you recall, back in November, I said, you know, the PRA, sort of, set a high-level capital requirement on day one of the acquisition. And there was always an intent that things would be looked at, in more detail, through the ICAAP process. So, that's underway at the moment and, you know, we'll see, but we think there are one or two opportunities to, you know, moderate the current capital requirement. But more news on that when we hear back from the PRA.

Ed Henning

Okay. And just a last one from me. Just on your guidance on cost, does that include the drop-off of the cost from the J.V.?

Ian Smith

Yeah, it does, although we are, sort of, dealing with a, sort of -- at slightly lower than -- a lower drop-off because of the delay to the J.V. completion than when VM originally set the guidance but we're, kind of, managing that within the cost space. So, yes, it does include some of the investment management business costs going into the JV later this year.

Ed Henning

Okay, thanks, appreciate your time.

David Duffy

Thanks, Ed. Do we have another caller on the line?

Operator

We now have a question from Victor German calling from Macquarie Bank. Victor, please go ahead.

Victor German, Macquarie

Thank you. I was hoping just to follow-up on, actually, on capital and margins, as well. The second half margin guidance implies a pretty wide range there. And given the trends that we see in this quarter, I'm just interested in terms of, if we could, sort of, just zoom in on this, and appreciate that obviously, you didn't really want to change your guidance from what you've given earlier, but I'm just interested, sort of, what -- why is the range so wide for the second half and is there anything, in particular, that we should be thinking about?

Ian Smith

I mean, so, Victor, the range is one that we specify for, you know, the full year. And, you know, I think, is guiding to -- within a, sort of, five-point range feels reasonable to us. I think I'm inferring, from your question, is, so, you know, how big is the step down in the second half? I mean you know, broadly speaking, I've talked about the influences on that margin. I'm not sure how much more I can give you. I'm not going to narrow the range for the full year because, you know, there's a degree of uncertainty out there.

Victor German

Right. And those uncertainties, predominantly, relate to that mortgage issue that you've talked about, or is it more relating to potential MREL issuances? What's -- where are the, sort of, potential question marks?

Ian Smith

So, two influences. And apologies if it hasn't come through clearly on the call. There is, absolutely, pressure on the average yield in the mortgage book. You know, we're going to see very substantial refinancing in the second half of the year. That will, obviously, be replaced with front book business that is at a low rate and that introduces some substantial pressure to mortgage margins. We'll offset that with -- a little bit -- with everything else we do in the book.

In terms of funding costs, not really, sort of, pinning this on MREL, per se. Then, you know, our MREL issuance will be towards the end of the year, the sort of, new issuance for this year. But you'll have seen, you know, a 34-basis point increase in the blended average cost of wholesale funding over the last half. And, you know, that's contributing to pressure on funding costs and margin.

So, those are the moving parts and, as I say, it is a step down. We saw our mortgage margin, in the second quarter, come down -- oh, sorry -- not mortgage margin, the bank's net interest margin in the second quarter, come down to 169 basis points. So, you know, the exit rate, if you like, is within that guidance range. And we expect to stay in that guidance range for the second half.

Victor German

Okay, thank you. And then maybe just very quickly, on capital. I appreciate your comments around dividends and you haven't paid dividends in the past. But obviously, your capital position has improved since your standalone entity. Just interested in, kind of, where is the hesitation coming from? Is it, simply, a historical issue, or are you waiting for more clarity on capital and, sort of, where you would you like, I guess, the capital position to be to have a, sort of, a more stable dividend?

Ian Smith

Yeah. So, we -- and, you know, we are, as I say at CYBG, is you know, in the early stages of being a dividend payer. So, you'd expect us to build on this. But you have highlighted one of the key determinants, which is, you know, getting clarity on capital requirements from PRA, which we had always said was going to be one of the key determinants of where we would want to operate from a capital perspective. And so, if you'll allow us, Victor, we'll come back to that and talk about capital much more holistically at the CMD in June.

Victor German

Thank you.

David Duffy

I think we have another call on the line, as well.

Operator

We now have a question from Azib Khan calling from Morgans Financial. Azib, please go ahead.

Azib Khan, Morgans

Thank you very much. A couple of questions, a couple of related questions from me, on capital. So Ian, just following on from your response to the last question, does that mean you anticipate the ICAAP to be complete by the Capital Markets Day? And can we expect you to announce the CET1 target operating range at the Capital Markets Day?

And the second question, on capital formation. With your CET1 ratio now at 14.5 percent and your fully-loaded CRD IV minimum CET1 is sitting at 11.6, is it fair to say -- would you agree that there doesn't look to be much scope for capital management?

Ian Smith

Hi, Azib. So, you know, we're certainly hopeful that we get the ICAAP outcome by Capital Markets Day and we're, absolutely, prepared to, you know, to dig into capital in some depth at that point. But, you know, we're in the hands of the PRA to a certain extent, in terms of timing. But let's see. And I'm not going to get into, you know, specific discussions around capital levels and what we might want to hold as buffers and things like that, not because I'm sort of dancing around the topic, but we need to have a holistic conversation here. You know, we've got investment requirements. We've got a bunch of moving parts and we're going to bring all of that together for you at Capital Markets Day. So forgive me, but I'm going to not be drawn any further there.

David Duffy

Okay. Do we have any more calls, Andrew? There's one more call, question on the line?

Operator

Our next question is from Guy Stebbings from Exane BNP Paribas. Guy, your line is open.

Guy Stebbings, Exane

Good morning. Appreciate you don't want to say too much on capital until the Capital Markets Day, but could you talk about the outlook for risk-weighted assets on a sort of, 12 to 18-month view, given some of the regulatory changes? I mean presumably, the PRA mortgage risk-weight changes next year shouldn't have much impact, if any, given the recent timeframe for the model approvals, but would you anticipate much of an impact from the Virgin Money mortgage book moving to a 90-day definition of default for regulatory expected loss purposes?

And I had a quick second question, which is just on the structural hedge. I think it's grown by about 12 percent over the past year. Would you just consider yourself, broadly, fully-hedged now and thus expect the pace of growth to moderate, going forward?

Ian Smith

Yeah. Hi, Guy. Thanks for those. So, you're spot-on. You know, our IRB accreditation in the CYB heritage means we've already dealt with the change in definitive, definition of default - that's easy for me to say! But Virgin Money still has some RWA inflation to come from that.

We're seeing some puts and takes elsewhere in this, as there always are. So, I'm not expecting to see a material, or even, a substantial bump in RWAs over the next 12 months or so related to, sort of, regulatory and policy. And you know, we've got some other, sort of, ongoing work, both in the mortgage portfolio and in unsecured, that you know, I think will help to offset any challenges there so, I think pretty steady.

And, in terms of the structural hedge, the increase in the hedge balances is us getting our arms around the Virgin Money liability portfolio. We've identified a chunk of liabilities that we think qualify for hedging, different to what Virgin Money used to do. I don't expect certainly in the short term, to see any significant changes there. You know, we've been through the book and identified those liabilities that are appropriate for hedging. So, that's the driver of the increase and you should expect to see things pretty stable in terms of scope of the hedge.

David Duffy

Okay. I think we've done the questions on the line and we'll come back. We have three questions here in the room. So, who's going to go first?

Charmsol Yoon, UBS

Charmsol Yoon from UBS. Just to follow-up on the mortgage redemptions. So, you mentioned you expect very substantial redemption in the second half. Looking back to the first half, was the redemption unseasonably low? Lower than what was expected and that sort of helped you manage the yield?

Ian Smith

It wasn't -- Charmsol, hi. It wasn't seasonally or abnormally low. It was, you know, sort of pretty regular compared to previous periods. It is just a very specific refinancing peak in the second half.

David Duffy

If we just pass along the row here and we'll come down.

Jenny Cook, Exane

Jenny Cook, Exane. I just wanted to pick up on my colleague Guy's question actually, on the structural hedge. You attributed much of that to the increase in the administered deposits from Virgin Money. I was just wondering; how should we think about that perhaps changing over the next year or two as you kind of consolidate that and change that franchise perhaps more into non-interest bearing deposits versus administered deposits? How should we think about the kind of weighted average life in respect to that?

Second, I just wanted to pick up on the 91 bps increase that we saw in the cost of risk on the unsecured book. I think you attributed half of that to IFRS9. If you could provide any colour around that, in terms of kind of why that won't recur ongoing, or could we see that perhaps come back? Just to understand the drivers a bit. Thank you.

Ian Smith

Yeah, sure. So, let me deal with the impairment stuff. So, no - I'll go in the order you asked. On structural hedge, I'm not expecting to see, you know, significant changes, certainly in the near term, we'll be clear and transparent about that.

In terms of impairment, yeah. So, IFRS9 first of all, attracts, you know, significant day one provisions when you put a balance on, that you wouldn't under IAS39, particularly in unsecured. So, you know, you incur a 12-month ECL from day one. As that cycles through, you'll attract more sort of stage two provisions, and as I say it’s this acceleration effect, which is magnified in a growing book as well. And there was, you know, substantial growth in the book over the last few years. So, that's really that sort of IFRS9 impact, and I'm surprised that we haven't seen that as clearly in some of the other banks out there, but to be fair, they're probably in a slightly different position on the growth curve, particularly in relation to unsecured, than we are. So, it is that sort of step up from no provision to a 12-month ECL to a much more sort of fully loaded expected credit loss on the assets, if you like.

So, in terms of where we go from here. First of all, you won't see as strong growth as you saw in the sort of early days of building that credit card book in Virgin Money. And, you know, you've seen that sort of seasoning of the balances that are on the book anyway, they've sort of attracted their full loading of losses, if you like. So that's why, again, we're pretty confident that we'll see things level out from here.

David Duffy

Okay, over here?

Ian Gordon (Investec)

Morning, Ian Gordon, Investec. Just one, and it's a fairly stupid one, really. I know I shouldn’t be surprised by what you've done in terms of prepayments on the TFS, because you've done what you told us you were going to, but I still struggle with the concept that you're choosing to accelerate the prepayment or phasing profile at a time when TFS is staying cheaper than perhaps we thought it was, and it's obviously below the wholesale funding cost. So should I take that as a signal that you have increased confidence around your deposit gathering from relationship balances and/or incentivised switching, or is there something else at work?

Ian Smith

Thank you, Ian. A good question, because we have some of these debates with the PRA who worry about, you know, particularly the sort of levels of TFS that some of our peers took while the scheme was open, including Virgin Money. And refinancing that is quite important, and so, getting runs on the board and making progress. We're very focused on the long-term shape of our balance sheet. As you know, we supped with a long spoon on TFS. We knew what we were getting into when we acquired Virgin Money in terms of the refinancing requirement. There were many, many other really attractive things about the Virgin Money business that enabled us to take that TFS issue in our stride.

So, I think you're right. You should see this as confidence in our ability to get on with refinancing. We want to be ahead of the game. We always set out to do so. And, you know, I think the better we put a slightly anomalous funding tool behind us, and as a funding tool, in both heritages, the better for the long-term health of the business.

Martin Leitgeb, Goldman Sachs

Yes, good morning, Martin Leitgeb from Goldman Sachs. Could I have two questions please? And the first one is just a quick follow up on the gross yield of the mortgage book. And it seems to have held up fairly well compared to some of the peers over the last two quarters and so I was just wondering to what extent, if any, there was any mix change in the mortgage book, whether that's loan to value, product category, or so forth?

And the second question is just on the deposit side. And just looking at, obviously the focus on current accounts, post-merger the current account balance having fallen, current account share as a whole. How has the competitive landscape changed for current accounts in the U.K. in your view over the last couple of months, six months, and is your ambition still to bring the balance of deposits back or the split of deposits back towards how it was pre-acquisition? Thank you.

Ian Smith

Yeah. Thanks Martin. I think that there is probably a bit of a mix benefit in our mortgage book compared to the large incumbents. You know, so the CYBG history was, you know, of having hunted for, you know, value in first time buyers and, you know, those other parts of the mortgage book where we could get a bit of a premium. So, I think there is a bit of a mix benefit and, you know, some of that also depends on those sorts of refinancing volumes as we talked about. So, we're pretty pleased, but we do recognize that it's a tougher world out there in mortgages.

And then on deposits, absolutely. The sort of medium to long-term goal for us through deployment of Virgin Money brand and, you know, a fantastic, sort of, digital capability, is to, you know, seek to restore the balance if you like, in our deposit book, as you say. We've doubled the cost of our blended average cost of deposits as a result of the combination. It's a big project for us to move that forward and we'll do that in the business side as well as retail. So, we would expect to do that.

In terms of the market at the moment, it's probably, you know, some of the really generous offers have definitely abated. I think there's a bit more focus on, you know, rewarding loyalty rather than up front switching, so you're seeing that through credit interest offers and things. And that was why I made the point. And I was trying to make two points in my remarks earlier. The first is, you know, where you can win a customer and you're offering them a current account for their day to day balances and a linked savings account and they'll sweep into that account. They feel pretty good about that, because, you know, we're offering them a fair proposition in terms of what they earn on their balances and certainly, a lot fairer than some of the big players. And so, we like that. And the blended average cost is absolutely manageable and certainly much more attractive than simply going out on best buy tables for savings and things. So, really focused on that. And we think we can grow that. And the reason we think we can grow that is, the real driver there was B. We launched B three years ago -- was it three years ago?

David Duffy

Yes.

Ian Smith

Three years ago. And we have not -- much to Helen Page's disappointment in me, we have not, you know, put a whole bunch of marketing dollars behind that. And we've grown it steadily over the period. With the brand, with some more oomph in marketing, and we think we can really make a splash with what is a very customer-friendly proposition. And, as I say, we've delivered significant growth in balances -- three billion of deposit balances, with no money behind it. So, yeah, we feel good about that. And that will be a lot about what we talk about on CMD.

David Duffy

Good. I think we've nothing else on the line, and I think we've covered everything else in here. So, thanks again everyone for coming, and for joining late in Australia. And we look forward to seeing as many of you as possible at the Capital Markets Day. Thank you. We will close it there.

END OF CALL