Virgin Money UK PLC Interim Financial Results 2022 – Fixed Income Call Transcript

Hosted by Justin Fox (Treasurer), Richard Smith (Head of Investor Relations) and Matthew Harrison (Head of Treasury Debt Capital Markets)

Justin Fox, Virgin Money UK PLC:

Good morning, everyone. Thank you for taking the time to join us today. Hope you're all well and have had a good weekend. I'm 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. If you haven't already done so, please take a look at the Financial Results section of our website, where you will find today's Fixed Income slides, which Richard and I will go through. As always, we hope these sessions cover the right topics in the right level of detail and as ever, we are grateful for any feedback.

Today's slides will take you through a brief overview of our first half financial performance. We'll walk you through the key elements of our capital, funding, and liquidity position and update you on our issuance progress and plans, and a few other key themes emerging that we feel are worth sharing. At the end, we'll open up for Q&A as normal. I'll now hand over to Richard to talk you through our interim results.

Richard Smith, Virgin Money UK PLC:

Thanks Justin, and good morning, everyone. Starting on Slide four, over the first half of the year, we've made good initial progress delivery against the accelerated digital strategy which we announced in November 2021. We are happy to report a continued improvement in our financial performance, this has been supported by the strategic momentum in the business, combined with an improved operating environment. Our statutory profit before tax was £315 million, significantly higher than H12021 with stronger, underlying profit of £388 million. We have also delivered a strong CET1, with a 9.1 percent statutory RoTE. Total income increased 16 percent year on year, with a stronger contribution from both net interest income and other income, driven by a positive rate environment and a continued improvement in customer activity levels. We are particularly pleased with our net interest margin performance, which has significantly strengthened to 183 basis points for the half year, and we now expect a stronger outlook for FY22 NIM of between 180 and 185 basis points. Other income of £83 million also reflects an improvement in customer activity, across both Business and Personal customers. Underlying costs of £456 million were broadly stable year on year and despite a higher inflationary backdrop, we continue to be well-placed to achieve our broadly stable guidance for FY22 and our objective of £175 million of gross cost savings by FY24.

Asset quality remains robust with a low impairments charge of £21 million or six basis points cost of risk. Notwithstanding the post-COVID recovery, we remain cautious going forward, given the combination of the Ukraine conflict, widening interest rates, inflation, and cost of living. Having returned to paying dividends alongside our FY21 results, and following the Group's successful participation in its inaugural stress test last year, we're pleased to update the market on our capital framework and return policy, which Justin will go through in more detail shortly. Given our strong capital position and robust H1 performance, the Board has also announced an interim dividend of 2.5 pence per share.

And let me now turn to our view of the economy on Slide five. This slide details the economic outlook from our third-party provider, Oxford Economics, which has informed our IFRS9 modelling. The biggest change in the backdrop since we updated at full year results is the increase in inflationary pressures. This has led to a further large increase in energy and other commodity prices, including food, with the Bank of England increasing rates and a significant steeping of the yield curve in response. The latest outlook for GDP currently remains resilient, despite slowing growth in Q1 and the base case suggests that the economy broadly has recovered back to pre-pandemic levels.

Consumer activities levels remain strong across our credit card book with spending now back to pre-pandemic levels across all categories, including travel. There is some potential that we could see slower growth in certain segments, such as the mortgage market as rates rise further, but to date, that's been limited. Expectations of peak unemployment continue to reduce in the most recent outlook, with levels predicted to remain below 4 percent in the base case. Our early warning indicators continue to be benign, and whilst the outlook is more uncertain, we are tracking these inflationary pressures carefully for any impacts that they might have, including cost of living for individuals, and also for our business customers. However, overall, our book is performing well, and we'll be monitoring closely.

Moving on to Slide six. You'll see here that we have managed overall volume broadly flat across the period with strong growth in Unsecured, offset by modest reductions across Mortgages and total Business. In Mortgages, we've been selective on new business volumes, given the competitive backdrop. At the full year, we mentioned that we were seeing spreads below the back book level, and this trend has continued through the first half. So we are comfortable with our defensive performance, and we will look to regrow the mortgage book with the market, when pricing is more attractive. Business lending has reduced 2.5 percent, reflecting reductions in government guaranteed lending schemes, as expected. In the BAU Business book, we saw growth in balances in the second quarter, and we are building a strong pipeline into the second half of the year, and we expect to see those balances continue to grow. We're happy with our performance in Unsecured, where we've grown balances by 7 percent, led by cards, where we continue to take market share. In March, we saw the highest ever amount of monthly retail spend, and we continue to expect strong levels of growth for the remainder of the year, supported by the strength of our digital propositions.

Moving on to asset quality on Slide seven. We're pleased with the quality of our lending book, and are well placed to manage through current risks and uncertainties. We are, of course, keeping a close eye on the war in the Ukraine, though, would note that we have no meaningful direct exposures to Russia or Ukraine, as a UK focused lender. Overall, our final ECL provision of £479 million reflects a reduction of £25 million from FY21, set out on the left. That performance reflects our solid credit quality, which has remained resilient throughout the year, with low arrears and default levels, and refreshed economic scenarios. We reduced total PMAs by around £30 million, despite including an additional PMA of £25 million to take into account possible impacts of affordability stresses on existing customers. Despite the reduction in provisions, we've maintained a strong coverage ratio of 66 basis points, which remains well above pre-pandemic levels. This resulted in a modest income statement impairment charge of £21 million, equivalent to a cost of risk of six basis points. Looking ahead, we expect our cost of risk to rise through FY22 towards through the cycle levels. We are conscious that the outlook remains uncertain, especially with high rates of inflation increasing the cost of living. We have yet to identify any material concerns across lending portfolios, but are monitoring the situation very closely and are taking action on additional underwriting measures to reflect the affordability stresses for new customers.

Moving on to our progress on sustainability on Slide eight. Our ESG agenda continues to gain momentum, and progress has been made across all of our ESG goals. Sustainability implies ‘over a long period of time’ and we remain focused on embedding ESG throughout the organisation, to support our 2030 aspirations and ultimately, a more sustainable future. However, it's worth taking the time to reflect on some of our ‘here and now’ achievements. These include our continued focus on defining a national measure for the Poverty Premium in partnership with Smart Data Foundry; promoting the Turn2Us Benefits Calculator to help over 65s claim entitlements - with over 1,000 calculations now completed, something incredibly relevant against today's cost of living squeeze. We have the Sustainable Business Coach, available in the App store, to aid new businesses to identify their high priority ESG goals, their progress score, and actionable guidance to enhance their business. From a product perspective, we launched Greener mortgages incentivising customers to own a more energy-efficient home and launched our Sustainability-linked Business Loans, waiving arrangement fees to customers who meet the thresholds set out by the Sustainable Business Coach, and we will soon be launching our agriculture specific initiatives.

Finally, in terms of our green funding plans, it is something that we continue to look at, but for the time being, we are focused on improving our data further. We are working on a data project to track EPC data across our mortgage book, and this will increase our capability, supplement our reporting, and help provide the infrastructure to support a green funding framework. We must also demonstrate lending against our new ESG products, as this will drive the funding need, and enable us to develop a truly customer-driven ESG funding solution.

Finally, I'll finish with our guidance and outlook on Slide nine. The left-hand side sets out the FY22 KPIs and guidance. We're tracking well against this, and we have given upgraded guidance for FY22 NIM and are now looking for 180 to 185 basis points, as I mentioned and we've also updated our capital framework and dividends, as promised. We are maintaining our medium-term outlook, as repeated here on the right, and in particular, our double-digit statutory RoTE, and also including the updated capital framework.

I'll now hand back to Justin, to talk through the capital, funding and the liquidity position of the Group in more detail.

Justin Fox:

Thanks, Richard. So, if you could turn to Slide eleven. We are happy with our current capital position of 14.7 percent CET1 ratio, which represents a 35-basis point increase from the full year, looking through the benefit of software intangibles, now removed. Strong capital generation in the first half reflects 103 basis points of underlying profits, offset by 6 basis points from modestly higher RWAs, 10 basis points from AT1 distributions, 25 basis points from the dividend accrual at 30 percent, and 27 basis points of other items, primarily restructuring charges and acquisition accounting unwind.

Looking to the remainder of the year, we expect CET1 to remain broadly stable, reflecting continued capital generation from ongoing statutory profit, offset partly by RWA growth as the Group targets growth in higher-risk weighted unsecured and business lending and further dividend accrual. Our FY22 RWA expectation does not include any benefits from the move to IRB for our credit cards portfolio or the adoption of hybrid mortgage models, both of which await regulatory approval. We expect the mortgage hybrid models to take effect from FY23, and the cards IRB transition at some point after that.

Moving to Slide twelve. As you can see, our capital position remains robust across all measures. As at our full-year presentation, our Pillar 2A CET1 requirements reduced by 50 basis points to 1.7 percent. A lower Pillar 2A means a lower MDA hurdle at 8.7 percent, given us a meaningful £1.5 billion CET1 management buffer on top of the half billion pounds of on-balance sheet provisions. Total capital at 21.8 percent, and the U.K. leverage ratio, 5.1 percent, both remain strong and at 31.7 percent, we remain comfortably ahead of our MREL end-state requirement of 24.7 percent.

Turning now to the breakdown of our capital stack on Slide thirteen. Compared to others in the market, we have a very straightforward capital structure. All the group's regulatory capital and MREL is issued by our holding company, Virgin Money UK PLC, and it's fully eligible from a CRD-IV perspective. So, there are no issues around grandfathering. There's also no FX exposure in the capital structure, providing stability during periods of market volatility. We have an excess total capital of 8.3 percent over our regulatory minimum and as I've mentioned before, we don't have a target level for AT1 or Tier 2 per se, but what we're looking for is a balance between maintaining a regulatory efficient buffer while supporting our targeted growth aspirations, which as we've explained before, include a higher allocation in unsecured and business lending.

Over the medium term then, our AT1 and Tier 2 stack will evolve, as we manage buffers within the parameters I've just mentioned, primarily through redemptions and refinancing activity and as a reminder, our call policy remains unchanged. Future capital call decisions will be assessed on a broad economic basis, so, balancing factors, including balance sheet movements, relative funding costs, current and future regulatory capital and MREL value, rating agency treatment, and wider wholesale funding needs. And of course, all calls are subject to PRA approval, with whom we have an active dialogue.

Turning to our MREL position, as I've already mentioned, our MREL ratio of 31.7 percent comfortably exceeds our end-state MREL plus buffers requirement of 24.7 percent of RWAs. Again, we do aim to maintain a suitable buffer over our end-state requirements, to help better manage maturity risk.

Our view on issuance guidance hasn't changed since the full-year. That is, we don't see a need for incremental capital issuance over and above refinancing, and the timing of refinancing will reflect a broad spectrum of factors, not least having stable market conditions. And as we have no senior HoldCo senior issuance plans this year, again, given our comfortable MREL position, and the fact we don't have any HoldCo senior redemptions until 2023.

So, turning to Slide fourteen. What I've just said makes a lot of sense in the context of the updated guidance on our capital framework. This reflects a refinement to our internal risk appetite, which has been informed by the conclusion of our inaugural Solvency Stress Test exercise, which I will come to in a minute. As a result, we think that a CET1 target of 13 to 13.5 percent is a sensible target level for us to be operating at, particularly when set against our expected regulatory minimum, as set out on the left-hand side. But, given the current heightened macroeconomic uncertainties, we expect to operate above this range for the time being.

We're also pleased to return to paying dividends sustainably and are committing to a full-year dividend payout ratio of 30 percent. This payout supports our expected growth plans and allows for at least some net capital generation. This first year, we're paying a 2.5p dividend at the interim, and going forward, we expect to pay around a third of the prior year's total dividend, alongside our interim results with the remainder as a final. We will supplement the ongoing dividend with buybacks subject to ongoing assessment of surplus capital, market conditions, and regulatory approval.

In terms of timing, we expect that any buybacks would be aligned to our May interim results from full-year '23, not alongside our November full-year results. This timing reflects the conclusion of the Bank of England's stress testing process and subsequent buffer determination, which is generally at the end of the calendar year. We've not ruled out buybacks for the current financial year. However, we would need to take into full consideration the current uncertain environment, and any buyback would be subject to regulatory approval. It's worth noting that our total capital MREL buffers will remain comfortable, even at our target operating CET1 range and fully-optimised AT1 and Tier 2 buffers and allow for a sensible buffer over MDA, particularly when compared to larger domestic peers.

Moving on to funding, on Slide fifteen. We delivered further growth and customer relationship balances, which were up 4 percent in the half, thanks to strong performance in new current accounts, supported by our compelling new Brighter Money Bundles; adding product features, such as the launch of debit card cashback, and improved customer experience, supported by further roll-out of digital onboarding. Relationship Deposits now comprise 50 percent of total customer deposits, which, together with a further reduction in more expensive term retail deposits during the period, meant we further improved our funding mix, which drove an overall reduction in cost of deposits, despite higher base rates.

On TFSME, when the scheme closed in October 2021, we had drawn our full initial allowance of £7.2 billion, whilst repaying all of our TFS drawings. At £7.2 billion, TFSME represents 8 percent of total assets, which feels like the right balance between supporting additional lending for the real economy, whilst not increasing refinancing rates. As with FLS and TFS, we plan to repay TFSME about one year ahead of contractual maturity and having almost a billion pounds eligible for tenor extension to 6-10 years helps to reduce the cliff-edge risk further.

The incremental TFSME drawings, along with the successful £600 million 5-year covered bond transaction during the period meant wholesale funding increased to £15.5 billion, as at the first half, offsetting the reduction in term deposits. We continue to expect £2 - £3 billion of issuance this year, and have made good progress in the first half, with a successful £600 million covered bond trade in February, followed-up with a £700 million RMBS issuance in late April achieving solid outcomes despite what has been a challenging market.

Wholesale funding costs have clearly widened since the start of the year, for reasons we all know and understand. Those increased costs are in line with our funding plan assumptions, largely because our financial planning process happened much earlier than other banks, given the timing of our year-end. Our overall strategy remains the same. We compare wholesale funding costs, liquidity costs against the franchise benefits and wider strategic goals associated with our deposit strategy, to ensure we optimise the overall funding costs for the bank.

Quickly, on liquidity, LCR was 139 percent because we opted to manage liquidity slightly lower, as more of the term deposits have matured away. However, it continues to comfortably exceed both regulatory requirements and more prudent internal risk appetite metrics, ensuring a substantial buffer in the event of any outflows due to the cost of living squeeze.

Moving to Slide sixteen, we're pleased with our performance in our inaugural Solvency Stress Test, and as you can see from the left-hand side of the slide, performed well relative to peers in what was a test designed to simulate a severe path for the UK economy in 2021 to 2025 on top of the economic shock associated with the COVID pandemic. On a pre-management actions basis, our CET1 drawdown of 5.1 percent was amongst the lowest in the peer group and shows resilience to outcomes for the UK economy, which are much more severe than current forecasts. With an excess to published reference rates from both transitional and non-transitional basis, and no requirements to take any additional capital actions, this was a solid first-time performance, and supported our updates to the market on our go forward capital framework and distribution policy that I discussed earlier.

On top of the regulatory deliverables, just as a quick reminder, along with the other larger UK banks we submitted our first resolvability self-assessment earlier this year. If you're not 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 that 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 the larger peers. We believe that the inherent merits of our simpler, more manageable scale helps position us well against larger, more complex firms.

Moving to Slide seventeen. I'll update you on our structural hedge first and then move on to our rate sensitivity. On the left, you can see at the first half, the group has £32 billion of balances in the structural hedge, having increased the size of the hedge in October last year reflecting one of the benefits of our deposit strategy. The average yield has increased from 45 basis points in the first quarter to 52 basis points in the second, reflecting the higher rate earned on the invested balances. You'll also recall we have a legacy hedge position that was previously unwound in the full year '20. The full year '21 contribution was around £150 million, and a full year '22 contribution is expected to be slightly lower, at around £120 million. So, overall, strong and increasing contributions from our structural hedge going forward.

On the right-hand side, we have set out what this means for interest rate sensitivity. You can see our interest rates sensitivity is pretty low in year one given the scale our of structural hedge and using our standard pass through assumptions. In practice, we have benefited significantly from rate rises recently as deposit pass through has been low. We've also now disclosed our interest rates sensitivities in years two and three, with the benefit in both years relating to the rollover of the structural hedge which builds up meaningfully over time in the rising rates environment.

Moving finally to Slide eighteen. So, in concluding, I would like to reflect on the progress we have made in the last couple of years. Many of you will have heard me say this before, but we sit in a category of one between the large O-SII banks and the challenger or larger mutuals. I still think that is fair, but I also think it comes with more advantages than disadvantages, but you'd expect me to say that. We're managing the transition to being tier one bank reasonably well; the stress test outcomes really demonstrate that. That transition has been quite intense and is a good reason why overall I think we don't fit into that challenger bank category. Integration is done and we are fully engaged now on our transformation, which is delivering results. Our balance sheet resilience is coming through, and that's a positive step for investors up and down the stack. Capital has improved -- in part because the balance sheet is lower risk than the market perceived, and performance over the last couple of years has shown that -- but we also have prudent risk appetite which is reflected in solid asset quality with robust coverage that sits above pre-pandemic levels.

I see our announced capital framework as being creditor supportive. Funding and liquidity are robust at a time when we have been transitioning the composition of our funding mix. That transition has helped in being able to lower deposit margins, but also helped build up the structural hedge, all of which supports NIM. Overall, we have distinct financial momentum in the first half of the year. Our balance sheet is conservative and well-positioned to manage an uncertain outlook. So, when it comes to thinking about our debt stack, our view has evolved. Initially, it was about managing down that overall difference to larger peers. Now, all of that has already happened, and therefore it will hopefully work its way through the stack as and when we refinance it.

Going forward though, what we think and talk about internally is where the fair value point is relative to those larger peers. There's an inherent strength to being a simpler, less complex bank that has enough scale to operate competitively in the markets it likes, with a risk appetite it is comfortable with. We think that means that there's further room to go in our relative performance to peers. What that differential should be is something for us to work out with all of you. In my mind, that all makes a pretty compelling investment proposition that supports further spreads compression to peers. So, for now, open up the lines for questions.

Operator, please go ahead.

Operator:

Thank you. We take our first question from Corinne Cunningham from Autonomous. Please go ahead.

Corinne Cunningham, Autonomous:

Good morning, everyone. Thank you for the call. I wondered if you could give us bit more detail on your liquidity position and your funding plans. And so, for example, what would the LCR look like if you excluded the TFSME and a bit more detail perhaps on how you intend to replace that. Thank you.

Justin Fox:

Well, I'll have to come back to you as to what it would look like ex the TFSME, Corinne, so, let me follow up on that afterwards. The way I think about it is we have seen elevated liquidity across all banks over the last couple of years, partly because of the excess deposits built up during COVID pandemic. But we have been managing some of that down principally because we been able to build up the relationship deposits and seen term deposits come down as a result and therefore, we haven't necessarily had to go out and look to maintain let's say, an LCR of about 150 percent. On a go forward basis, I think somewhere between 135 and 140 percent is about the right level and what that means is the way we've been thinking about it recently is clearly we've seen a mark up in terms of the increased cost of wholesale funding, certainly, relative to the back end of last year and certainly through January. And that is less of a concern for us because when we set our plan, effectively last summer because of the timing our year end and clearly, the cost of funding wasn't at the very low levels at that point.

So, the way we think about it is we have spread the drawdowns of our TFSME over the period, and what we'll be looking to do is effectively refinance those maturities up to one year in advance. So, that's what points us towards £2 - £3 billion of increased issuance primarily through covered bonds, but also with support through the RMBS programmes. And I think a couple other things that we did last year in terms of simplifying some of our funding programmes helps out; certainly the integration of the two type of bonds into a single covered bond program is helpful. And I think, the two transactions that we've done this year have been helpful exercises for us in terms of name recognition, because that was the first-time post-integration. The market got to see the benefits of the integrated platform.

Matt, have I missed anything else off that you would like to point out?

Matt Harrison, Virgin Money UK:

No, I don't think so, Justin. We can follow up on the LCR point, and Corinne we do -- on Page 61 of the interim financial results, which were published last week, give the breakdown, but let us come back to you on that.

Corinne Cunningham:

Thank you.

Operator:

We take our next question from Daniel David from Autonomous. Please go ahead, Daniel.

Daniel David, Autonomous:

Good morning, all, and thanks for taking my question. Just a couple, just based on what you said. I guess, you talked about the catalyst to your bigger peers in regards to where your debt trades. I'm just wondering, is there anything that we should be looking out for, is it likely to be a ratings upgrade that could see you tighten in? Or is there anything else that you call that you're looking for in the short term to maybe close that gap, or is there anything else you'd call out?

And then just a bit more of a broader one. So, obviously, we had the Bank of England's update last week. Does that change your view on the macro-outlook? Any thoughts with regard to their points on how that could impact your planning going forward? That'd be great. Thanks.

Justin Fox:

Yeah, sure. Let me take the first point, and then I'll bring in Richard for the second point. There isn't a specific catalyst that we're looking towards as being an event-driven exercise that would change our perception, I think it's something that we continue to work on over time. You know, we have an active dialogue with all of the agencies and we've been talking to them very actively about our plans and the execution of those plans. I think they'd like to see more evidence coming through, in terms of delivery or in terms of progress against those plans. But I don't think it's a specific event that would cause us to say, okay, job done. We have been, I think, if I look back over the last couple of years, Daniel, where we started off was, what is that absolute level of difference and over time, you know, that has improved. When we talk to the street, when we talk to investors, I think it's a question of improving that perception around our ability to deliver on the strategic agenda and look at the sort of benefits of being our size and scale and being able to operate meaningfully in the markets we choose.

Richard, is there anything more from your perspective, because I think clearly, you look at the broader IR side of things.

Richard Smith:

No, not specific to that. I have to talk to the macro as well I think, Daniel, your sort of point around, did the Bank of England change our view of anything? I think we had already started to incorporate quite a lot of the themes that they talked to. When we look at the inflationary backdrop that we've seen, we've already been building into our underwriting some of the sorts of cost-of-living stresses that people are seeing. If we put that in context on the personal side, we've been building in additional affordability checks that have higher energy costs associated with those. We've also been factoring that into our review of how we think about business lending as well and the sort of roll-off, and customers fixed energy contracts within that.

On the existing book that we have, we added an affordability stress PMA, so an additional buffer, of around 25 million in the half, which provides a bit of conviction just around the backdrop as well as the new underwriting that we're doing. I think we continue to monitor very closely the early warning signs that we're seeing. We're not seeing anything currently, we do stand ready if there were to be any areas of emerging issues to support customers through that, but at the moment, there's nothing presenting.

I think the other point I should make as well is just around the rate environment that we're operating in. We are, again, stressing customers already to a level above the current rate environment but if we continue to see rate rises coming through, that is already baked into our underwriting assessment as well. But there isn't anything that's really changed our view. It seems that obviously, we've been observing anyway, and they're already being baked into how we are operating as well.

Justin Fox:

I think the only other point I would say is that we've also been reflecting that on the liability side. So, clearly, with the benefit of rate rises coming through and a steeper swap curve we've been having and, away from that, the widening of costs within the wholesale side, we have been having reactive discussions with our deposit teams in terms of the relative value of where pricing is in deposit market, I can certainly see it becoming, you know, slightly more competitive going forward given those factors.

Daniel David:

Thank you. Maybe just one quick one, just following up on kind of size and scale. I think when we've talked in the past, you've mentioned that you were still digesting previous deals, so, maybe any comments on the M&A? I realise the market's maybe a bit more difficult than in the past, but just anything you can say on M&A or your outlook that'd be interesting. Thanks.

Justin Fox:

Richard, did you want to take that one?

Richard Smith:

Yeah, sure. So, nothing really changed in terms of our thinking. We continue to have a compelling organic strategy, and that remains our primary focus. We updated at Q1 to say that, if there were to be any sort of M&A activity, it would be focused much more towards smaller bolt-ons, and not so much the larger-scale M&A. But there isn't anything specific, and as I say, our kind of overall focus remained very much the organic strategy that we laid out at the full year and delivering that.

Daniel David:

Thank you.

Operator:

We take our next question from Robert Montague from Allspring Global Asset Management. Please go ahead, Robert.

Robert Montague, Allspring Global Asset Management:

Good morning, thanks very much for the call. Just one very quick question. On capital ratios, you refer to various internal model changes coming down the line. Can you quantify the impact on the ratio from those model changes?

Justin Fox:

Richard, have we offered guidance on what we expect that impact to be?

Richard Smith:

We haven't for some time. So, we did quantify the impact of hybrids a while ago, but things have moved on a little bit so, I would steer away from that at the moment. There's two qualitative comments that I can maybe give that might be helpful. The model changes that we refer to, there's two sets, so, there is mortgage hybrid models, which are anticipated to be an FY '23 event. We do expect those to be beneficial to us based on what we know today. We weren't caught by the average portfolio risk weights threshold of 10 percent, given that our average density is about 16 percent. The only comment that we've made around hybrid is that directionally we would expect it to be positive but we'll wait and see sort of how things crystallise as we get closer before quantifying that.

The cards IRB model changes are anticipated now to be an FY '24 event and much smaller in terms of quantum; we'll work through the plans with the PRA in terms of timing of an update. But as we see things at the moment, they're not a significant RWA change in that sense.

Worth just calling out Basel 3.1 consultations expected in Q4 and we'll see if there are any implications from that around the sort of mortgage hybrid interaction that we've got at the moment, but latest view would be positive FY '23 for mortgage hybrid; cards IRB limited change FY '24.

Robert Montague:

Thanks.

Operator:

We take our next question from Guillaume Desqueyroux from Sanlam. Please go ahead.

Guillaume Desqueyroux, Sanlam:

Hi, good morning, thanks for the call. I just have a couple. Can you indicate what you think the level of the bank official rate will really trigger further the competition that you mentioned -- like some kind of 75 percent pass through to your customer deposits, that would be kind of where I see the competition. So, if you can give a range where you think each will get more intense, that will be quite helpful.

And I guess, well you covered the other subject, but another question from me would be just on the regulatory front, what are the current operational review from the regulator? What are the key topics they engage you with; in particular I'm wondering on the credit card activity. If they keep maybe investigating or collecting information on the rate that can be disclosed on to customers, and what is actually really happening on the back end, either, like any kind of topic that the regulator spends some time on would be quite helpful. Thanks.

Justin Fox:

I can take the second part of the question. Richard, do you have a view on the first because I think our internal view of where the Bank of England gets to be probably not in line with the market, we talk about this a lot internally, but I think the market expectations as to where the terminal rate will be is much higher than we have in our plan. But how does that feed through in terms of the overall competitive dynamic between, let's say, the mortgage market? I'm not sure, Richard, if we got a view there.

Richard Smith:

Yeah. maybe if I can give a couple of comments, and we can frame it in that way. I think at the moment, what you've seen, it's been a very sharp steepening of the swap curve, which has yet to fully translate through into customer pricing on the asset side of things, certainly, in mortgages, you're seeing that, particularly and I think there's a couple of dynamics there. We are seeing customer pricing starting to improve, and you're seeing the sector as a whole start to pass on the pickup in swap curve into customer rate, but it hasn't yet kept pace with the increase that we've seen in terms of swap rates.

Now, clearly, swaps have been more volatile over the last week or so. But overall, I think there is always a lag in a rising rate environment; where you see that start to get passed through more as you progress further on and we've seen some pickup there. On the liability side of things, We flagged as part of the results that we were anticipating some normalisation in terms of the savings market and really, there's a couple of factors to that, which is partially some increase in terms of level of competition. The sector as a whole, for us, as well, we've been carrying additional balances related to COVID, we do expect some unwind of those balances start to come through as people spend those deposits that they've built up and we will see sort of how the pass through evolves, but we have assumed that you don't get the same sort of level of passthrough benefits we've seen in the early rate risers coming through, where pass through levels were near zero.

So, I think, you know, in terms of sort of competitive dynamics, at the moment, what we've baked into the NIM guidance, the 180-185 range, is assuming that there is, limited further mortgage spread benefit coming through over the remainder of the year and that you still continue to see a pretty competitive backdrop; a normalisation in terms of the savings market and I mean, that sense of those, sort of, three drivers I mentioned; continued benefit from the roll of the structural hedge as Justin talked to; and continued growth in terms of some higher-yielding segments, so those are really the drivers that we're thinking about there.

Justin Fox:

And then on the regulatory side of things, I mean, let's bifurcate between the PRA and the FCA, I think with the PRA, I think there has been a rather intense period of late for us, last year was pretty much consumed with the whole stress testing process and outcomes, particularly, as a first year we've actually done it. At the same time, for us, it was completing and submitting the resolvability assessments. So, the way I sort of think about it is you've got ICAAPs and ILAAPs; they help inform stress testing and the stress testing regulatory cycle, which in turn helps us think about resolvability and recovery planning. So, we're held to the same timetable that the larger banks need to complete these exercises in and that's been quite a transition for us. I think the key things for us are really about, okay, having gone through these exercises, what do they mean for us in terms of how we think about our risk, internal risk appetite framework, and how we're sort of using the outcomes from those exercises - so, that helped inform the capital framework and again, there's been a pretty active dialogue with the PRA around what that looks like, what it means in terms of how we manage excess capital, over and above.

Specifically on FCA driven activity around the insights in a number of underlying lending portfolios, I'm not aware of anything off the top of my head, Richard, that there's anything specifically going on there that we have mentioned to the market. I don't think there is anything in particular.

Richard Smith:

No, there isn't. I mean, there's always a very ongoing dialogue, so you do have lots of conversations around things. They are very focused around ensuring fair treatment of customers across all things, that's not to call anything out, specifically, but just as a BAU basis, we get a lot of dialogue around that. We haven't called anything out specifically in terms of that dialogue, it's obviously typically bilateral anyway, so we don't tend to talk too much in detail about it, unfortunately.

Justin Fox:

Yeah, I think the other area, Guillaume, that there is a pretty active side with the regulators right now is really on the sustainability agenda. I mean, clearly, all regulators have stepped up in that space, so, one of the things, again, when we think about how we apply and implement our sustainability agenda, is clearly very focused on the customer proposition and what that looks like, but also, at the same time, we know that the requirements for regulators are stepping up in this space. So, a lot of that's why we make the point about data management and acquisition so that we can then inform our approach and are we cross-purposing the data smartly, in terms of what's required for future regulatory exercises?

So, whilst we didn't participate in the CBES (Climate Biennial Exploratory Scenario) process, we were asked to basically go off and do the shadow work so that in future iterations, we would participate in that, that's been a very useful learning exercise for us. But the sustainability agenda, I think, is an area where there is an increasing focus from regulators and a lot of change going on there.

Guillaume Desqueyroux:

All right, thank you.

Operator:

We have no further questions. I'll hand it back to Justin for any closing remarks.

Justin Fox:

Well, listen, thank you very much for everybody for dialing in today. Appreciate your time and your support, hopefully this was useful for all of you. You know where we are if you have further follow-up questions, and we appreciate your ongoing support. Have a good rest of the day.

Operator:

Thank you for joining. This now concludes the call. You may now disconnect your line.

[Ends]