Paragon Banking Group PLC
2021 Full year results
Transcript of presentation to analysts

Nigel Terrington, Chief Executive

Record profits and strong momentum

Good morning and welcome to Paragon's 2021 Full year results presentation. Today we'll run through the results in detail, as well as providing an overview of the trading environment, updating you on our strategy and our observations on the outlook. But before we get into the detail, I'd like to spend a couple of minutes looking at the highlights of our results and our current priorities.

Business developed at pace during FY21

Whilst the results announced today cover the year to 30 September it certainly was a game of two halves.

The first half where society and the economy were dominated by the effects and consequences of COVID-19, including periods of lockdown and restrictions, and the second half influenced by the economic recovery as GDP clawed its way back to levels approaching those last seen in 2019.

I'm absolutely delighted with the way our business has performed. Not just its resilience during the depths of the pandemic, but also in the way strong momentum has been created alongside the economic recovery and the way in which meaningful progress has been achieved in the development of the Group's strategic aspirations.

Whilst the 62% increase in operating profits has been heavily influenced by the impairment charge, including a partial release of overlays, what this masks is a strong underlying performance with pre-provision profits increasing by 12.6% driven by loan book growth in excess of 6%, and NIM increasing from 224 basis points to 239 basis points supported by continued tight cost control, an excellent customer credit performance across all divisions … and all contributing to the delivery of a record operating profit of £194 million

Lending volumes have been strong across the Group exceeding both the guidance set at the beginning of the year and as reset at the half year. Mortgage Lending increased by over 29% and Commercial Lending by 23%, with good momentum evident at the year-end with strong pipelines providing a good base from which to build further growth into the new financial year.

This growth was funded by a strong performance by our Savings and Treasury teams, delivering record inflows whilst driving down funding costs supporting the NIM improvements mentioned earlier.

Our balance sheet has always been a great source of strength. We've always sought to operate with a cautious risk appetite, both operationally and prudentially and this has, of course, been maintained.

And the balance sheet itself is strong, with 99% of the loan book secured largely on property. Our capital ratios have been strengthened further this year by healthy retained earnings, a funding restructuring that released further capital and all of which has delivered a CET1 of 15.4%. And, which enabled us to commence a £40 million buyback programme during the financial year. And, has also enabled us to announce today an extension to that programme by a further £50 million.

Not only is this a strong financial and operational performance but the business has also made good progress with its strategic priorities and objectives, which have evolved as the environment has changed and which we can see on the next slide.

Key priority evolution

The pandemic caused us to reset our priorities and we've performed well against these. As the year progressed the priorities changed from one of defence and protection to an increased focus on recovery and opportunity.

During these changing phases, our people have been inspiring, showing great passion, commitment and importantly, agility in supporting our customers through the pandemic's various challenges and helping us to support our customers' own recovery strategies.

Over 90% of our colleagues have worked from home during the depths of the lockdown periods and have made a huge contribution to this excellent outcome. We are now testing various hybrid working models which are ably supported by cloud-based technology which is delivering greater agility and flexibility to our operating model. If we do need to invoke working from home strategies again, these could be executed within a matter of a few days if needed.

Payment holidays have all but disappeared, with very few customers requiring on-going support, although we continue to stand ready to help our customers generally and specifically through the Recovery Loan Scheme.

The capital, as you've already seen, has been well protected. The balance sheet is strong, we've been prudent with provisioning and leaving a capital base materially above regulatory requirements, and which is more than capable of supporting our growth ambitions.

The Group's reputation and franchise has been strengthened over this period. There is frequent engagement with our customers and feedback is positive, reflecting the hard work over the last two years.

New digital technology has been employed to improve the customer experience, enhance efficiency and strengthen our decision-making processes and our digitalisation programme is now being accelerated as part of our strategy to become the leading UK-based, technology-enabled, specialist bank.

I will now hand over to Richard to cover the financials in detail.

Richard Woodman, Chief Financial Officer

Thank you Nigel.

Income statement

I'll start with our income statement overview. The summary shows our total operating income has increased by more than 10% during the year, with net interest up almost 12% and a reduction in other income being seen as our serviced portfolios continue to amortise.

Costs were higher in the year, the largest factor being higher share-based costs, reversing the reduction seen in 2020.

Impairments saw a small write-back in the year. The write back reflects portfolio performance and modelled reductions – but our overlays remained broadly unchanged from their 2020 position, given the continued period of heightened uncertainty.

We also saw further credits from fair value movements in the second half. These largely reflect yield curve movements on swaps held against our new business pipeline which fall outside the hedging relationship requirements.

These various influences have contributed to our pre-provision profit increasing by 12.6% from its 2020 level,

Operating profits increased by 61.8% and pre-tax profits rose by 80.5%.

While not detailed on this slide, it is worth noting that the Group's tax charge equated to 23.0% for the year.

Headline tax rates will be rising in 2023 and 2025, but the changes to the banking surcharge will mitigate these increases to some extent. For 2022 we'd expect a modest increase in the tax rate – as a greater proportion of Group profits will be subject to the banking surcharge, however this rate is likely to be below the 23.9% implied by the current consensus.

Reported earnings per share have grown materially in 2021, benefitting from both the growth in post-tax profits, and the lower share count resulting from our buyback programme.

Segmental results

Moving forward to my next slide we can see how this translates at a segmental level.

Our two growth divisions have both seen really strong progress in 2021 with good growth at both the pre-provision and operating profit levels.

Idem Capital continues to amortise steadily, with income dropping by around a quarter as a result. The central area continues to bear the costs of unallocated funding (up around £3.3 million year on year) and central overheads, where the most material movement was the £8.7 million swing in share-based payments.

My next slide looks in a little more detail at trends in our net interest margin.

Following the impact of the Covid-led base rate changes last year, the previous NIM trajectory for the Group has now been resumed.

The historic reported NIM for the group was skewed by the impacts of the Idem Capital division, so in recent periods we have separated the Idem effects to demonstrate the underlying progress, and this is shown in the bottom chart.

The 15 basis point improvement in Group NIM in the year translates to an underlying 19 basis point improvement when excluding the Idem Capital portfolio.

Each of the Mortgages and Commercial Lending divisions delivered both stronger margins and higher balances when compared to 2020, the mix of the rate and volume variances is summarised in the appendix to this presentation.

Our NIM progress continues to reflect both asset and liability-side effects.

Structural improvement in NIM

The following slide details asset side influences on our structural NIM improvement

The front book / back book dynamic on Mortgages continues to be a favourable one, the back book comprising variable, Libor linked, or rather, now Term-Sonia linked loans, and the front book is mainly fixed rate in nature and carries a higher yield.

Our growing Commercial Lending book delivers a stronger yield than either the front or back mortgage books, and as demonstrated on the previous slide, the amortisation of the higher yielding Idem Capital portfolio is having an increasingly small effect.

Funding bridge

Moving on to my next slide, the development of our funding base has also contributed to the NIM improvement.

During the year we have continued to grow our savings base, which now exceeds £9.3 billion and delivers significant growth potential for the Group at attractive rates.

We have drawn TFSME, repaid TFS and refinanced the Group's legacy securitisations during the year. The securitisation refinancing has facilitated our Libor transition, generated capital and reduced Group encumbrance.

Overall, interest income dropped 24 basis points in the year, reflecting the lower base rate environment, and the Group's cost of funds fell by 39 basis points.

Our NIM outlook for 2022 sees a minimum increase of 5 basis points – this could be a little more, but while absolute rates generate higher returns on the Group's net assets, the timing of rate increases can skew this given quarterly resets on the variable rate loan book.

Operating expenses

My next slide looks at emerging trends in our cost to income ratio

As with the net interest margins, the influence of Idem Capital has a skewing effect on the Group's cost to income ratio. However this influence is now much reduced given the smaller portfolio size in Idem.

As I mentioned earlier, the largest individual element in the 2021 cost growth was the £8.7 million increase in share based payment accruals, reflecting the very different share price profile and performance in 2021 when compared to 2020. In aggregate this accounted for the entirety of the cost increase in the year.

Our expectation for 2022 and beyond sees a return to underlying cost growth, as wages increase and our investment in our change programme, which is mainly technology-related, continues and accelerates. Our guidance for 2022 costs is for a charge in the low 150 millions.

Economic outlook

Moving on to the economic outlook.

Under IFRS9, the economic projections we use and the weightings we apply to the differing scenarios have a direct impact on the provisions we hold for expected credit losses.

We've updated our scenarios from their 2020 levels but maintained the relative scenario weightings across the year.

The charts show the profiles we have used for our most important variables, being GDP and house prices. Our severe scenario follows the Bank of England's 2021 stress, but materially slows the house price recovery that was embedded within the Bank of England's own scenario.

The top right table shows the impacts on impairments if we weighted the individual scenarios at 100% each. At September 2020 the same analysis showed a £52.5 million impact from weighting the severe scenario at this level. The reduction to just over £40 million this year reflects the strong house price growth experienced in 2021, offset to some extent by the slower pace of house price recovery in our current severe scenario.

Having calculated our modelled provisions, we then undertook a separate assessment to consider the potential impacts that the UK's approach to managing the Covid pandemic will have had on disguising the drivers of credit losses.

Impairments

Moving on a slide, these overlays are detailed in the top right table, with the PMA levels at September 2021 being split fairly evenly between the Mortgages and SME portfolios.

The bottom left table shows the impacts of weightings on the impairment calculations – the £46.0 million of modelled impairments would be £7.8 million lower if we used the scenario weightings that were used when we first moved on to IFRS9, which reflected a far more benign period.

The bottom right table shows the relative movement in behavioural scores on our books since 2020, demonstrating the underlying stability and credit strength of the portfolio.

Capital movements during the period

You will see from my following slide that the combination of growth, profitability and capital management policies have left us with stronger capital ratios than we entered 2021 with.

Retained earnings and the results from refinancing our securitisations adding 3.3% to capital resources during the year. These are shown in the two Blue boxes in the bridge diagram

We have also seen a small adjustment for the IFRS9 transition, net lending growth, dividends and buybacks which together have utilised 2.2% of this increase – leaving our overall CET1 position of 1.1% over the year to 15.4%.

The Group's old Tier 2 bond was replaced during the year with a new, more attractively priced Green Tier-2 instrument – this takes the total capital position to 17.6% at the year end.

If we're looking on a fully-loaded basis, the CET1 and Total Capital ratios stood at 15.1% and 17.3% respectively.

Group capital

The spot position and associated ratios are summarised on my next slide.

In addition to the increase in capital resources during the year, our regulatory requirements fell following the PRA's capital SREP process. This reduction sees the Group's surplus over its regulatory capital now exceeding £0.4 billion, giving us capacity for stronger growth and further capital management.

The slide also notes the progress being made with the Group's IRB application – we are now well into our Phase 2 engagement with the PRA. This is a protracted and extremely thorough process, and we are still not in a position to give guidance on the exact timing or quantum of the final impacts. As soon as these become clear, we will update you all.

Dividend per share

My final chart looks at dividends.

The chart details the progress made on our dividend per share. The step up in impairments during 2020 contributed 4.8 pence per share to the reduction in dividend when we looked at it compared to 2019's level.

In addition to impairment write-backs in the current year, 2021 has also benefitted from material fair value gains.

To give you a feel for these impacts, we have shown how the movements on fair values and impairment writebacks have influenced our final dividend level for the year. The impairment effect is calculated by reference to the 7 basis point cost of risk we saw in 2019, being our last pre-Covid reporting period.

With the overall dividend for 2021 standing at 26.1 pence per share, the impairment normalised equivalent would have been 22.1 pence – the 4 pence difference comprising 2.3p for fair value movements and 1.7p for impairments if we'd rebased those at the 7 basis point level that we saw in 2019.

Thank you very much for your time, I will now hand you back to Nigel.

Nigel Terrington, Chief Executive

Strategy overview

Thank you, Richard … I'll now turn to the wider business performance … our strategy …. and outlook.

Our strategic priorities

This slide represents our strategic framework, including our key priorities of growth, diversification, digitalisation, capital management and sustainability.

We are a specialist bank, focused on sectors where we have a competitive edge because of our extensive and deep knowledge of the markets in which we operate, the customers we serve, the products we provide, the services we offer and the risks we take.

This excellence is created from our deep through-the-cycle experience combined with our extensive access to information and data analytics, some of which goes back decades and creates distinct competitive advantages for the Group.

These are being applied across our business, particularly our strategic priorities.

Strategic priorities – growth

As you've already seen we've achieved strong lending growth, not just in the last year, but over a sustained period – delivering a compound annual growth rate of 12.6% since 2016. Despite this, growth is a strategic priority for the future. We have a strong presence in the specialist markets in which we trade and we have significant capital capacity and operational leverage to deliver this growth. And, additionally, IRB has the potential to enhance these strengths even further.

Alongside our growth strategy we also want to achieve further diversification.

Strategic priorities - diversification

This diversification can be seen over the recent years and is being driven by our Commercial Lending division which generated over £75 million of contributions in the last year, and we expect this to rise further over time.

In many ways - to date - this has offset the runoff of Idem's income stream but, with Idem now only contributing 4% of profits, we should see Commercial Lending as a growth engine coming more to the fore going forward.

It should also be understood that, realistically, Commercial Lending is not one product line. As can be seen on the right-hand chart, it is four separate divisions that have little or no overlap. But one thing they do all have in common is that they are all benefitting from the increased digitalisation in their markets and importantly in their business models.

Strategic priorities - digitalisation

Technology is becoming increasingly important to all banks and this is also true at Paragon.

Our strategy to create the leading technology-enabled specialist bank is being achieved through a digitally-focused cloud-based modular development programme, which is delivering modern technology across key areas of the Group.

Some phases have already been delivered, such as the new Savings platform, which is enabling the bank to source deposits from a multitude of third party relationships such as Hargreaves Lansdown, Monzo and Revolut to name but a few, which is increasing the scale of our addressable market.

Additionally, the launch of our Commercial Lending portal in the SME market is using Open Banking capability to deliver an enhanced service, greater efficiencies and improved data analytics. These capabilities are helping us to erode some of the competitive advantages held by the large banks.

Additional, digital systems have been rolled out recently where the benefit will be seen in the years ahead but there are many more exciting initiatives in process.

The scale and significance of the benefits of our digitalisation strategy has led to us to accelerate this programme and we expect to deliver material technology changes in both customer and intermediary engagement by extensively employing Open Banking functionality.

The next slide considers how we are using Capital Management to support these strategies as well as optimising the efficiency of our balance sheet.

Strategic priorities - capital management

We have always seen the management of capital as an important discipline, and this will be even clearer in the future.

As Richard has already said, we're making good progress with our IRB accreditation which is initially focussed on buy-to-let but where we expect to also move on to development finance.

The crucial driver here is the enhanced risk management capabilities it provides, leading to a more direct relationship between risk and capital requirements, providing opportunities for further growth and allowing us to offer more risk-based pricing due to differential capital segmentation.

The impact of Basel 3.1 has eased as it now seems likely that the Bank of England will follow the EU's decision to defer implementation until 2025.

We have never been reluctant to balance our growth ambitions alongside returning cash to shareholders and, over the period since 2015, we have delivered dividends totalling £317 million and announced buy-back programmes totalling £308 million which combined represents nearly 50% of our current market capitalisation.

And we have today extended our capital management programme with a further £50 million buy-back on top of the £40 million buy-back announced last year. We have been capital generative adding 2.6% to CET1 at the pre-distribution level over the last year and, as at the end of September, we had a surplus capital over our regulatory minimum, in excess of £400 million.

So, despite the buy-back programme, we still have plenty of capital to support our ambitious growth plans.

Turning next to sustainability.

Strategic priorities – sustainability

Financial institutions are becoming increasingly aware of the responsibilities they have towards the environment, society and their wider stakeholders.

We take these responsibilities very seriously but, as is the case for many, we recognise that this is work-in-progress - not just in terms of our own operations and our funded emissions, but also in the way in which we communicate.

With our full year results we have today published our first sustainability report which sets out our progress on the main ESG issues for our business.

We have also launched a range of green initiatives and products during the year and these product ranges have continued to be extended over the last few months.

We issued the first ever UK bank Tier-2 Green bond, where the proceeds will be used to provide environmentally enhancing lending products.

And, in addition, we are also offering incentives for highly rated EPC buy-to-let mortgages and supporting environmentally friendly housebuilding projects, as well as offering finance on electric vehicles.

These new products provide further evidence that we are backing our words with real action to support our commitment and doing what is right.

Whilst there's much more to be done, we are determined to support our customers in achieving their sustainability ambitions for the benefit of all our stakeholders.
I'll now turn to reviewing each of our key product lines starting with buy-to-let.

Buy-to-let

Momentum has been strong with lending exceeding £1.6 billion.

The buy-to-let pipeline stood at £1 billion at the end of September and is currently in excess of this level … and we therefore expect 2022 to deliver further growth in volumes.

Redemptions remain low, driven by customer retention activities, thereby continuing to support growth in the loan book, which increased by 8% year-on-year.

The post Global Financial Crisis book increased by 19%, the difference showing how much of a drag the old book can be, although this clearly reduces over time.

Rental demand has been strong throughout the last two years with the exception of London, although even that has now seen a recovery in rental levels, as people return to the office.

Customer and market feedback suggests lending demand is expected to remain robust in the year ahead. Whilst interest rates may well increase in the coming year, the application of stringent underwriting stress tests will, we believe, continue to show the resilience of the BTL market and our book in particular.

Proven resilience of business model through the pandemic

We have deep experience in buy-to-let going back over 25 years with extensive data capable of supporting this stress testing, our IRB programme and our underwriting process as well as our portfolio management.

The quality of the loan book has been evident through the customer credit performance over time and across economic cycles - even under the stresses in the pandemic and the Global Financial Crisis. With an average LTV of only 61% and importantly only 1.9% greater than 80% LTV, the strong asset backing of the portfolio is clearly evident.

Data analytics and technology are playing an increasingly important role. Our new intermediary portal, a cloud-based platform supporting intermediary engagement, has been well received. Separately, every month our systems analyse 650 million pieces of customer data which is used to produce behavioural scoring models in our portfolio management teams.

We can therefore be confident that despite the strong growth we're seeing, it's being delivered by maintaining our disciplined approach to risk, which has been successfully applied over the last 25 years.

Turning now to our Commercial Lending division.

Commercial Lending provides increased diversification

Commercial Lending equally had a strong recovery with volumes reaching £971 million, a 23% increase on last year and, with its enhanced risk adjusted margins, helped drive the improvement in NIM seen at a Group level.

I will cover Development Finance and SME lending in a little more detail, but also of interest was the second half performance of motor finance where we saw a significant step-up in activity which we anticipate continuing into the future and which has been recently enhanced by our entry into the growing electric vehicle market.

Now, looking specifically at development finance.

Commercial Lending - development finance

We have a strong franchise and reputation in the SME development finance market and the strength of our client relationships and the support provided during lockdown has paid dividends, with our new lending exceeding £500 million for the first time. Although the loan book didn't grow in 2021, this was primarily due to the interruptions to the normal repayment patterns seen in the lockdown period in the previous year.

Margins have been stable and the credit performance has been exemplary, with LTVs around 62%.

The development finance pipeline has been stable and we're optimistic that 2022 will see further growth in new lending volumes – although it's evident across the market that there is some supply chain disruption which is causing delays and adding to cost.

However, similar to all our lending, stress testing is used as part of the underwriting process.

Commercial Lending – SME lending

Our SME lending division has been impacted by customers deferring investment decisions and making extensive use of the Government's schemes, such as CBILs, bounce-back loans and more recently the Recovery Loan Scheme - in effect pre-funding future requirements.

Non-governmental SME lending is down by 19% since the start of the pandemic. However, we have outperformed the sector and our origination levels witnessed a good recovery across the year, increasing by 17% compared to 2020, and with the loan book up by 12%. Our CBILs and Bounce-Back Lending was relatively modest by comparison with balances ending at only £92 million, primarily due to our focus being on supporting existing customers.

Payment holidays, which were a feature of last year's accounts, have virtually unwound with only 1% of the book requiring some form of on-going support.

We also recently launched the first phase of our digitalisation platform in SME lending, being a cloud-based portal, which uses full Open Banking functionality. It's been successfully rolled out across the intermediary community and will be used alongside data driven models accessing nearly 4,000 pieces of customer data on every loan as part of the underwriting process.

And finally turning to Funding …

Funding

Our Savings and Treasury divisions have had an outstanding year.

The deposit book is up 18% over the last year and balances currently stand at over £9 billion. This has been achieved whilst rapidly reducing retail funding costs, down from 134 basis points in September 2020 to 109 basis points at the half year and 91 basis points by the year end.

With a still favourable front book / back book dynamic, there are still some benefits to come. However, we are conscious of the interest rate cycle turning, and our balance sheet is structured deliberately with that in mind.

We have also refinanced over £2 billion of legacy securitisations, which supported the LIBOR transition process, improved NIM and released capital tied up in old SPVs. As previously mentioned, the Group also refinanced its Tier-2 bond with a new Green Tier-2 debt issuance, at nearly 300 basis points lower than the existing deal, virtually all of which was due to improvements in Paragon's credit spreads.

New technology is already playing an important role within our Savings business and a new digital platform was launched during the year. As I mentioned earlier, this is being used to manage our third-party relationships, but has the potential to deliver enhanced capability in due course. Additionally, we have continued to extend our product range, recently entering the SME savings market and we will continue to seek to innovate and develop alternative distribution opportunities.

Our view is that there is potentially a big prize on the savings side with over £860 billion of deposit balances held with the clearers, earning virtually nothing, and where Open Banking technology could help breakdown the inertia within the current system, leading to a more level playing field and an erosion of one of the big banks' key competitive advantages. This will of course take time, but the scale of the opportunity is meaningful.

So, in conclusion …

Conclusion

The recovery in the Group's performance reflects how well-positioned the business was going into the pandemic, including the resilience of our operations and our ability to be agile in dealing with the challenges of the pandemic as well as the subsequent opportunities that have emerged.

Clearly the emergence of a new variant causes some uncertainties on the shape of the economic recovery. It also poses questions about whether the working-from-home model will return, but we are well prepared and can execute this strategy within days if it's required.

The strong loan growth in the year has continued with good momentum. We're investing further and on an accelerated basis in new digitalisation technologies to support our growth plans.

Nevertheless, there's still a level of uncertainty in the speed of the economic recovery and, unless the variant destabilises matters, it's likely that interest rates will rise. Consequently, whilst we expect to see good growth in new business levels, we will maintain our disciplined approach to risk and we will review further the Covid overlays in 2022.

So, looking forward and to provide some guidance on the year ahead, we anticipate:

- Mortgage volumes exceeding £1.7 billion
- Commercial Lending exceeding £1.1 billion
- We expect NIM to grow by at least 5 basis points … although clearly this is subject to interest rate changes
- And costs will settle at around the low £150 million area

The delivery of an underlying 15% return on tangible equity is tantalisingly close and with strong capital ratios, significant liquidity, continued operational capacity and leverage and a clear focus on optimising capital, we are well placed to support growth and to react to opportunities, both organic or inorganic, in the period ahead.

I am incredibly proud of the way the business has performed across recent times and due credit must go to my incredible colleagues across the business who have supported our customers, each other and the wider community, ensuring that we always seek to do the right things.

Whilst the environment holds some uncertainties, we are in exciting times, which are providing a range of opportunities for our business. We have evidenced our resilient model and the strength of our balance sheet across cycles and we are confident in realising the bank's potential and in becoming the UK's leading technology-enabled specialist bank.

Thank you.

Q&A

And the first question is from the line of Benjamin Toms from RBC. Please go ahead.

Morning both and thank you for taking my questions. The first is on costs and the second is on ESG.

On costs, your guidance for next year is in the low £150 millions. That implies quite a significant increase from this year. Can you just break down the year on year delta. In cost:income ratio terms on the back of an envelope, I think it implies that the cost: income ratio will go up in FY22 compared with consensus expectations rather that the cost: income ratio going down. Is that broadly the correct way to think about it. I know it depends on what you assume for NIM growth but even if I double your 5bps increase guidance year-on-year, I still get the cost: income ratio going up. And on the pre-recorded call you also used the language of settling in the low £150 million region, does that mean you expect flat-ish costs post full year 22?

And then, on ESG, 62% of your loan book has an EPC rating of below C. I think that's bank in line with the Private Rented Sector average. Are you seeing 2028 requirements around private rented property having to be in Band C or above as a risk or an opportunity?

Richard Woodman, Chief Financial Officer

Ben, it's Richard. I'll pick up on the costs. In terms of the changes – as you'd imagine – for the bulk of the business, we got a pretty stable position but we have a few areas where we've seen some quite material growth. On top of that, we have also a period where we've got more material wage growth – so we're looking at 5% inflation to start the year in terms of the delta.

We've got three other areas where we've moved up quite materially in the year. One of those is on savings, where our outsourced approach actually is linked to the size of the savings book rather than inflation factors – so that grows with the size of savings and which as it's becoming the predominant funding source is probably going to be 15 to 20% year-on-year.

You also have a lot of growth going on in our Commercial Lending division where, again, you're looking at around a 15% growth in the cost base.

The other big area to look at is on systems and IT and, if you recall, when we've discussed this before we tend to expense our IT investments. We only carry around just over £3 million of capitalised software on the balance sheet so most of our development costs goes through opex rather than capex and a long depreciation curve. So that's one of the reasons things are going to be up a little bit and we're expecting our systems costs to be up around 20% year-on-year in 2022.

So, those are the main items and that should take you to something at or just over £150 million.

In terms of the cost: income ratio, yes, I absolutely get it. If we capitalised a little more in costs we could have kept that flat year-on-year. We see cost: income as an output rather than a target. It informs us or where we are efficiency-wise but we would rather have those expenses actually put through the P&L rather than capitalised for a later date.

So, those are the main points on costs but you're right directionally in terms of cost: income ratio for next year.

Nigel Terrington, Chief Executive

Is that OK on that Ben? OK. So on the ESG point. So, 62% of the book with EPC lower than C but, as you say, pretty standard across the industry. I'd say it's pretty standard across the home ownership industry as well and your question is this an opportunity or a threat? I think it's both in that regard.
I think the threat will be mitigated by the fact that in order for the industry – and bearing in mind this is not us it's our customers as it were – but there's obviously indirect consequences, there is an indirect expectation from Government that there is enough capacity in the market to be able to achieve all of the retro-fits that will be needed across that period in that timescale.

My personal opinion is that it does not exist. There is not enough capacity for it to happen in that timescale so one suspects the Government will have to go back and revisit that timescale in due course.

However, we stand ready to support customers. We already have a number of green initiatives out there. We have pricing discounts for landlords with A-C, we have products on the new build side with the development finance offering discounted pricing in order to encourage people - builders or landlords - to buy properties that are of better quality in terms of the EPC side. We offer further advances to help people with the retrofit programme. So, I do see it as an opportunity.

I think there will be a lot of demand over the coming years to support the needs of the population of the UK – let's now make it all about landlords here for a second – to achieve what they need to achieve to manage the emissions levels – but there would naturally be a supply chain. It can't all happen in the limited timescales that the Government seem to be indicating. There is no firm guidance at the moment. It's only supposition at this stage, but, if that all comes to pass, there's not enough capacity to be able to deliver it.

The next question is from the line of Gary Greenwood from Shore Capital. Please go ahead.

Morning. I've got three questions if I can. All Ds actually – dividend, digitalisation and diversification.

So just starting on the dividend, I note that you called out the roughly 4p of benefit that came from the low impairment charge and also from the fair value gains. If I look at earnings for next year on a reported basis, it's entirely possible that they could be flat or down slightly so on that basis are you willing to have a dividend that would actually step backwards in the current year if you stick to your 40% payout ratio.

Secondly on digitalisation. Again, just sort of following on from the previous question on costs. I don't know if you can quantify the absolute level of spend that you had on digitalisation in 2021 and therefore we've got a sort of base of which to project the growth that you talked about. And then also maybe talk about how that evolves going forward - whether this is a one-off lump of investment that will then reduce or whether this is a sort of step up to a sustained higher level.

And the last question is on diversification. You've talked quite a bit on this particularly in the Commercial business. And I'm just wondering if that is really just all about organic growth in the existing businesses or whether you're still looking to additional capabilities and therefore whether inorganic growth would come into the equation too. Thank you.

Richard Woodman, Chief Financial Officer

In terms of the dividend, we've tried to demonstrate what that underlying / normalised level of 22.1p would be and we would portray any growth against that. It's very difficult where you have a period where you put in very substantial provisions one year and then release them the next to maintain a steady progress in terms of the absolute level of the dividend. I think on a normalised basis we would absolutely look to seeing that as being progressive but you're quite right, subject to where your numbers come out for 2022, it would be possible that our pound note dividend would be less.

But, we'd maintain the payout ratio and that underlying, core normalised growth rate ought actually to be the thing that we would point out to investors.

We did actually think, clearly, it was very important to reward investors in this very good year after the difficult year last year.

Nigel Terrington, Chief Executive

So, the digitalisation. So, during the course of the year, there's probably around £2 or £3 million worth of expenditure in there and we would expect that just to move up a bit from there.

I don't think it's an abnormal one-off lump this year and / or an abnormal lump next year or in the years afterwards. This is a steady progression of investment on this side but also just to point out the level of capitalisation that we do is very low.

You sort of do a side by side, across the industry you'd just see ours is low single million pound figures that we choose to capitalise and hold as a balance sheet asset because that's part of just a very prudent approach we take to things.

So, we do have a phased transformation programme. So, we're not trying to do one big-bang project that comes together in one weekend during the course of the year or next. So, because we're dealing with it on a modular and sequential basis it means we can phase the introduction of this over a number of years.

So, every one of our business areas is going to go through a digital transformation programme – some of which is already done. So, we have already absorbed some of it. So, we've already put in place the third party digital

platform systems for when we deal with third party accounts, third party relationships like Hargreaves Lansdown etc. Additionally, we've already introduced the new SME new business portals and the mortgage portals so these are already up and running and so there are now phases going on to build additional modules attached to that as we go through. So, I think that that modular approach ensures that we don't try and do perhaps a highly risky big bang event that happens over a weekend but equally also helps us phase the work over a number of years.

In terms of diversification, there is a longer-term plan here to create greater diversification for the business.

Some of that is being done organically already so you know you can just see - and I tend to view diversification more about diversification of earnings rather than diversification of balance sheet assets - and so you can see the way in which we have increased the contribution of income streams from the Commerical area increasing at a faster rate.

Clearly buy-to-let has had a pretty buoyant year and so the speed of that change maybe is not as dramatic in this last year as it would have otherwise have been but what you can expect to see is further continued growth in revenue in Commercial probably ahead of buy-to-let just be virtue of a combination of good growth in the net loan assets in that particular area, combined with a higher yielding set of products as well.

If M&A comes to pass, then clearly one of the things that we would like to do is find that can also deliver diversification. You know, we look long and hard and you can see we've got quite a bit of capital to support growth whether that be organic or inorganic but we're very fussy as you will well know and we're also quite conscious that we're only ever going to buy anything that represents the right business for us and at the right value. There's lot of things for sale at the moment, there's lots of things for sale at the wrong value so we're very patient and we'll bide our time.

The next question is from the line of Jason Napier from UBS. Please go ahead.

Good morning gentlemen. I've got two questions. Let's begin with costs if we could go back to that topic. The Group has delivered extraordinary changes under your stewardship in terms of mix and product capabilities but I guess it's come at a cost of fairly sustained negative jaws and a steady upward march in cost: income ratio and so I wonder in the light of forecasts that we have for revenues that grow faster than costs on a sustained basis, I just wonder whether there's a component of travel and arrive where the transformation matures and you could expect to deliver faster revenue than cost growth on a multi-year basis or whether there are offensive and defensive moves afoot to broaden your product reach or your customer reach that should see us positioned for sustained investments that have costs grow faster than revenues over the longer term.

And then secondly, I wonder whether you could just comment on what you are seeing in competitive terms in terms of product spreads and how that might play into overall longer term net interest margin expectations.

I appreciate what you're saying about the timing of rate changes potentially skewing rate outcomes but I wonder whether in broad terms if you could talk about what should happen to Group NIMs over I don't know a 2 year period if we've got rates going up 50 basis points. Thanks very much.

Nigel Terrington, Chief Executive

Your travel and arrive point is an interesting one. I think the cost: income point which was also raised a little earlier is something where we regard that as output rather than an objective or a target in itself because when you take a business as we had before - sort of largely monoline - and then diversify into a range of different asset classes and then become a bank or probably vice versa - become a bank and then diversify a range of asset classes - which typically structurally would have a higher structural cost: income anyway, and then continue to go through a post-global financial crisis world where regulation has only got added to rather than taken away that what you tend to see there is the level of investment that preceeds the revenue benefit that has come through.

What we believe we have is quite a lot of operational gearing, operational capacity and also a capital capacity as it were. You see there's over £400 million above our regulatory minimum that we have in that regard, so there's lots there that's at our fingertips that we're able to do all of which will contribute to enhancing revenue faster than incremental costs. But there's been quite a level of investment over the years in order to get to that point.

But I do think this is a multi-year opportunity but it's also something that happens over the medium term. So, you can see why with a variety of aspects about the current year why the cost: income ratio won't necessarily make the progression that it could do over the medium term.

You know, we're in the low 40%s and I do think we could see further improvement for that in the coming years but it will be a medium term output rather than a short term target.

The other to bear in mind is also one other structural thing is Idem. We did put over a number of years a page in the presentation pack about the effects of Idem which created I think a probably artificially high NIM for a business on an ongoing basis.

Idem's cost: income ratio is less than 10% if you isolated that by itself and that tends to create a headwind that as Idem unwinds – gets to modest proportions – it's effect on the overall results starts to get diminished as well.

If you look, Idem is contributing a relatively tiny amount towards profits now and so its effects and contribution to the cost: income ratio is less significant than it has been in the past.

So, there's a bunch of structural reasons – investments, investments because we're a bank, investments because we're in a digital process change, and also the unwinding of the Idem position it's quite significant effect on the revenue line in previous years. So, that's to sort of leave that at that.

So, in terms of competition, you know there's good healthy competition in all of the markets in which we operate.

The thing that we've always sought to do is to trade in the areas where, because of the product complexity or the specialist nature of them, it tends to not attract the mass market or the price-led initiatives where some of the larger lenders will seek to operate.

So, as a consequence, during the course of this last year, we've seen massive spread compression taking place on the mortgage side, where the big players have used capital / excess liquidity to really drive those yields down. That's not been the case on buy-to-let. There's been some asset yield compression but it's modest by comparison and certainly less that the compression that we've seen on the liability yields so overall I would say that I think that position is there and I think that it's likely to maintain itself over a period of time.

Also don't forget, we are going through the process on IRB and so within the type of products that we can offer we've been largely constrained by the somewhat flat capital charge that tends to apply on a standardised basis. So, once IRB arrives we can then start looking at our business on a more credit segmental basis which will therefore give us a broader market reach and allow us to compete in areas that we have not hitherto been engaged in.

I think the final point you raise was on the rate rise. Richard, do you want to cover that?

Richard Woodman, Chief Financial Officer

Yes, sure. So, with around £1 billion of net assets invested in variable rate assets, typically cash, that we've sticked back at the Bank of England, what you find that is at absolute higher rates, we earn more on NIM and we don't put hedging in for that sort of structural position.

We have it there deliberately. The view is that at very high rates, you would probably see some potential higher bad debts but that would be offset by the stronger NIM you would achieve. So, that's the reason we don't run a

structural position there but you ought to, on a rested basis, see a higher income for a higher rate and typically it's around £10 million for a 1% increase - so if rates are going to be up 50 bps that's going to have a 2 or 3 basis point impact on NIM so relatively modest in the overall Group sense.

You did mention the timing and that is important for us. The bulk of our variable rate assets reset at the quarter end, so if Bank rate increases happen in December, March, June or September, actually we get little if nothing in the way of any funding disadvantage in a rising rate environment.

If they go up in January, April, July or October, we typically face a whole quarter's worth of higher funding costs before the asset side catches up and it's just the way we structure the balance sheet so, much like the costs in terms of journey and arrival, the resting rate for higher rates is stronger but the movement can cause disruption depending on the profile of that movement.

And, to be honest, we saw a little bit last year. If you remember, we had that very material reduction in our cost of funds which very quickly got related through to the asset side and it took us a while then to catch up on the liabilities.

Thank you very clear.

The next question is from the line of John Cronin from Goodbody. Please go ahead.

Hi Nigel. Hi Richard. Thanks for the presentation.

A few questions from me. First of all, sorry to flog the costs point to death but just wanted to come back to the first question on outlook beyond FY22. Looking at FY23, presumably the significant step up is next year and then should we think about it pretty flat year-on-year for FY23 or should we expect to see continued absolute cost increases and I note your reference to the investments programme being a multi-year process in that respect.

My second question is on asset yields and I know you've spoken on the call already about competition in your markets. I'm just wondering how sensitive in buy-to-let particularly you are to the likes of when Foundation Homeloans or Kensington get quite aggressive on pricing. We've seen your yields remain pretty stable, albeit with some compression, and I guess with that in mind how resilient are your yields to that kind of sporadic increases in competition that we see on the part of some of your smaller peers.

If I can just add an adjunct to that as well probing on the rate sensitivity point, just a little bit curious on what assumptions underpin your sort of £10 million guidance for a 100 basis points impact. I suppose my own concern there is it hard to pass on the higher rate especially if we see a series of rate increases to the borrowers just given default risk given the rates are already perched at relatively high absolute levels whereas on the term deposit pricing we'll see most of that come through.

And then finally, just on IRB, look you've given some very clear guidance again this morning in terms of the progression in that respect. Is there anything you can say specifically on timing expectations – you know how long a typical Phase 2 process takes with respect of the mortgage book and what kind of stage of advancement you are at specifically with regard to the development finance portfolio ie could we see both potentially receive accreditation at the same time or is development finance likely to be 12 months plus behind mortgages. Thank you.

Richard Woodman, Chief Financial Officer

So on costs, as Nigel said it's a multi-year programme but we're very, very busy with this at the moment. I think if you're looking at proportionate increases, I think 2022 should be much greater than 2023 but I'd still expect a little bit more cost in 2023 and, to be honest, the other thing we've got to bear in mind is what the inflationary environment is in terms of wages. So, I think it would be odd for us to see growth in 2022 and then flat thereafter,

but hopefully the rate of growth would be much reduced and caught up by and overtaken by the growth in NIM to Jason's point earlier in terms of that longer term progression.

Nigel Terrington, Chief Executive

In terms of asset yields, you highlighted some of the non-bank competition there.

These guys have kind of entered the market in recent years and have had varying degrees of activity from time to time.

They are part of a much wider tapestry of competition whether that be from the bigger banks or building societies.

So this market has never been without its competition and you know we all take all competitive threats very seriously.

But I repeat the point, you know one of the things that we have not had in our competitive armoury is the application of IRB. And IRB, it's not, it's not … I mean people just naturally assume it's all about how much capital we can give back on the back of it. You know, one of the fundamental things is it provides an alignment between capital and risk and therefore, at the moment, as a bank we have pretty much the same capital requirement whether it's a 10% loan to value or an 80% loan to value.

So, here, you will be able to apply much greater segmentation of risk, much greater segmentation between product offerings and therefore be able for us to compete at a much more interesting level that we've ever been able to do before.

So, yes there will always be competition and we will always keep a very close eye on it. We've got a very strong franchise, a very strong brand within the sector. Very focused on the professional end of the buy-to-let market where it's not just about the lowest price on the block. It's the broader product offering that you bring and the service and the experience which, you know, goes back many decades. So, you know, it is something to keep an eye on but we're very confident of our competitive position across the whole sector.

Just on IRB, we can't give any guidance because the timing of this is in the hands of the PRA, but we are well-advanced on our mortgage programme. We are well-advanced within the Phase 2 part of the mortgage programme but what that means between now and when the accreditation is delivered is an uncertain timescale and certainly not a science.

Development finance won't be landed on the same day, but I would suspect it is not as complicated a process because development finance uses the slotted model approach rather than using the advance modelling approach that tends to be used for mortgages.

In terms of development finance though, we won't have to do a Phase 1. We've done that and we will go straight into Phase 2 and, as I said, that is because there is a less complicated route through on that side. So, whilst it won't be delivered on the same day as mortgages, I don't think you've got the same duration to wait for your accreditation on that side.

And I think the other question was on interest rates in term of what happens in the event that rates go up and what happens to the inside?

We've got on the liability side – again, we'd have to wait and see – it's all been a bit stop start hasn't it in terms of what happens with interest rates because one month it's going up the next month it's not.

But, in terms of the expectations, there is a market expectation that deposit rates won't get passed on in full and, you know, we can't talk about what we'll do and what others will do specifically, but there is an expectation out there that not all of the base rate increases will be passed on in deposit rates.

But, in terms of, on the asset side, one thing just bear in mind, it's a fixed rate market. Pretty much everything we do on the asset side, it tends to be largely fixed rate and so, as a consequence, it's more about the yield curve and the shape of the yield curve and what people think about will be happening in sort of two, three, four or five years' time rather than necessarily what is happening today.

And, there's a lot of uncertainty about that and we've seen an expectation recently of rates rising and then going nowhere beyond a certain period of time.

So, again, I'd just go back to Richard's earlier point. It's complicated to try and determine what happens in a movement up in interest rates. A 1% increase in rates would typically throw through to a net positive £10 million in the net interest income line on a settled basis, but there are timing and phasing differences on that which are all driven by the pipelines and how the liabilities reset relative to the assets but that would be in the medium term unwinding effect of it all.

Ladies and gentlemen, as a reminder, if you would like to ask a question, please press star followed by 1 on your telephone. The next question is from the line of James Invine of Societe Generale. Please go ahead.

Hi. Good morning to you both. I've got two please.

The first is just a quick on IRB and to what extent you are factoring any IRB benefits into your pricing at the moment.

And then the second one is just I wonder if you can help us think about the Group's returns on equity as the mix changes. So basically what are the returns on equity in the two businesses and maybe just help us think about that. The biggest part of your cost base is in unallocated items and, I know it's called unallocated, but I'm just wondering if you might be able to indicate broad proportions between mortgages and commercial please.

Nigel Terrington, Chief Executive

OK. Very clear statement on IRB benefits – nothing is taken into account in terms of IRB yet apart from the cost – and I wouldn't really classify that as a benefit, that's more of a pain in the neck. So, nothing in there so that's future opportunity rather than anything taken into account today.

I would say the return on tangible equity point is less about what's achieved in a relative position between each of the divisions. It's more about the fact that we have the capital in excess of the regulatory minimum of over £400 million. If you consider that is being not utilised therefore the return on that capital which is probably largely held in deposits with the Bank of England is earning you 10 basis points - so the more significant effect is if we can employ more of our capital into higher yielding assets, then you should see further improvements in the return on tangible equity.

All of our businesses, we seek to achieve the minimum return on tangible equity of at least 15% and that we strive to achieve and we achieve on each of the business lines.

However, the bigger prize is in employing that surplus capital rather than leaving it idle or leaving it with a very modest return.

Richard do you want to cover the unallocated cost point.

Richard Woodman, Chief Financial Officer

Yes, sure.

So, we run a centralised model.

So, we have one IT department and last year, for example, they did a lot of work on the SME division in terms of getting that portal done. This year, the focus is more on mortgages. You know, we don't allocate it because it's not allocated on a sustained basis so where we have those efforts it varies from period to period. It's very difficult to do it and say well actually that's the all-in costs for mortgages may be x, where it could be x minus £5 million the next year.

So, we very deliberately keep those costs centrally. We keep all of our savings costs centrally. I suppose, if you wanted to, you could allocate those by the relative proportions of the drawn balances but, you know, what we try to do is to optimise the overall efficiency but those areas are costly.

You know we keep all of our regulatory costs centrally and that's a big number.

We've got a lot that we put into things like the IRB programme. Now, the bulk of that work over the last couple of years has been on buy-to-let. There's been more on development finance, but the other divisions will benefit because they don't have to do a Phase 1 going forward. So, you start to get into very, very spurious levels of accuracy and allocation if you try to properly move those areas out to the divisions.

Now overall, if I look at the position between buy-to-let and the commercial divisions, then once you've got towards an IRB end-state I don't think there's much of a difference between the returns we get from both.

James Invine: Can I just have follow-up please on the costs. Can you say what the headcount in Commercial Lending has done over the last few years. It's notable that the direct costs really haven't grown very much. I mean, I think they were £24 million this year and it was £21 million I think looking back in 2018, so you haven't seen much growth in the direct cost base despite a huge growth in the business franchise.

Richard Woodman, Chief Financial Officer

No, and the area that you would expect to see more headcount growth would be the SME division and clearly the whole UK SME market has been put under a little bit of pressure over the last 18 months and so, one of the reasons we haven't seen the headcount growth to date that we are forecasting is the fact that the business has not been there and available to frank those overheads.

We expect them to come through now and we're spending more money again, as a I say, on the systems and other developments side within that area.

We've started to add some heads on our development finance business and that programme should continue and so you will see a more material step up in costs directly in those areas in 2022.

I think I mentioned earlier, we're looking at somewhere between 15 and 20% of the uplift there.

The next question is from the line of Perlie Mong from KBW. Please go ahead.

Thanks for taking the question. It's just one on impairments so just really on the cladding issue. So, how much do you think that's going to be an issue for your portfolio and to the extent that it may be an issue how much provision have you taken on that?

Nigel Terrington, Chief Executive

So, as a lender we always had a very underweight position with regard to high-rise blocks. You probably may know that we have our own in-house team of surveyors very focused on our business and one of the things that we've always had – going back to pre-global financial crisis – we always had a very restricted policy on high rise properties and city centre properties. So, as a consequence, there is not a big exposure at all to properties that have got a so-called cladding issue.

I mean ultimately this is an issue for the customer rather than us but clearly the Secretary of State says it might impact the value of our security. You know, clearly, as you'd expect we've done assessments of our portfolio and we don't think it's necessitated any specific provision as a consequence.

Perlie Mong: I can just see that you're PMA hasn't changed very much this year so, what are the pre-conditions for you to release more of that PMA?

Yes, so what you will notice is that we've skewed it more towards the SME side of the business rather than the buy-to-let.

I think, clearly, there were a lot of customers that took payment holidays last year but the performance of those subsequently has been very good. There's been a bit more volatility in those loans and so we've seen a greater proportion of them going through to both having additional arrears but also clearing arrears so there's just a bigger delta, if you like, in the performance of those so we've maintained the PMA there but the very material increase in house prices over that period has meant that loss given defaults actually have much reduced so, as a consequence, we've reduced the level in mortgages.

Overall though, I think the SME area is a little more opaque and clearly it's an area where there are more businesses that are prone to interruptions and continued interruptions from things like Omicron if there's a – you know – lockdown or closures in the economy. So, with that lack of line of sight from the impact of all of the government reliefs and the like to our underlying models, we felt that we needed to put additional PMAs there.

But overall as you say there's been very little change in the aggregate position and the main movement in the year has just been a like-for-like in terms of the actual underlying modelling.

Ladies and gentlemen, as a reminder, please press star followed by 1 on your telephone. There are no further questions at this time and I would like to hand back to Nigel Terrington for any closing remarks.

Nigel Terrington, Chief Executive

Thank you very much.

I hope this has given you a good opportunity to run through the results with us and to discuss any particular questions that you have.

Richard is available to discuss with you today and tomorrow any particular areas that you want to cover and also to ensure that you've got as much information as you could possibly need in order to update your models etc.

In this regard, just the sort of final remarks from me will be, as I said earlier, we're absolutely delighted with these results. Not just in the financial results as we delivered this year – the 62% increase in profit - but actually in the fact that over the last two years we have continued to show the strength of the operational resilience of the business, the financial resilience of the business in terms of how good the asset quality is and the strength of the growth in new lending – a reflection of how good the franchise is.

And, with further developments, more structural developments – whether that be on the transformation programme or IRB - it gives us a lot of confidence about the prospects for the future and we therefore look forward to 2022 with increasing degrees of excitement and opportunity.

And, on that note, I will finish there and look forward to no doubt catching up with you in due course.

Thank you very much.