Paragon Banking Group PLC
2021 Half Year Results Webcast
8th June 2021

Speakers

Nigel Terrington, Chief Executive Officer

Richard Woodman, Chief Financial Officer

Questions From

Benjamin Toms, RBC

Gary Greenwood, Shore Capital

John Cronin, Goodbody

James Invine, Societe Generale

Edward Firth, KBW

Telephone Operator

Hello and welcome to the Paragon 2021 Half Year Results presentation. My name is Rosie and I'll be your co-ordinator for today's event.

Please note this call is being recorded and for the duration your lines will be on listen only, however, you will have the opportunity to ask questions at the end. This can be done by pressing *1 on your telephone keypad to register your question at any time.

If you require assistance, please press *0 and you'll be connected to an operator.

I will now hand you over to Nigel Terrington, CEO to begin today's conference. Thank you.

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Introduction & Key Highlights

Nigel S Terrington, Chief Executive

Good morning and welcome to Paragon's 2021 Interim Results presentation. Today, we'll be running through the results in some detail as well as providing you with some background to the trading environment, updating on our strategy and with further observations on the outlook particularly for the second half of the year.

Before we get into the details, I would like to just spend a couple of minutes looking at the half-year highlights and our current priorities. So, if we turn to the first slide.

This presentation and the results announced today cover the six-month period to 31st March during which society and the economy have continued to be dominated by the direct and indirect effects and consequences of COVID-19.

Most of this period we have all been subjected to varying degrees of lockdown and restrictions, and in this context, I'm absolutely delighted with the way our business has performed, not just in its resilience but 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.

While the 45% increase in operating profits has been heavily influenced by the impairment charge reducing to normalised levels, what this masks is a robust underlying performance, with strong recovery in lending volumes and pipelines near record highs, good momentum in the growth of the loan book, NIM increasing from 229 basis points to 232 basis points and is on an upward trajectory which we can expect to continue for the foreseeable future. And, of course, an excellent customer credit performance across all divisions.

The underlying momentum of the business is strong. The interruption to new business flows, particularly in the second half of last year, has largely unwound. With lending volumes up 45% on the second half of 2020 and with strong pipelines in most of the group's divisions means that we can expect a strong second half in activity levels as well the further improvement in margins.

We have always sought to operate with a cautious risk appetite, both operationally and prudentially, and this has of course been maintained. The balance sheet is strong with 99% of the loan book secured, largely on property.

Our capital ratios have been strengthened by retained earnings, our funding restructuring that has released further capital, all of which has led to delivering a CET1 of 16% and has enabled us to announce today a £40m buyback programme.

Not only is this a strong financial and operational performance but the business has also made good progress in its strategic priorities and objectives, which we can turn to on the next slide.

A year ago the onset of the pandemic caused us to reset our priorities. We have performed well against these objectives and remain committed to keeping them at the heart of our operational decision making.

Our people have been inspiring, showing great passion, commitment and dedication in supporting our customers through this difficult time. Over 90% of our colleagues have worked from home over the last 15 months and have made a huge contribution to this excellent outcome.

In turning to the future our operating model will of course change, but this will only be implemented when we have fully analysed and completely understood the consequences of a hybrid model.

We are now in the pilot stage of the return-to-office phase, testing different types of hybrid models and making further use of cloud-based technology that will add to the capability of an already flexible and agile team.

Payment holidays have been provided across most product lines and were supplemented with CBILS and Bounce-Back Loan facilities particularly in SME lending.

Whilst payment holidays have all but disappeared, we continue to stand ready to support customers and the economy should it be required including through the Recovery Loan scheme where we were one of the first participants when this latest government initiative was launched.

The capital supporting our business has been well protected. The balance sheet, as I've already said, is strong and is prudently provisioned with a capital base materially above regulatory requirements.

The Group's reputation and franchise has been strengthened over this period. There is frequent engagement with our customers, and feedback is both positive and reflective of the hard work over the last 15 months.

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

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

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Financial Review

Richard J Woodman, Chief Financial Officer

Thank you, Nigel. I'll start with my income statement slide.

As you can see, we've delivered strong headline performance with operating profits and pre-tax profits up strongly when compared to last year's first-half outturn.

I'll talk in more detail to the main items over the coming slides, but in summary we've seen further progress on net interest income with our margin recovering strongly following the decline in the second half of last year.

Our third-party servicing portfolios are steadily amortising resulting in the period-on-period reduction in other income.

Operating costs were up year-on-year, but the main movement relates to share-based accruals. These represent a catchup after the writeback that we reported at the interim last year.

Impairment charges were materially lower at £6m. Within these we've made additional overlays to our impairment models which now hold coverage ratios steady from their 2020 year-end position.

Yield curve movements have contributed to a rapid recovery in fair value movements. These tend to zero over time, but if you recall were a sizable debit in 2019.

Moving on to look at our segmental results, our two core operating divisions, Mortgages and Commercial Lending, saw strong increases in the contributions they made to the Group results for the period. Whilst the most material item was the reduction in impairment charges, first half pre-provision profits increased by 7.3% in Mortgages and 27.1% in Commercial Lending, demonstrating the underlying strong performance of these divisions.

Idem Capital's performance was little changed year-on-year with the ongoing amortisation of the portfolio remaining stable, building on a continued strong cash flow.

The central area reflects the share-based costs I mentioned earlier in the overheads line, but also a combination of both higher liquidity and lower returns on that liquidity in the income line.

My next slide looks at net interest margin. The charts clearly show that the drag effect coming from the Idem Capital portfolio runoff is having an increasingly small impact over time.

The material change in base rates seen at the onset of the pandemic in 2020 resulted in a short-term NIM impact on the second half with the margin falling to 2.18%.

Benefits of the lower rate were immediately passed onto our borrowers, but it took a while for funding to readjust. This impact was fully unwound during the period with NIM now ahead of its first half of 2020 level.

We continue to benefit from a structural NIM accretion with new Buy to Let loans being originated at wider margins than the back book and Commercial loans also being written at wider rates. This is shown very clearly on my following slide.

The legacy portfolio is gradually amortising but at a slow, steady rate. New Buy to Let loans are being written at yields of around 2% more than the back book and with even stronger Commercial Lending yields our overall portfolio generates the underlying structural NIM enhancement.

My next slide shows the change in funding mix across the period. The first half of 2021 has been a really busy and a very productive period for our Savings and Treasury teams.

Nigel will show a longer-term profile later on for we have seen some material movements in the last six months with Savings balances increasing at increasingly attractive rates for the Group. TFSME has been drawn. TFS has largely been repaid and the legacy SPVs have continued to be refinanced.

Savings deposits continue to be the focus of our liability expansion with the core proposition being enhanced by a broader development of relationship platforms.

Moving onto operating expenses, our cost to income ratio has been materially influenced over the past few years by the profile of Idem Capital's earnings, Idem being a high-yield low-marginal cost business.

The chart shows the profile of the trend movements in the ex Idem ratio together with the reported level.

The reported ratio has been broadly unchanged now since 2018 reflecting continued business investment, IRB costs and some relative swings on share-based expenses. On this latter point, we saw a writeback in H1 2020 and a catchup again in the last half year, the average of the two periods being in line with the previous reported levels.

Whilst not material relative to our peers, we have increased the scale of our software capitalisation when compared to 2020 as our technology enhancements get rolled out.

The bulk of our costs continue to be expensed, but the capitalised element has risen from £0.4m in the first half of last year to £1.4m in the latest period.

Our underlying costs continue to run a little below expectation, but the pickup in share-based costs means we'll be leaving our full-year cost guidance of around £138m, unchanged from the level we gave you at the end of last year.

My next few slides cover various aspects of the impairment charge to the Group. I'll start with our economic outlook and the scenarios we've used for our underlying impairment modelling.

As you can see from the chart at the bottom of the sheet our GDP forecasts for the base upside and downside scenarios reflect varying degrees of recovery from the COVID pandemic. They're all overlaid with different assumptions regarding house prices, which are only expected to remain positive in the short-term in the upside scenario.

Our scenarios continue to reflect rising unemployment, peaking at between 7.8% on our base case and 11.9% in our severe case. But clearly, we note recent performance and forecasts which suggest these levels may well not be reached. Our preference though at the interim has been to remain prudent here, given the 4 plus million people who remain on furlough.

For the severe case, we've taken our 2021 Bank of England stress and overlaid this with a harsher house price profile. This represents near 35% peak to trough reduction in house prices and a very slow recovery from that position.

The scenarios table on the slide details the impact that the different economic scenarios have on our interim provision and there's a £65m swing between the upside and severe cases. This potential volatility in outcomes has contributed to our thinking and our approach to post-model adjustments at the interim, and I'll come onto those in a moment.

My next slide looks at payment holidays and clearly this has been a particular feature of the COVID response.

We hit peaks in the summer of 2020 of around 2.5 billion of customers taking holiday reliefs. The levels are almost fully back to normal payment arrangements and only £30m or so of balances are still remaining with payment holidays in force.

Of those customers that took holidays there's been a pretty even distribution between those that saw their arrears worsen afterwards and those where their position improved.

Whilst the net figure in the little box on the left is minimal there's a greater degree of volatility in these accounts, which again contributes to our thinking around post-model adjustments.

If we can move forward a slide this one details for the actual impairments, PMA approach and coverage ratios.

Starting with the table on the top right the multi-economic scenarios used before any PMA would have delivered a reduction in the calculated provision to £54.9m. The effect of this would have been to take the impairment coverage ratio down from 64 basis points at the year end to 47 basis points at the interim.

A consistent application of the PMAs we used at the year-end which reflect the general lagging impacts of government interventions on impairment emergence and the specific effect on payment holiday accounts would have taken the coverage ratio to 57 basis points.

Given the volatility we've seen around scenarios at the interim we've added a further PMA. This serves to maintain coverage ratios at the September 2020 level.

The table at the bottom left shows in the right-hand column the actual levels reported at the interim. To give some additional transparency around the impact of weightings and PMAs, we've shown the level of provision required if PMAs were retained at their September 2020 levels but instead applied to the weightings that we used when we first transitioned to IFRS 9. This is in the left-hand column and reflects more benign times.

As always, we'll keep a close watch on consumer - customer performance and macro developments to determine the right levels of scenario weightings and PMAs at the year-end.

My final table on this page details the year-on-year comparison as indexed behavioural scores for each of our retail portfolios. Whilst there will always be volatility within any average the overall position for each portfolio is improved from its March 2020 level.

My next slide summarises the main movements in capital from September 2020 to March 2021. The first one we note is on the IFRS 9 transitional adjustment and the impacts here are immaterial at just 0.01% of CET1.

Profit levels have been strong in the period as we've reported, and this has contributed a 1.1% CET1 improvement.

The balance sheet was little changed in the period and the overall risk weight density actually fell. However, we expect this to reverse going forward as our Commercial Lending portfolio expands.

In numbers terms, our risk rate density was 44.6% at September 2020 but has reduced to 43.5% at March 2021.

The interim dividend has been set in line with policy at a half of last year's final dividend. This represents a 0.3% use of CET1.

Other movements are a bit more material this time around. We've seen favourable impacts on the deficit on our Defined Benefit Pension Scheme. This fell to £11.8m at 31st March, contributing 0.1% to our CET1 figure.

Fair value movements on portfolio hedges have contributed a further benefit and the repackaging of extant securitisations removed £0.2bn of risk weighted assets from the balance sheet. These represented the fair values of currency derivatives and associated CVA adjustments within those deals. This contributed some 0.5% CET1.

At 31st March, we had a further £0.2bn of fair values ascribed to currency swaps in vehicles where calls have now been placed. As such there'll be a further small CET1 gain in the second half of this year from this activity, but this won't repeat again going forwards.

Our UK leverage position continues to be strong and generates no constraint on our operations.

My final slide summarises our capital position at the interim.

The impacts on the previous slide have contributed to a strong capital position at March, with CET1 16% and a total capital ratio standing at 18.2.

In addition to our actual capital levels increase, we've also seen our regulatory requirements fall during the period following the PRA's review of our ICAP in their periodic C-SREP process.

We would always look to operate at a level above the regulatory minimum and we should also note that the countercyclical buffer currently stands at zero. But notwithstanding those, our capital position still remains strong.

This exceeds our near-term organic growth requirements, so we've chosen to announce the buyback of up to £40m that Nigel mentioned as part of his introduction.

My slide also notes the ongoing progress we're making with our IRB application. As I mentioned last year, we've started with Buy to Let and our Phase II documents are with the PRA for review where we await their feedback and a confirmation of their requirements for the next stage of our engagement with their expert teams.

We're also well progressed on our development finance IRB rollout and would expect the application for that portfolio to be made in early 2022.

In summary, I'm really pleased to be able to summarise such a strong set of results with record first-half profits, continued caution on our impairment assessments, a capital base that reflects these strong earnings, a quality loan book and careful balance sheet management.

And I'll now pass you back to Nigel. Thank you.

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Business Review and Outlook

Nigel S Terrington, Chief Executive

Thank you, Richard. I will now cover the wider business performance, our strategy and outlook.

This slide represents our strategic framework, something we set out in some detail at the last year-end, and it is clear how we applied this in practice in the first half of the year.

The use of the deep knowledge and multicycle experience across the Group supported by extensive data analytics can be evidenced in each business line and will be seen across the next few pages.

Importantly this capability enables us to take a low-risk approach in specialist lending sectors where larger banks would struggle to achieve the same outcomes.

The increasing focus on specialist markets also needs to be set in the context of the need for scale. Banking has relatively high fixed cost structures and certain markets do not generate adequate revenue either through yields or in absolute scale, and consequently we seek to avoid them.

This can be seen by the recent decision to exit our presence in the second charge market. The market is small and was not capable of generating sufficient revenue to justify the investment required.

Technology is becoming increasingly important to all banks, and this is also true of Paragon. Our strategy to create a technology-enabled specialist bank is being achieved through a digitally focused cloud-based modular approach, delivering modern technology across key areas of the Group.

Some phases have already been delivered such as the new Savings platform, 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, thereby increasing the scale of our addressable market.

These capabilities are helping us to erode some of the competitive advantages held by the clearers such as their cost of funds and capital efficiency via IRB. However, always we will retain our key points of differentiation, particularly around our focus as a specialist bank.

We stated at the year-end that we remain committed to the return on tangible equity target of 15%. There has been nothing this year that has shaken us from this belief and our decision to launch a buyback programme is part of the process of delivering on this commitment. Although it should be emphasised this is not to the exclusion of employing capital to support growth organically or inorganically.

Turning to the next slide, we can look at our wider responsibilities. 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 recognise as is the case for many that this is work-in-progress, not just in terms of our operations and our funded emissions, but also in the way in which we communicate.

In our full year results we expect to share with our stakeholders a more meaningful description and explanation of our activities and plans. However, we have not been idle. We recently issued the first ever UK bank Tier-2 Green Bond where the proceeds will be used exclusively to provide environmentally enhancing lending products.

In addition some of our lending products such as the recently launched EPC A-C rated Buy to Let mortgage provide further evidence of our commitment to doing what is right.

As I said, this is work-in-progress for all of us, but we will have more to say at the year-end.

I can now turn to reviewing each of the key product lines, starting on the next slide with Buy to Let.

The comparable period last year was in reality largely pre-pandemic, so achieving 95% of the 2020 equivalent period volume is pleasing in itself. However, momentum is strong with H1 lending of £715m, which itself was 58% above H2 last year and where this year's Quarter 2 was 16% above Quarter 1.

The Buy to Let pipeline stood at £930m as at the end of March but has strengthened further since then. We therefore expect the second half of the year to deliver further growth in volumes. Redemptions remain low, driven by customer retention activities, thereby continuing to support growth in the loan book.

There is of course a lot of noise around the housing market due to the stamp duty holiday as well as lockdown-driven changes in property demand.

The freezing of the market last spring, thawed by the summer. And although some softening was evident in Central London, this has now stabilised, with all other regions remaining steadfastly robust in terms of both purchase activity and rental demand.

Turning to the next slide we can look at the Buy to Let credit performance. As you are aware we have extensive experience in Buy to Let going back over 25 years, with data capable of being used to support stress testing, our important IRB programme, underwriting, as well as portfolio management.

The quality of the loan book has been evident through the customer credit performance over time and under stress in the pandemic, as well as during and after the global financial crisis. With an average LTV of only 64.4% and importantly only 2.9% greater than 80% LTV the 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 with open banking and API capability has been well received.

Separately our systems analyse 750 million pieces of customer data and are used in behavioural scoring models in our portfolio management teams.

We can therefore be confident that despite the strong growth we are seeing it is being delivered with the same cautious risk appetite that has been successfully applied for approaching three decades.

Turning now to our Commercial division. Commercial Lending is of course a more cyclical business line and new business activities were more immediately impacted by the onset of the pandemic last year, something that was particularly true in SME lending.

As can be seen from the graph on this page, activity levels were particularly affected by the first lockdown last year. However, the first three months of this calendar year witnessed a good recovery where it is notable that the economy as a whole has learnt how to adapt to lockdowns.

This recovery has continued into our quarter three, which has also been supplemented by Motor Finance, restarting a broader range of products.

We can now look at the Commercial business lines individually over the next few pages.

Development Finance has had a comparatively robust and stable pandemic, with new lending up 16% on last year and the portfolio seeing a 10% increase to over £550m, with yields being maintained. With a pipeline that has seen further growth and is close to an all-time peak, the prospects for our Development Finance division are increasingly encouraging.

If you now turn to the next page, we can look at our SME division. SME was our most impacted division with customers deferring investment decisions and making extensive use of government initiatives such as CBILS and Bounce Back Loans, which in effect substituted for more traditional facilities. Whilst we have participated in these schemes, our focus was very much supporting our existing customers, rather than using those schemes as a marketing initiative.

In credit terms the portfolio has performed well with payment holidays reducing to negligible levels. Only 1% of the book now requires some form of ongoing support. The page shows how well diversified the portfolio is and has only £32m of balances in the more COVID affected sectors, and of this, only £2m is at stage 2 and 3, under IFRS 9.

New technology will also play a role here as well. A cloud based, open banking and API capable intermediary portal is being developed, which will be used alongside a data driven decisioning model, accessing over 3,000 pieces of data as part of the underwriting process.

Customers have been more optimistic about the future and increased investment is being seen. Month on month progress is now being achieved as the economy recovers and we expect strong outperformance in the second half of the year compared to 2020.

So finally let's look at the Savings and Funding side of our business. Our Savings business has been a real standout performer. Deposit balances are up 25% over the last year and up 10% since September and more recently passed through the £9bn portfolio milestone. This has been achieved whilst rapidly reducing retail funding costs, down from 134 basis points in September to 108 at the half year and now has fallen below 100 basis points.

With a still favourable front book, back book dynamic we expect further reductions in funding costs in H2.

Not only has the Savings business funded the growth in the loan book, it also refinanced over £800m of legacy securitisations, which also 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, on this occasion at nearly 300 basis points lower than the existing deal, virtually all of which was due to the improvements in Paragon's credit spreads.

We have not had to issue MREL debt and although the framework is currently being reviewed by the Bank of England, we do not believe MREL will apply to us for the foreseeable future.

New technology is already playing an important role within our Savings business. The new digital platform being used to manage third party relationships as I mentioned earlier, has the potential to deliver enhanced capability in due course.

Our view is that there is potentially a big prize due to the structural changes in the Savings market, with over £800bn of deposit balances held with the clearers earning virtually nothing. And where open banking and API technology could help breakdown the inertia within the current system and lead to a more level playing field and an erosion in one of the big banks key competitive advantages. This will of course take time, but the scale of the opportunity is meaningful.

So finally, in conclusion the first half of 2021 has evidenced how well the business was positioned going into the pandemic, how well the disruption was managed and how we are in a strong position as the economy moves out of recession.

Lending volumes have been growing on a monthly basis as momentum has seen quarter two outperform quarter one. And with strong pipelines, we are expecting further growth in the second half of the year.

These are of course unusual times and numbers have been more volatile from period to period. In order to help we are providing some explicit guidance, although please do not expect this to happen every year.

We've previously expected Buy to Let volumes of £1.35bn for the year, we now expect £1.5bn.

Commercial Lending expectations are that volumes should now exceed £900m for the full year.

Our original NIM expectation was for 229 basis points for the year. This has already been exceeded in the first half and with good asset yields, the continued structural shift in the business mix and further funding cost benefits to come we are now looking at NIM for the full year to be at least 235 basis points, with the upward trajectory set to continue for the foreseeable future.

Costs should be in line with the original expectations of £138m.

The quality of the balance sheet, underpinned by strong capital ratios has ensured the Group is incredibly well positioned to deal with any disruption caused by the unwinding of the Government support programmes, as well as being well placed to support growth and to react to opportunities, organic, or inorganic that may arise.

These have been challenging times and this pandemic is not over. But I am incredibly proud of the way our business has responded in supporting our customers, our staff and the wider community by doing the right things and doing them well.

Whilst there are unknowns in the periods ahead, we are also excited by the opportunities that may emerge and in continuing to develop and grow the business to become the UK's leading technology enabled specialist bank.

That concludes the presentation part of today's event. We are now ready to take questions.

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Questions and Answers

Telephone Operator

Thank you. So as a reminder, if you would like to ask a question please press *1 on your telephone keypad. Should you wish to withdraw your question you can press *2. You will be advised when to go ahead.

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

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Benjamin Toms, RBC

Good morning and thank you for taking my questions, two from me please. Firstly, on the dividend buyback, can you just talk through the Board's thought process of the balance you've chosen between dividends and buyback, and the quantum of the buyback?

And then secondly, in December 2020 there was a government paper requiring all non-domestic buildings to have an EPC rating of B or higher by 2030 to be let or sold. I'm just interested on your thoughts on, one - whether a similar rule could be imposed on residential property in the near future and secondly whether this would be a big deal if it was? Thank you very much.

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Nigel Terrington, Chief Executive Officer

Okay, so let me just handle that. So the mix between our different methods of capital repatriation and frankly more broadly the employment of capital is always something that needs to strike a balance.

So you know you've clearly seen a very strong accretion to our capital ratio and our strategy and policy in terms of dividends has always been in the past that you know a dividend is a phrase, it's a bit of a cheesy phrase but you know a dividend is for life, that is what you want to maintain, you know, to the absolutely extent possible.

So we have always taken a more cautious approach to dividends, our pay-out ratio of 40%, 2.5 times covered, has been something that we've always wanted to adhere to and then use buybacks as a form of - a method of regulating our capital. If you look back over the last five or six years, we've been a frequent user of that strategy and we have had extensive buyback programmes in the past.

So this should not be any great surprise and it's actually just a continuation of what we have done in the past, and you should read nothing more into that.

The important bit though is our view is that you should not also view a £40m buyback as being anything to do with - we're lacking ideas, we're lacking growth, you can clearly see strong growth in the expectations for the business going forward. But clearly, we have a very high level of capital, and we just think that it's appropriate to regulate that a little bit further.

In terms of the EPC question, I think the journey - the travel, the journey that we're on here is that we should expect continuing tightening of the various standards on the various sustainability measures. So you know you've seen us launch a product this year where we have offered particularly attractive terms for landlords with an EPC rating of A to C, it's like an encouragement for landlords to upgrade their properties.

I think if you address this to the wider market there is a lot that has to happen between now and 2030 as you pointed out in terms of improving or upgrading the standards in the property. But I think the government - you know we've got COP26 later this year, the government is very intent on its strategy towards wanting to get as many improvements across the economy as a whole in terms of sustainability.

I do think that this is one of the big potential strategic initiatives for the banking sector across the next ten to twenty years. It's clear that none of this is going to happen overnight, but I think that the industry will have to pay a lot of attention to upgrading or getting the properties to be upgraded over the course of the next sort of nine years or so.

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Benjamin Toms, RBC

Thank you.

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Telephone Operator

The next question comes from the line if Gary Greenwood from Shore Capital. Please go ahead.

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Gary Greenwood, Shore Capital

Hi, morning, I've got two questions if I can please. So the first one was just following on from Ben's question on capital and just thinking about your ROTE target. I think historically you've talked about maybe getting down to about a 13% core Tier-1 ratio is the right sort of level for the Group to operate. So I was just wondering if that's ultimately the target in order to deliver that 15% plus ROTE target?

And then the second question is on funding. Obviously good to see the Green Bond launched at a price well inside of the older bond. I was just wondering how much of the improvement in pricing you would put down to the fact that this is a Green Bond and therefore you are getting these sorts of ESG benefits?

And then also related on funding, obviously your loan to deposit ratio has been coming down as you've been growing the retail funding within the business. Do you have a sort of target ultimately that you want to get that down to, is there sort of a right balance there for the business? Thank you.

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Nigel Terrington, Chief Executive Officer

So let me just deal with the Green Bond to start with and maybe Richard you'll pick up on the capital point earlier?

In terms of the Green Bond I think we made a comment in there that most of that 300 basis point improvement was attributed to a tightening of the Paragon premium, the credit premium over the risk-free rate compared to where we were five years ago.

I would say this is still very early days for the development of the ESG agenda and the investor community looking at these bonds as being - where there is a sufficient degree of differentiation taking place because it is a Green Bond, as opposed to you know a non-green bond.

I also think that deal was a sort of sub-sterling benchmark issue. So a typical sterling benchmark issue is around £250m, it's only £150m, so because of that a lot of the bigger funds, some of the more household names, it's just below their radar. So I think that would have attracted a broader ESG following if it had been.

So I don't think there was much in the price because of it but I do think that there is a lot more to come from that in the future. Richard, do you want to cover the ROE?

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Richard Woodman, Chief Financial Officer

Yes, sure Gary. So start with I'd stick with that 13% CET1 level as our broad guide. I think that there will be further updates that we'll need to give as we go through the roll out of IRB in years to come. The relationship between the Pillar 1 requirements and Pillar 2 capital mean that that appropriate figure may change over time a little bit. But certainly for your plans at the moment I would stick on that basis.

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Gary Greenwood, Shore Capital

And just on the retail funding the level that you'd wish to get that at?

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Richard Woodman, Chief Financial Officer

Yes, so if you go back go the point that we launched the bond - the bond sorry - the bank, clearly, we were pretty much 100% incumbered, you know the Group's funding then came in the form of warehouse and securitisation lines. But if you look at the typical balance around most European banks, you've got incumbents of probably between 20 and 30%. I would have thought that in a BAU environment that's the sort of range that we would end up looking to operate in.

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Gary Greenwood, Shore Capital

That's great.

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Richard Woodman, Chief Financial Officer

Slightly inverse of your loan deposit point, but you get to the same answer.

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Gary Greenwood, Shore Capital

That's very clear, thank you very much.

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Telephone Operator

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

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John Cronin, Goodbody

Good morning, thanks for taking my question. I have a few, the first one is on Buy to Let - asset yields. And just in relation to your full year NIM expectation of greater than 235 basis points, so that embeds assumed stable pricing through the second half? And maybe if you could talk a little bit about what you're seeing in the market in terms of competition, rate competition particularly?

Secondly, I just wanted to ask as well on Basel 3.1 and when you expect to have some more clarity from the PRA in terms of the recalibration of the standardised risk weights regime. Look I appreciate that your IRB application with respect to Buy to Let is in train and could well be approved before the 1st of January 2023, but I just wanted to get a sense of the kind of latest in terms of your thinking on the standardised risk weights and how they might move?

And then finally just a quick one really on - given your pre-funding and excess capital and albeit you've announced a £40m buyback, but what kind of opportunities are you seeing in the market for potential inorganic expansions, you know how is pricing in relation to any potential such transactions? Is that pretty - are price expectations excessive on the part of vendors? If you could speak a little bit there about what we might or might not see I suppose on a medium-term view that would be helpful. Thank you.

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Nigel Terrington, Chief Executive Officer

So Richard, cover Basel 3.1 and then I'll pick up the others.

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Richard Woodman, Chief Financial Officer

Yeah sure. So in terms of the process on Basel 3.1, we understand that the PRA are going to run a consultation process later on this year, with the idea then that they will produce a policy standard in the middle of 2022 and the latest we've heard they are still very much aiming at a 1st of January '23, introduction.

So I think there will be a lot going on over the next few months, certainly by the time we report at the full year we would have expected for that consultation period to have been completed and we'll be able to update you then on what our view around that consultation is. Until we see it it's hard to tell.

In terms of the piece around the risk of any potential risk weight inflation that comes from Basel 3.1, it's worthwhile nothing that during this period we've had an update on our regulatory capital requirements from the PRA, which has resulted in a much-reduced level of Pillar 2A from the levels that we were operating at previously.

In terms of capital risk in Basel 3.1 that mitigates that risk very, very materially, if not wholly. And so we can look forward confidently in terms of our capital position, almost absent any consideration of the timing of IRB or that Basel 3.1 introduction. And on that basis, that's why we've been happy to announce the buyback today.

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Nigel Terrington, Chief Executive Officer

Okay, so in terms of the Buy to Let, I presume John you're talking about mortgage yields as opposed to the underlying property yields?

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John Cronin, Goodbody

Yeah.

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Nigel Terrington, Chief Executive Officer

But you know where you saw a pricing - let's call it a mini correction take place a year ago for the mainstream mortgage market, it was - just as people rebased in a risk environment, rebased their pricing upwards. It was less pronounced in the Buy to Let market, but there was also a fair bit of LTV adjustment that took place at that point as well. So for a low LTV the pricing was maintained. So on a risk adjusted basis there was certainly an enhanced mortgage yield that was coming through.

I would say if you looked at the data, there is nothing to suggest - as I say there is some softening taking place in the mainstream mortgage market now, but that's not feeding through so significantly certainly in the data onto the Buy to Let market.

We do see a little bit of noise out there. There has been typically credit standards have been - people have been very sensible on that. But there has been a little bit of price competition I would say coming from some of the non-banks. I think they have had a bit of a run on very - you know much cheaper wholesale funding costs that have come through in the last few months or so. And so I think they've got a little bit of a benefit from that.

But we're getting a very, very strong return on equity on our Buy to Let products. We have certainly got a much better funding position than we had a year ago, than we had six months ago. And I think as I pointed out in the presentation, our front book back book dynamics are such that you know we expect to see further liability margin improvements coming through, not just over the next six months, but probably for at least a year or so, maybe longer beyond that as well.

So whilst there's a bit of competition it's certainly not something that is being massively disruptive. And so that's that.

In terms of the M&A side you've seen the fact that - a little bit like we've not been frightened to use capital buybacks as a method of regulating our capital. Also, one of the things I like about buybacks is they act as a discipline. You know there is always a danger for banks if they have got too much capital it burns a hole in their pocket, and they have a need to spend it. I don't think we've ever felt that.

And so for us we always wanted to sort of use any capital on the acquisition side to develop the business. So you've seen us make four acquisitions in five years, all of them have been very, very useful and supportive of the diversification strategy and have basically helped us form the Commercial Lending division as it is today.

All acquisitions in fact all organic initiatives and growth have to pass the centralised 15% return on tangible equity objective. So if we find an M&A opportunity it will have to get through that test.

Now for as long as I can remember vendors have always had a high expectation of value. And sometimes those can be realised, not with us, but they can be realised and sometimes they're not. We are very patient, and we will not dive in unduly on any part of our business in terms of the M&A front. And we also have the discipline there to say we're happy to return capital if we cannot employ it in any useful and meaningful timescale.

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John Cronin, Goodbody

That's very clear, thanks. Can I come back on one point, actually for you Richard. Just on the receipt of the policy standard in mid '22 from the PRA as in your expectations, is that enough time for the industry to get itself prepared you know to the extent that there is substantive change in the risks weight recalibration context?

I mean look I appreciate from your perspective you're made the point that you must reduce P2A requirements so that is naturally going to mitigate, and you know you might well have IRB anyway, I guess. But you know is it enough time for systems change, could you see I suppose a potential push on the part of the industry to have the kind of implementation date of the 1st of January 2023 pushed out, or am I overthinking this on the systems capability point?

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Richard Woodman, Chief Financial Officer

I think more notice would obviously be better than less. The requirements have been pretty well trailed for some time, so that market has got a pretty good idea of what's going to come along.

I do think there are some nuances that people's existing systems for their risk weight reporting don't cover that easily in terms of their core reports at the moment. You know one of the obvious things is the potential for using original valuations rather than index valuations for their reporting and analysis. So the degree to which that is a major systems recalibration I think is going to be one that each individual firm will need to look at.

It feels like a very tight period, and you would normally expect something a little bit more material in terms of timeframes to deliver that. So I think a lot will depend on the interpretation that that PRA take. If they, you know, there will be a range of national discretions and interpretations that they need to incorporate. And if those are more consistently and closely aligned with that approach of banks at the moment it may well be quite possible then to get that done in time. The more radical the changes the more challenges there will be in terms of implementation.

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John Cronin, Goodbody

Thank you.

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Telephone Operator

The next question comes from the line of James Invine from Societe Generale. Please go ahead.

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James Invine, Societe Generale

Hi, good morning Nigel, good morning Richard. I just wanted to ask please about any insight you can give us on the resilience, the financial resilience of landlords. I mean I presume you saw the English Housing Survey that came out fairly recently and that was suggesting that 9% of private rental tenants are in arrears, so that's up from about 3% prior to COVID, which given that you have a reasonably decent metric on credit quality means that the landlords are able to take the pain. How much more pain could they take, I mean just assuming the unemployment numbers don't turn out quite as well as expected and so on. How much more pain can your landlords absorb before they start passing it on to you?

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Nigel Terrington, Chief Executive Officer

Okay, so yes, we did see the English Housing Survey and we obviously conduct a lot of our own private surveys. We also do, one of the things I referenced in the presentation was the analysis that we do on a monthly basis where we download 750 million pieces of data. This is not our own, this is our customers' data but from public information and this gives us a little bit of an insight into their lives.

I appreciate that does sound a little bit Big Brother, but - and it tells us even though the loan is fully performing, and they haven't missed a beat, it will give us a little bit of a warning, a heads up if there's anything odd going on in their lives. And frankly there is nothing that gives us any cause for concern about the underlying behavioural modelling characteristics of our landlords.

Now turning to your point specifically on what tenants are doing. There is - invariably some tenants will have come under some pressure during the course of this last 12-month period. What landlords have done, where they have come across those situations, I think they have behaved very responsibly and very sensibly, and they have worked with the tenants where that has been necessary. And they have agreed maybe a temporary reduction in rent, they have agreed that they can pay let's say 80% and the 20% would get in effect capitalised into a payment plan over an extended period of time.

What we are seeing is no undue levels of stress applying across the book and no notable levels of stress even in some subcategories or even geographic regions as a consequence.

You know unemployment I think has surprised us all about how resilient it has been. You've seen - you know the forecasts were 8, 9%, you know when this all kicked off, and here we are at 5% and you know seemingly heading south. We have clearly got the unwinding of the furlough scheme still to come later in this year. But we also see significant talks of labour shortages taking place across key parts of the economy.

So overall you know we always keep an eye on it. We're monitoring our portfolio on a very regular basis. There are no levels of stress that give us any cause for concern. But we have been cautious which is one of the reasons why we've maintained our coverage ratio where it is.

Also, I would point to the loan to values, you know at 64% loan to value, you're got a lot of asset coverage, only 2.9% of that is above 80% loan to value. And when you look at one of the things that people have highlighted is Central London has been a bit of an area of weakness, which - there has certainly been some weakness in rental demand up until maybe six months ago. It stabilised then and actually rents are starting to rise again in that area.

But our average loan to value in London, we don’t' have much by the way in London, but the average loan to value is below 50%. So I feel pretty confident that the position could be maintained.

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James Invine, Societe Generale

Okay, got it. Thank you very much.

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Telephone Operator

Before we continue on to the next question, please be reminded that should you have a question you can press *1 on your keypads.

Our next question comes from the line of Edward Firth from KBW. Please go ahead.

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Edward Firth, KBW

Morning everybody. I have two questions please. The first one was just coming back to this question of your yield on new mortgages, which I think in the presentation you said was almost 4% and just trying to really understand that, because I mean rental yields in the UK are running at somewhere just under 5, I can go out tomorrow and get a Buy to Let mortgage at 1.5%.

And I just don't really understand why when the market is so benign for house prices, the outlook is so good, unemployment is so great, but firstly people are prepared to pay that to you when the yields they're getting can't be much in excess of that and or why other banks are sort of piling into that market and undercutting you. So I guess that would be my first question.

Should I go onto the second one, or do you want to answer that one first?

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Nigel Terrington, Chief Executive Officer

Okay, let me just deal with that one.

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Edward Firth, KBW

Sure, sure.

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Nigel Terrington, Chief Executive Officer

So the mortgage yield that you're referring to that's lifted from the pack is the EIR, so that would include fees so that's not the headline rate. And secondly, whilst you can get mortgages at 1.5%, and obviously lower than that in the mainstream market, it will also depend on a whole bunch of other characteristics, one of which is whether they are a specialist landlord, whether they are dealing with more complex properties, for example, HMOs, student blocks, or anything like that.

So there is a whole range of factors here why 1.5%, because if that rule applied everyone in the world would get a mortgage at 1.5% and you know …

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Edward Firth, KBW

Exactly that's what …

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Nigel Terrington, Chief Executive Officer

So it is more complicated than that and there is a broad range of criteria that apply. You've seen that about 96% of all of our new lending is in a category called complex. And complex will be the professional landlord, it will be corporate situations, it will be complex properties like an HMO, a student block, or something like that.

So you can see that those are not done by the mainstream high street lenders, just because it requires a bit more experience and it's less commoditised in its approach. So that's why we justify a premium mortgage yield relative to some of those more mainstream products.

The rental yields, 5% or so, and there is a range, it would be lower than that in London, but you can get quite a bit higher than that depending on different parts of the country and whether you have a complex property. Student lets for example, do not get 5%, they are higher than that and they need to be higher than that because there is usually more maintenance cost involved in it.

So it is a variety of factors that go into this. And you shouldn't look at a 5% return versus 1.5% or 4% or whatever, because that's assuming 100% gearing, as your costs, which clearly never happens. You know the average of 64% would mean that you're looking at 3.5% versus 5% in your example. So you know where you're approaching their, whatever it is, 140 to 150% debt service coverage ratios.

So I think it is for a whole bunch of those reasons why I don't think that that's necessarily - life is not as simple as that. Do you want to cover the second question?

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Edward Firth, KBW

Just slightly related to that, you might quote this somewhere and I apologise. Do you know what is the average rental yield of your financed book is, do you have some sort of measure of that?

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Nigel Terrington, Chief Executive Officer

I think we can measure it against what is current as in what we've originated now. But you know we've got loans on the book that - you know we've got £4bn worth of loans that pre-date the financial crisis. There has been fairly strong rental inflation since that time, so we can index it, but it wouldn't be as accurate a piece of data as a relatively new.

But the yields off of our new flow will typically be in the order of somewhere between 5.5 and 6%.

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Edward Firth, KBW

Okay. That's very helpful thanks.

And then I guess my other question was related to house prices, you know a sort of broader sector question. But I go back to this time last year everybody was sort of super bearish on house prices and very cautious and prudent. And we come on a year and house prices are up what, 11%? And now everybody seems super bulled up on house prices and super optimistic. And yet we're also thinking about rising interest rates, stamp duty coming back in. So you know it's not impossible to think of a situation where that might not necessarily come through in the same way as it didn't come through last year as we expected.

What's your thinking on that, both in terms of how you manage the business but also just generally in terms of are you as optimistic as perhaps many commentators are, or do you seem more reason for caution let's put it that way?

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Nigel Terrington, Chief Executive Officer

Yeah, I mean you're right. I mean there are a lot of things in the last 12 months that surprised us and the strength of the housing market or the strength of house prices and the housing market have been one of them.

Clearly you can't have 11% increases in house prices taking place year in year out. And what you've got is a couple of factors. You've clearly got the extra spurt of activity being caused by the stamp duty changes. Now I think the actions that the government took to phase out stamp duty is sensible. You know we've always seen stamp duty changes being used as a bit of a blunt instrument that accelerates activity and then there's a cliff edge and it all comes off in the next quarter.

Here there was a small blip that took place in March, I think there will be a small blip in June, there will be a small blip in September. But phasing that out is both helpful for the market, helpful operationally and also is something that will at least mitigate to a degree that cliff edge type of event that we have seen in the past.

I think then you will undoubtedly get a final quarter of the year which will be a quieter quarter than we will have seen in the previous year. But when you look at the long-term situation, I think you have to always come back to affordability. Affordability is running at kind of half the levels at which you would say this looks like a problem. And clearly, it's a combination of very low interest rates and incomes that have been, you know generally supported over X number of years.

So I think house prices would have to still run up quite some way, I'm not suggesting this will happen by the way, in order to show affordability constraints like that times that we saw running up into the financial crisis and actually any other time when there was a house price correction, you always - it was the pre curser was when affordability was getting stretched. And it is a long, long, long way from getting stretched.

So I get your points about 11% is not sustainable and it's not, but nor do I think it's in correction territory either.

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Edward Firth, KBW

Great, thanks so much.

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Telephone Operator

We have no further questions coming through, so I will now hand back to Nigel for any closing remarks.

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Nigel Terrington, Chief Executive Officer

Okay, so thank you for your time this morning. I mean you will have got a real sense from us about how pleased we have been with the performance of the business. You know the operational resilience has been very evident and very strong. And my hats go off to our colleagues who have been absolutely wonderful in the way in which they've supported this business and our customers throughout the difficult period. And then just when they need to take breath, they're not supporting the growth phase as we emerge from that difficult 12 months.

The business is in really good shape. We have got a lot of capital, to the extent that we can afford buybacks. We've got a lot of capital to support organic growth and if the right opportunities come along, inorganic growth. But more importantly than that is just the underlying business trend with good momentum in terms of new lending.

And actually quite importantly I really want to emphasise this is the NIM, you know, we make our money by the size of the loan book increasing, multiplied by the NIM, that generates the vast majority of our income. And that NIM, there is the structural improvements that are taking place on the asset side as the business mix changes, but also, we're seeing the real benefits of the way in which the funding side has kicked into gear over recent times and the way in which the NIM is being improved by benefits on the liability management of the business.

And the dynamic there is that there is more to come from that side, both in the short term, but I also think there is a longer-term structural shift taking place in the way liability management is done in the banking system in the UK, which should bring us advantages.

One of the key bits we're seeking to do is this levelling up concept and it's not like trying to jump on the government's bandwagon, but it's a levelling up in terms of the competitive position versus the giants in our industry. And we are trying to do it on our capital side through IRB and through the developments on our liabilities side. Those two big advantages there of improved capital efficiency and improved funding efficiency will give us so much more flexibility in order to expand and grow our lending side.

So we're very excited by the opportunities ahead, both organically and across any opportunities that may occur on the wider sense.

We're never going to be frightened about returning capital because I think it operates as a very good and strict discipline for our business. But we always will keep a weathered eye on the wider situation. You know as I said in the presentation, we're in the middle of a pandemic, you know, some of the numbers are going in the wrong direction, the vaccines are great, but we need to get them rolled out. But we also live in a world where every country is interconnected in some way.

So there is a pandemic and therefore we've chosen to be cautious in terms of the way in which we have managed the provisions and also cautious in the risk appetite that we continue to adopt through the business.

So very excited and we see some very interesting times and opportunities ahead. Richard has already got some meetings lined up with you over the next day or so. If any of you want to speak to him a bit more we're here to help, we're trying to help you with this. We have given specific guidance this year on some numbers because we do understand there's a lot of moving parts and it is quite involved. So please feel free to get in touch with us we're happy to speak with you further.

So once again thank you for your attention this morning, thank you for your interest and we look forward to speaking with you in the near term, or if not in six months' time. Thank you very much, bye.

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Telephone Operator

Thank you everyone for joining today's conference, you may not disconnect your lines. Thank you.

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