Paragon Banking Group PLC
2022 Half year results
Transcript of presentation to analysts

Nigel Terrington, Chief Executive

So, good morning and welcome to Paragon's 2022 Interim results presentation.

But, let me start, by actually welcoming you here in the room. And it's such a pleasure to be able to see human beings in the flesh rather than actually through the medium of a screen. So, hopefully, we are back to a new more positive normal in that regard and, for those that are not in the room and have dialled in maybe we'll get to see you next time or in between.

So, today we'll run through the results in detail as well as providing on overview of the trading environment, updating you on our strategy and our observations on the outlook, including upgraded guidance for the full year.

But before we go into the detail, I'd like to spend a couple of minutes looking at our key highlights.

Strong operational and financial performance

These results show a strong financial and operational performance and reflect the growing momentum in the business alongside the clear progress in the strength of our various franchises.

Operating profits increased by over 27% to £105 million … a record outturn for the business. Our profitability is, as you know, driven by a combination of the loan book and the margin so it was particularly pleasing to see both the loan book expand by 8.6% to nearly £14 billion and the Net Interest Margin increase by 25 basis points to 2.57%.

This impressive growth in the revenue line has also been supported by tight cost control, notwithstanding the inflationary environment and our digital cloud-based transformation programme, as well as the excellent customer credit performance which continues to perform to the same exemplary standards seen over many years.

New lending has been strong across the Group with volumes touching £1.5 billion over the 6 months - up 32% compared to last year – and has been complemented by good progress in new customer retention strategies. Our new business pipelines are particularly encouraging in both Buy-to-let Lending and Development Finance which bodes well for the full year outturn.

Our Savings business has also delivered good growth in the period with the deposit book - both directly originated and via our third-party platform relationships - now totalling almost £10 billion, all at attractive pricing.

Our balance sheet has always been a source of great strength. We've always sought to operate with a cautious risk appetite – both operationally and prudentially – and this has of course been maintained. At present there is no evidence of any credit deterioration in any of the portfolios, although the environment is clearly suggesting there will be challenges ahead for the UK economy. Post the end of March we sold the remaining part of Idem's unsecured loan portfolio, realising a modest gain and which will also de-risk the portfolio further.

Our balance sheet and low risk appetite provides a high level of protection. 99% of our loan book is secured largely on property, with the Buy-to-Let portfolio sitting at 59% LTV and capital ratios are robust, with CET1 at 15.4%. The £50 million buy-back programme announced in December is well on the way to completion and, reflecting our confidence, we have today announced that this programme has been increased by a further £25 million to £75 million in total.

Our strong financial and operational performance for the first six months, and the confidence we have in the strength of our business model, franchises and market propositions, mean we can upgrade our guidance for the full year for new lending volumes in Buy-to-Let and the Commercial Lending divisions, as well as upgrading our NIM expectations whilst importantly maintaining the guidance for our operating expenses.

I will now hand over to Richard to take you through the financials in detail.

Richard Woodman, Chief Financial Officer

Thank you Nigel. Good morning.

Income statement

My first slide summarises the income statement for the half year. Total income was up 17.5 percent on 2021's level, at just under £182 million pounds, with net interest income up 18.8 percent and other income down 9.7 percent, this latter measure reflecting the trend reduction we have seen on this line in recent years.

Operating costs have risen by 13.8 percent. This reflects a combination of inflation effects and further investment and headcount increases as we predicted at the 2021 year-end. Notwithstanding this increase, we remain comfortable with the cost guidance we originally gave for the year.

We saw a small impairment charge for the period, representing a cost of risk of 2 basis points, with a cautiously positioned economic outlook being balanced by strong collateral values as house prices have risen.

The overall operating profit for the six months was £105.5 million – a 27.3 percent improvement on the level reported for the first half last year.

We have also posted a strong fair value gain for the period – this chiefly arises from swaps being put in place for the buy-to-let pipeline. These get fair value treatment until the underlying mortgages complete and accounting hedge effectiveness is achieved. These credits will amortise back over time but could well be replaced by further credits or debits from emerging pipeline hedging, given the yield curve volatility we're seeing at the moment.

Underlying profits were up 27.3 percent and underlying EPS was up 29.4 percent (the difference largely attributable to the changing share count given the ongoing buyback programme).

Segmental results

On the segmental slides, we can see strong improvements in pre-provision profits in mortgages and commercial lending, our two key operating divisions, and a continuation of the trend reduction in Idem as its portfolio amortises.

The central segment has benefitted from greater interest earned on central liquidity as rates have risen but also sees higher operating costs – because most of our tech project costs are focused in our central teams.

Last week we disposed of the remaining unsecured loans in the Idem book for a very small gain, which now just leaves the secured portfolio. For those of you looking to update models, the unsecured portfolio generates just about half of the total Idem operating income.

Net interest margin

With an uncertain rate environment our initial guidance for the year was to see NIM expand by more than 5 basis points. However, we have seen a stronger than anticipated expansion across the period – our deposit beta was minimal for the first two base rate movements, and we now expect the full year outturn to be more than 20 basis points above the 2.39 percent we reported last year. This assumes a more normalised relationship to movements in base rates going forward.

Paragon is not immune from competitive pressures in the savings market, with Chase Bank being a notable new entrant during the period. As such we tend to see a ratcheting effect following Base Rate movements, with margins initially widening and then reverting to some extent as rate administration activities kick in and the eventual deposit beta is delivered.

As I mentioned on my introductory slide, the volatile yield curves that accompany the tightening phase by the Bank of England have created material fair value gains. We exclude these when looking at underlying performance but they are a good guide to the value that would have been lost in cash and profit terms if we'd hedged our loans at completion, rather than as they went through the pipeline.

For some time now we have highlighted structural NIM benefits from our front book/back book dynamic on the mortgage book and our commercial lending diversification. This underlying trend has continued in the period but has been eclipsed by this liability tailwind that we've seen from the rate environment.

Operating expenses

Costs have increased as predicted, and I have highlighted three of the more specific areas on the slides here.

Headcount has risen after a flat period during lockdown, and at the 2021 year end I highlighted that our wage inflation going into this year was about 5 percent - salary reviews taking place at Paragon on 1 October so, it was done with a fair degree of knowledge.

We are undertaking a broad-based system enhancement and digitalisation programme, which has been developing in recent years and which has seen further growth in 2022. Nigel will talk to this in more detail in a while, but the investment is designed to enhance customer and introducer experience and also add operational efficiency. These efficiency improvements are particularly important in a higher inflation environment especially as the Group looks to deploy its capital and funding strengths to accelerate growth.

Finally, I'd like to re-emphasize that this cost growth was planned and that we remain comfortable with the original guidance we gave for 2022, with full year costs being in the low £150 millions.

Economic outlook

For a couple of weeks in January I was actually looking forward to talking to you about a less volatile economic position, but the effects of Brexit and Covid have been swiftly overtaken by the war in Ukraine and the rising costs of living which has rather stymied that plan.

In response to this environment we have updated our multiple economic scenarios and we have applied the weightings that we applied when we first move into Covid – which were materially higher than we saw when we first started doing IFRS9.

This weights our downside case at 35 percent and our severe case at 15 percent. You will see that the 100 percent weighted scenarios, whilst still material, result in a lower level of volatility than we saw at the year end in 2021 or even more in previous years, with the upside to severe spread reducing to £55.3 million pounds – and this is largely a result of house price inflation since that date.

Despite this cautious stance, the resulting impairment charge has reduced from its first half 2021 level, and is summarised on the next slide.

<u>Impairments</u>

So, having peaked at 64 basis points in September 2020, our impairment coverage ratio gradually reduced as the immediate Covid concerns receded and the portfolio seasoned. The ratio fell to 49 basis points at the 2021 year-end and stands at 40 basis points now. With an almost fully secured balance sheet, rising house prices have had a positive effect on security values, mitigating the effects of these cautious economic scenarios.

We continue to hold just over £14 million pounds of overlays on the impairment models, but these have been skewed increasingly towards the potential impacts of higher inflation on our customers, rather than the pure Covid-related scaring that we used before. Absent the overlays, the table on the bottom left of the slide shows our impairments would have reduced to £32.3 million pounds, with a 23 basis point coverage ratio, had we applied the scenario weightings we used when we first transitioned to IFRS9 – and that's with those underlying harsh scenarios in the severe and downside cases.

Finally for this page, the table on the bottom right shows the behavioural scores of our differing portfolios over the past year – these tend to be a really good lead indicator for emerging stresses in the book and are closely monitored especially when things are volatile, but you'll see here, that they remain very, very stable – as per Nigel's comments earlier.

<u>Capital movements during the period</u>

When looking at capital movements during the half year we have seen a stronger than normal contribution from earnings retentions – which has been boosted by the positive fair value adjustment I have already noted. Net lending, dividends and the share buyback have combined to result in the CET1 level remaining unchanged across the period. The figures reflect the completion of £37.5 million pounds of the first buyback, in addition to the final couple of million we had left over from the 2021 programme.

<u>Group capital</u>

The continued growth in the commercial lending has seen the Group's average risk weight density increase marginally during the period. Notwithstanding this and the distributions made, we ended up with a CET1 of 15.4 percent and a total capital ratio of 17.5 percent.

The PRA has made no secret of the challenges it faces with resources, especially in its IRB authorisations unit. In addition to a number of aspirant firms such as Paragon, they have been going through the process of updating existing IRB firms' mortgage models to a hybrid basis and this has put them under a lot of pressure.

Despite these challenges we've made good progress and we've had really good engagement around our modelling approach and we expect to be discussing the other Phase 2 elements across the summer months. Whilst we would very much like for the process to be running at a faster pace, we have been really encouraged by the feedback that we've had from the PRA and we're confident in achieving a good accreditation in due course, which builds on our strong credit performance, established governance and proven modelling credentials. And, as soon as we are in a position to give more detailed guidance we will do, but we're very much dictated by the PRA's timeline and the time it then takes for us to make refinements when we've had their feedback.

Dividend per share

My final slide looks at the progression of the dividend. Our normal policy is to make an interim dividend of around 50 percent of the prior year's final and so we have announced the 9.4 pence for the half year. For the full year our policy remains to distribute around 40% of underlying earnings.

Thank you. I'll now hand you back to Nigel.

Nigel Terrington, Chief Executive

OK. Thank you Richard.

Our strategic priorities

Turning now to 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 risk that 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 which also creates a distinct competitive advantage for the Group.

These priorities are being applied across Paragon's business lines as core principles guiding our activities.

Continued progress in fully integrated strategic priorities

Our strategic priorities are simple, fully integrated and work hand-in-glove with each other in pursuit of the Group's overall objectives.

We have, and continue to seek, strong balance sheet growth in our chosen markets where we can optimise a good and sustainable return on capital utilising the Group's core strengths, including its highly efficient operating model. Capital is strong and the Group is effective at internal capital generation - supporting the ability to grow substantially from here and the return of capital through a 40% pay-out ratio and an extended buy-back programme over many years.

Digitalisation is supporting further organic growth. Our diversification strategies, opportunities to improve efficiency further and an increasing focus towards an enhanced sustainability model - all of which are reflective of the Group's approach to its responsibilities whilst adding further growth and product diversification.

Now turning to each of these areas in more detail...

Growth

This latest reporting period has delivered strong growth in both new lending and our loan book. But it's not a one-shot wonder.

We've witnessed strong growth over many years, with compound average growth in new lending of 18.1% since 2015. The specialist markets in which we operate are witnessing good underlying growth levels where we have also achieved market share gains aided by additional product launches and improved engagement with our distribution channels.

It's not just about new customer origination though. There have been increasing efforts paid toward enhancing longer term customer relationships thereby improving retention levels, as can be seen by declining levels of customer attrition and also repeat business from our existing customers.

Whilst our loan book has expanded by 8.6% over the last year, there's more to come - part of which will also deliver further diversification.

Diversification

The success of our diversification strategy has continued with the Commercial division's share of new lending rising to 43% of total lending and it's income contribution rising to £42 million in the first six months, which compares to £38 million in the equivalent period last year and £6 million five years ago.

As previously mentioned, this has essentially offset the run-off of Idem which only contributed £6 million toward profits in the period.

Whilst we have sold Idem's residual unsecured loan portfolio, we still have strong and experienced M&A capabilities in the Group and we will of course have the potential to acquire portfolios should the opportunity arise in the future.

As the chart on the right shows, Commercial is not one product or one business line thereby providing further diversification.

Funding diversification is also a crucial value driver. Securitized funding has now reduced to £1.8 billion which represents 12% of the Group's total debt compared to 100% ten years ago. The optionality this provides is highly attractive and its value is evident in the current favourable conditions in the retail savings market compared to the wholesale funding markets.

Diversification will be further supported by our digitalisation programme.

Digitalisation

Paragon – as I said- is a specialist bank with a technology strategy targeted at delivering: a better customer proposition through faster delivery with enhanced service levels; and provide improved data to facilitate better decision-making, and improved cost efficiencies and increased operational leverage.

We are undergoing a multi-year, multi-business line cloud-based re-platforming programme which will transform the way we engage with both the intermediary market and also new and existing customers.

New digital technology is being introduced into virtually every corner of the bank with a prioritisation towards customer-facing areas.

Our new in-house savings platform is already operational and supports our growing third-party relationships, enabling us to reach customer segments not available through traditional channels.

New business origination portals have been launched for our Buy-to-Let business, as well as our SME broker community. These portals are helping our brokers provide a better, faster service to our potential customers.

The launch of a new platform for Development Finance is imminent and a digitally-based mortgage underwriting and processing platform is currently under development - the first aspect of which has been focused on providing further product offerings to existing customers. This has already delivered notable successes in accelerating the decision-making process which to date has seen execution times improve materially, as well as supporting our existing customers with additional financing requirements on a highly efficient basis and which could be used extensively as customers seek to upgrade their properties as part of their own sustainability requirements.

Our new systems will make extensive use of API and Open Banking technologies and which will help to enhance our customer propositions on an increasingly cost-effective basis.

Turning now to capital management …

Capital Management

At Paragon we're blessed with strong levels of core capital and high levels of internally generated capital which for the first half of the year alone added 1.6% to CET1 pre-distribution. However, we always treat capital as a scarce resource and will always maintain a disciplined approach to its employment, prioritising the optimisation of the returns we can achieve.

We are achieving a return on tangible equity tantalisingly close to our target of 15% and we believe this target is not just achievable but sustainable.

We have also managed strong growth ambitions whilst delivering significant cash flow to shareholders consistently over many years. The dividend pay-out ratio of 40% has seen £339 million paid to shareholders since 2015 and this has been supplemented by buy-back programmes totalling £335 million. Combined with a bit of rounding, this amounts to £675 million of capital being repatriated to shareholders since 2015, representing nearly 60% of our current market cap.

As Richard mentioned earlier, our IRB programme continues to make good progress and, whilst it's a long and complicated process, there are noticeable benefits to come.

The PRA is expected to undertake a consultation on Basel 3.1 later this year and this has the potential to be disruptive for the sector as a whole - and, before we know it the January 2025 implementation date will be here. However, in this regard we are very well positioned.

Our capital levels and internal generation capability are real strengths and, with current capital levels standing significantly above the regulatory minimum, we have plenty of capital to support our ambitious growth plans.

Sustainability

We have been active in our broader responsibilities in our sustainability agenda.

Significant work has been undertaken using our advanced data analytic capabilities to measure the level of operational and funded emissions, as well as the risks these bring.

Increasing disclosure and public engagement are evident with our inaugural sustainability report published at the end of last year which has been universally well received. Additionally, external ratings have been achieved, confirmed or upgraded.

With regard to funded emissions, we've released a range of product initiatives designed to encourage our customers to invest in improving their own emissions on their properties or in their businesses. We're also offering finance to support electric motor and commercial vehicles - a trend which will only grow rapidly from here. We have also offered a range of facilities to SME customers supporting their environmental plans.

A range of operational initiatives have been undertaken which will continue in order to improve the emissions directly under our own control as we move increasingly towards operational net zero by 2030.

We're also conscious that our broader responsibilities are not just related to climate change, as important as that is. We have continued to actively support the communities we work with and of course our colleagues - particularly through the challenges of recent years as we have all learned to adapt to new ways of working.

We are particularly proud to announce that we've been accredited Platinum status by Investors in People - the highest possible rating which is only held by 3% of those reviewed and less than 1% of all companies across the UK.

Turning now to some comments on our key trading divisions.

Buy-to-Let

The strong momentum in Buy-to-Let new lending has continued from 2021 into the current year. New lending is up 19% compared to last year and the period ended with a pipeline of over £1.3 billion. We are therefore guiding that our new Buy-to-Let lending for the year as a whole should now be in excess of £1.8 billion.

The dynamics of our target market has changed in recent years and continue to change. We've seen continued evidence of professionalisation of the Buy-to-Let market, with professional landlords expanding their investments and increasing market share, and whilst 2021 was dominated by house purchase transactions, 2022 is the year of the remortgage - it being the fifth anniversary of increased landlord demand for five-year fixed rate mortgages.

We have invested further in technology and processes to improve our customer retention proposition where redemptions have fallen again on the new book to 5.9% - leading to a further reduction in customer attrition and a growth in the Buy-to-Let loan book of 8.5% to £11.8 billon.

And, as you would expect, the credit performance has been exemplary.

Proven resilience of business model through the pandemic

Data analytics and technology have always been used extensively in our Buy-to-Let business over our 25 year history and has been used in supporting our IRB application as we employ methodologies to more accurately align capital allocation alongside risk.

Our Buy-to-Let credit performance has always outperformed the sector and this remains the case today. The support facilities provided during the pandemic are all repaid and arrears stand at 15 basis points - virtually a third of industry averages - and with average LTVs at 59% and only 1.6% of the loan book greater than 80% LTV, this demonstrates the asset backing of the portfolio is incredibly strong.

Rental demand was disrupted in the pandemic, with city centres experiencing weakness while urban areas witnessed heightened demand. Rental levels have risen 11% over the last year due to a significant shortage of stock in the sector where we are seeing tenant demand at an all-time high.

Turning to our Commercial Lending division.

Commercial Lending provides increased diversification

The graph on this slide shows the level of new lending in our Commercial division since 2018, which now represents 43% of the Group's volumes.

Here we can see the pre COVID trajectory has now been fully restored, continuing the upward trends, supporting the diversification of income and contributing to the Group's structural NIM accretion.

Turning to the various businesses within Commercial division … first Development Finance.

Development Finance

In the first half of the year, new lending in Development Finance increased by 41% to £324 million leaving the loan book at £673 million - 22% above a year ago.

Whilst housing demand remains strong, there are supply chain disruptions which naturally delay housing starts and through the various phases of the build programmes.

Nevertheless, momentum has been good. Development Finance benefits from long lead pipelines due to the nature of the sector's financing requirements. The pipeline of undrawn commitments - those facilities that are on the books but where staged payments are still to be paid - stands at £600 million, providing good visibility to the levels of lending activity over the next 12-18 months.

Development Finance will shortly complete a re-platforming which will deliver an improved customer service proposition and greater efficiency as well as enhancing data management capabilities to support the next phase of our IRB programme.

SME Lending

Turning to SME lending.

The Covid pandemic had the greatest impact on our SME division, creating high levels of payment deferral and significant reductions in customer demand part of which was met by the various Government funding schemes.

The credit performance has returned to normality and customers who are in need of support are negligible.

Whilst customer demand has yet to return to pre-pandemic levels, this is primarily driven by the significant levels of advanced, government funding provided at the time, and which continues to be offered albeit at greatly reduced levels.

We participated in these Government schemes but only to a modest extent, largely limiting our involvement to supporting existing customers only.

Notwithstanding this, there are encouraging signs of renewed activity. New lending is 17% up on the equivalent period last year and, by comparison to industry data, we're achieving an improving market share. The loan book stands at £639 million, an all-time high for SME lending.

We are also part way through a cloud-based technology, re-platforming programme which is making extensive use of API technology and Open Banking, including the recent launch of a broker portal which is already being used by over 60% of applications. It has the ability to access over 4,000 pieces of customer data on every single application, including embedded online access to customers' current account information as part of the underwriting process which is a significant benefit for us and which was historically only accessible by the large banks.

Turning now to the remaining components of the Commercial division.

Motor Finance & Structured Lending

First, Motor Finance which experienced a sharp slow-down during the pandemic and, for a period, operated at virtually tick-over levels.

However, following a review of its strategy, it launched with a more targeted approach in specialist sectors where risk reward could be better optimised.

New lending has increased to £76 million in the first half and further growth can be expected from here. New product launches commenced in the leisure markets and in the electric vehicle sector which naturally should expect to see significant growth as the sector delivers and matures in the coming years.

And finally Structured Lending, which provides asset backed lending to the non-bank specialist lending firms, has seen an encouraging recovery from the pandemic with an increasing number of facilities being added alongside an improved utilisation of existing credit lines.

Clearly good progress has been achieved across our Commercial Lending division. However, we are conscious that these asset classes are more cyclical in nature and that the environment could be more challenging in the year ahead, so the strong disciplined approach we've taken in the past will put us in good stead and will continue to be applied going forward.

So, as already mentioned, we are upgrading our full year guidance on new Commercial Lending to above £1.2bn from £1.1bn.

Finally turning to Funding.

Funding

The deposit book is up 14% year-on-year and now exceeds £10 billion. We've continued to strengthen our franchise, enhancing flows with our third-party relationships like Raisin, Hargreaves Lansdowne, Monzo and Revolut.

There's been a significant change in the interest rate environment and clearly this process is still underway. Base rates have increased so far by 90 basis points, with the beta providing a current tailwind feeding into NIM.

Consequently, we are also upgrading our full year NIM growth expectations from over 5 basis points to over 20 basis points.

Technology is also playing an important role in our savings business. A new platform to support our third-party deposit relationships is effective and working well, delivering improved efficiencies, strong operational control and enhanced resilience.

The demonstrable success of our funding strategy has also been recognised externally with Fitch recently upgrading our Long Term debt rating to BBB+

Looking forward, Open Banking is becoming more embedded in the banking and payments sector. There are over £1 trillion of balances with the major banks earning nothing, or next to nothing, even after the recent base rate rises. New technology will reduce friction and should improve inertia and we've seen some of this strengthen during the pandemic as flows into the clearers grew. There is a big prize here and we are seeking to exploit the opportunities that should emerge.

The Group has a long history and a strong presence in the securitization markets and, whilst pricing is unattractive at present, it remains open to us to tap this funding source opportunistically.

Conclusion

So, in conclusion.

The pandemic showed how well both operationally and financially resilient the business was and the strong growth and momentum in the recovery period reflects the strength of our franchises, our market positioning and our ability to execute.

Loan growth has been strong and improved customer relationship management is leading to greater retention levels, supporting good balance sheet growth.

There is significant cloud-based technology re-platforming programmes underway across the Group which will improve both our customer and market propositions … and improve our decision-making and cost efficiency … and much of it has the potential to help level the playing field with institutions that benefit from structural competitive advantages.

The strong performance of the business in the first half of the year and our market positioning provides us with confidence looking ahead. Consequently, as mentioned earlier, we have increased our guidance for Mortgages, Commercial lending and for the Net Interest Margin whilst maintaining our cost target.

Nevertheless, we recognise that the country is facing a weaker economic outlook. There is geopolitical volatility, a cost of living squeeze and interest rates will certainly rise further from here. However, our business is well structured, operationally resilient and financially strong. We have also shown our agility in reacting to stress events on more than one occasion in the past.

Whilst the environment will create challenges, it will inevitably create opportunities and we are well positioned to react to them as and when they emerge.

Questions

So, that's the end of the presentation. We'll now go to questions. We'll deal with this in three phases. So, we'll deal with questions from the room, we'll then deal with questions from the room and then we'll deal with questions from the webcast. So, there will be pauses in between, while they get loaded up. So, if we go now, we'll go to the questions in the room.

Ben Toms, RBC

Firstly on costs, you've reiterated your guidance for the full year today. I think in the current environment the market will quite like that. I think previously you said in terms of guidance for 2023, you'd said that costs would be up again but at a lower rate than than the increase in 2022. Just interested in your thoughts there as the inflation environment has changed since you last said that. I think consensus has it going up for about 6% next year so just in that sort of context?

And then secondly, in the context of the cost of living crisis and buy-to-let … how should we think about that? Is that good for buy-to-let with the scenario being that people can't get on the mortgage ladder so they end up renting instead and that's good for landlords and should we think about that differently if it comes with a large fall in house prices at the same time?

Richard Woodman, Chief Financial Officer

So, the tech investments that we're making carry on into 2023 and probably into 2024 in terms of the ones that we're seeing at the moment so we wouldn't expect any reduction in terms of the pace of growth in the tech side. There will be volatility around inflation levels. As it stands today, inflation may be a little higher towards the end of the year than we were predicting at the outset. Some of that may feed in a little bit but, overall, if it does move, we don't expect it to be a material move up from the levels that we see in consensus for 2023 yet.

Nigel Terrington, Chief Executive

Turning to the question on the rental side of life. So, clearly what you have … our view is, it's evidenced over previous cycles, the demand for rental property actually rises in an economic downturn so it's kind of counter-cyclical in that nature.

People who'd by buying a house – house purchase, first time buyers, less, therefore moving into the rental sector. The rental market is incredibly strong at the moment. One of the key issues is a shortage of stock rather than … you know … there is a natural inflationary pressure and long-term, there is a very close co-relation between rental growth and wage inflation, so you've got a natural underpinning to rental growth still coming through but, with the counter-cyclical element, we can see that continuing, maintaining itself, in the current environment and potentially getting stronger.

The shortage of stock is a product of … go back to 2016 and the Government's change in the tax arrangements and probably then with some further house price appreciation, some of the amateur landlords have exited the market and, so as a consequence, you've seen rising tenant demand and declining levels of overall stock. What we have seen within the professional landlord community is that they have absorbed the kind of vacuum that has existed and so we see professional landlords gaining market share. So, not only have the market levels of growth but also our target market has expanded as part of that.

Now weaker economic scenarios can create other problems elsewhere and one of the things we're also very conscious of is tenants may be suffering their own squeezes and so we do engage with the landlords and we assess their ability and their capacity to be able to support tenants through challenging periods.

One of the things we also embed in there is, when we underwrite, we stress test the loans, so you've got an Interest Cover Ratio of 212% on flow. The stock will be a fair bit higher than that as well so there's quite a lot of capacity there for the landlords to absorb the pressures within that and we do think that there will be some counter-cyclical element to demand which will keep demand for landlords' properties going up.

<u>Perlie Mong, KBW</u>

Can I just ask one on NIM trend and what's happening on funding cost side? So, obviously I've heard what you've said in terms of there's more challenger banks etc coming in. Just wondering how competitive you've had to be at the front end, because there's a lot of things like you've pointed out - there's a challenger space where people are being quite competitive in terms of pricing, but the rest of the market, where the large banks are, people are not particularly moving because of inertia - so just how competitive have you had to be in terms of funding cost?

And, the other one is impairment. Obviously, again, noting that you have not seen any credit deterioration but it's a broader question … where do you worry the weak spots might be and what are some of the economic metrics or customer behavioural metrics that you're looking at because I'm sure you know as well as I do that we seem to be living in a world where none of the banks are seeing credit deterioration but the market is incredibly worried and with metrics like unemployment and arrears being lagging indicators by nature, by the time those come through it might already be too late. So, how do you think about impairment and what are the metrics that you look at as an indicator?

<u>Nigel Terrington, Chief Executive</u>

OK. So, in terms of NIM.

The NIM is one stat - one line - incredibly complicated though because it has got liability movements both in variable and fixed rate, you've got what's going on in the swap market, you've also then got what's going on in the asset side depending on stock and flow - so there's a million variables that go into create one number. So, first of all, it's complicated.

Secondly, you've got a crazy market going on at the moment where there's so much volatility. So, let's just take the swap market. It's up 2% since Christmas – five year swaps - 2% since Christmas and 80 basis points in three weeks. So actually trying to work out what the trend rate is and whether it is still going to be that number in three weeks' time, let alone what it is today, is very difficult and when you look at mortgages, mortgages don't reprice as quick as swap markets do, so you've got leads and lags and trying to work out what the correct underlying trend is, is really, really difficult.

On the deposit side, there's been a very helpful tailwind that's come through. We've seen Base Rates up 90 basis points but our variable rate deposit book has not moved as much as that by some margin. But, you know, there is still a process because we've got another Base Rate rise probably coming this week – either 25 or 50 – and what happens to the dynamic of that is challenging as well as to determine what then feeds through to NIM in the second half of the year and beyond.

So, with all of these changing dynamics and the things are moving very quickly – you know, almost unprecedented level of rate of change in interest rates that are coming through – it makes it really difficult to give you one nice, neat answer to that question.

So, what we've done is given you the guidance of the +20 for the full year and we're confident in that number because we don't know what's going to then happen with you know Chase came in and lobbed a grenade into the market with their current account with a 1.5% rate on it and that sucked out quite a bit of activity for a period of time. It's less significant now but I don't know what they're going to do next week … maybe they'll do it all again!

But again, you've got fast-moving activity, fast-changing environment and I think with all of that noise it's very difficult to land on one, nice neat number apart from the guidance that we've given you for the full year.

In terms of impairments, well we start with the basis of the quality of our book. I've bored you endlessly over the years about that and we've repeatedly outperformed on credit time after time after time.

You specifically asked a question about the forward-looking metrics. We do have the behavioural scoring index which we do use. This is data that we pull in. I think it's about 600-700 million pieces of data we draw in from credit reference agencies on our customers every month and that feeds through into creating a behavioural score index which gives us some sort of early lead indicator as to whether portfolios are weakening or strengthening and, again, there's nothing of note coming through on that.

The other bit is now with the developments in technology, it gives us access to current account information for a lot of our customers. We were historically blind to seeing customers' current accounts but now, particularly on the SME side, it's particularly valuable. We can go in and extract data to be able to see what's happening in terms of current account activity with our customers with their accounts at Natwest or Barclays or wherever and to be able to see whether the turnover is going up this month versus last month, whether there's been any unusual payments going on, whether there's any unusual activity that's happening and we use that to feed into our underwriting processes but separately we also use it as a monitoring tool as well and, again, there is nothing that's telling us to be concerned. We can identify individual customer's issues on that as well.

Shailesh Raikundlia, Liberum

I had three questions if possible.

Just to follow up on the NIM side, you're highlighting that Base Rates are going to go higher from here so, in terms of your guidance, are you anticipating any further Base Rate rises in that because obviously if the pass through has been very low so far, it will probably be higher (your margin) if interest rate keeps rising to where the market is expecting?

Secondly, on the redemptions of your book, you highlight that the redemption rates have remained quite low. I see on the statement that you say the maturities are coming through quite significantly, so I was wondering what you think redemptions will be for the second half of this year given the fact that you've got a very strong pipeline coming through?

And thirdly, just on the IRB application. Basel 3.1 you highlighted at 2025. But, I'm just wondering - obviously the PRA might have its own ideas of how to implement that – if you have had any ideas about how that might potentially impact you, given that it's taking you quite a lot of time to get to

IRB. Do you have any sense of what the PRA is thinking about the buy-to-let market, for example, in terms of risk weighted assets?

<u>Nigel Terrington, Chief Executive</u>

Simple answer to the Basel 3.1 is that there's a consultation due out towards the end of the year. The Bank of England does not provide much guidance in advance of its consultation papers unfortunately, so we're going to have to wait until we see that.

We've done our own modelling, we run our central capital forecasts, we run sensitivities around that which would be assumptions we make based on the European model of Basel 3.1 versus we stress that to become more unhelpful, less unhelpful. In all scenarios, our capital is more than sufficient to meet our planned requirements going forward so there isn't any point across our internal five year plans where we have any cause for concern around the levels of capital.

<u>Richard Woodman, Chief Financial Officer</u>

So, explicitly within our numbers we've assumed two more Base Rate increases in this half year. But the challenge you have with the reaction to that changes - the deposit beta doesn't just happen the day after the Base Rate changes. It could be a week, a month … we could be reacting now to the last one for the next two or three weeks as well. It's a messy environment from that side.

I think the other point though comes back to the position that Nigel talked about in terms of swap rates and some of the fixed rate business - but then if you look at the fair value adjustments that you'll see that we've put through, we make extensive use of hedging of our pipeline – that's all come through as a positive in this period. It will unwind going forward but had we not hedged, all of that hit would have come through against NIM over the next few years.

So that does help smooth the position of the pipeline. For a new customer, putting a new loan in today, they'll probably be getting a tighter spread against the swap than will be the case over the medium term.

Mortgage rates do increase, typically monthly, and so it will take some time to get that position back to equilibrium, but we also had it the other way for the last eighteen months, where we were getting more than the normal relationship between swap and mortgage rate and that's embedded for the next five years in terms of our NIM programme. So it's quite difficult to distinguish exactly which little bits are driving which elements of NIM within the book because you've got these overall positions, both from historic fixed rates and also the administered rate books which are giving us some tailwinds at the moment.

<u>Nigel Terrington, Chief Executive</u>

So, split the loan book into two – it's the legacy book and the new book. The last loan that was written in the legacy book was in 2008 so you can see the youngest customer in that has been with us for 14 years.

So, what you have is an older population and also customers that are coming closer to maturity. So it's no surprise that the old book redemption rate is slightly higher than the new book.

The new book is something where we have active engagement with customers in offering additional products, additional services to them and where we see the potential for greatest levels of retention activity.

We’re 2.5 months into the second half of the year, we engage with the customers quite a bit ahead of today so have we fairly good visibility - so we’re confident that the redemption levels that you see are going to be maintained for the rest of the year … barring Chase Manhattan deciding to go into attacking redemption customers.

Jason Napier, UBS

Just coming back on NIM, I wonder if you could talk about two things please. The first is flow credit spreads in buy-to-let and the rate elasticity one might expect on that as rates go higher – clearly not everyone thinks the Bank of England is going to 3.5% - but what your experience has been in terms of what yield that product can achieve in a higher rate environment?

And then secondly, just looking at mix change and that as a driver of margin before the rate cycle became such a central conversation for investors. You know, the well-established trend was that mix change would deliver an underlying increase in margin over time. Does that change as rates go higher, given the new funding mix of the business?

Nigel Terrington, Chief Executive

Dealing with the first question. This builds on an earlier question which was around NIM but the challenge in trying to talk about swap rates and flow rates is quite difficult, given the apparent speed differences between swap rates movements and mortgage rate movements.

Now, if you look at the speed at which lenders generally, not us specifically, but lenders generally change their rates … it doesn’t happen that often. You probably would have gone with about once a month – maybe a bit more frequently – but it certainly doesn’t keep track with swap rate movements and part of trying to understand what the correct flow rate is, you need some stability. You need just a period of time when rates stop moving dramatically over a relatively short period of time. So, to be able to be too specific on that is kind of difficult.

When we’re lending to customers, what we always want to do is to ensure that there is going to be sufficient rental cover to the debt service cost and so, when we’re looking at that, we’re currently looking at an ICR of 212% which is incredibly strong relative to the minimum sets of requirements that we have and so, without any change in the rental levels, there is still quite a lot of capacity to be able to absorb higher interest rates from here without there being increases in rental levels.

Rentals are up 11% over the last year – not a million miles away from underlying wage inflation – and underlying wage inflation co-related to rents is a very well and long-established trend.

And so, you expect both of those dynamics to work and so there is still a lot of road still to run in terms of how far interest rates could go up relative to what the market could absorb and what the customers could absorb.

Fundamentally long term, the mix in our product shifts between back book front book and different asset classes has been underpinning about a 5-10 basis points upward movement. Now, nothing has changed in that so underlying structural NIM movement should still be for the foreseeable future, moving by 5-10 basis points. The macro stuff is the noise that goes on around it.

James Invine, Societe Generale

In recent years, the yield on your new mortgages has been around 4%. Could you please update us on this number, now that the five year swap rate is around 2.8%?

Nigel Terrington, Chief Executive

OK. So, it's the same problem of looking at the swap rate which moved 80 basis points in three weeks and comparing it with a mortgage rate. So, it's actually not helpful to be able to compare one with the other. A lag is needed to be able to see what the correct mortgage rate should be relative to that swap rate.

James Invine, Societe Generale

Could you tell us what portion of your book are HMO properties? Is it fair to say that nearly all the HMO landlords pay the utility bills for their properties and have you assessed how well the landlords will be able to cope with the significant increase here?

Nigel Terrington, Chief Executive

Yes, so it's about 15% HMO – it's about 15% of new business. HMOs typically have a significantly higher rental yield relative to the average rental yield, therefore they'll have a significantly higher ICR relative to the debt service costs and therefore they have quite a lot more capacity to absorb inflationary costs in whatever shape or size and quite often HMOs, which their name gives a clue to have multiple tenants. And so, if any one individual tenant has a problem, they have a diversification of income streams as well.

So, we're big fans of the HMO market. We think it's a very strong, stable market tended to be found more in city locations but we're big fans of that sector and it's a very strong part of our business and we're very supportive of it.

So, I think that's it for the day. Thank you. It's been great to see you. Great to be able to shake hands at last. It's much better doing it this way every time.

But we're very happy to have further conversations. Richard and I will be around for a little while to come here.

Richard has earmarked this afternoon and all day tomorrow to have conversations with you so, if you've got questions and you want to pose any hopefully very difficult ones for Richard, then we'll be able to help you with your models over the coming days.

So, thank you very much. Absolute pleasure to see you. Thank you.

Ends