Paragon Banking Group - 2023 Full year results

Nigel Terrington, Paragon

A very good morning and welcome to Paragon's 2023 full year results presentation.

Slide 2: Agenda

Today, as normal, we will run through the financial and operational performance in some detail ... and provide you with our view on the outlook … as well … of course … leaving plenty of time for your questions. But first let me start with a few key messages:

Slide 3: Strong performance and enhancing the franchise

Our business model is designed to deliver above average risk adjusted returns driven by a superior understanding of the specialist markets in which we trade, the products we offer, the services we provide and the customers we support.

The strength of our franchise is the product of a deep knowledge and awareness which lay at the very core of our specialisation focus and which is rooted in our purpose - itself embedded in the extensive through the cycle experience of our people, the knowledge we have and the data we hold, which in the case of Buy-to-Let, goes back over 28 years and which is something genuinely unique in the UK.

The value of this franchise continues to grow from strength to strength.

The last two years have seen significant volatility in domestic politics and the economy has had to deal with inflationary pressures, a cost of living crisis, 14 base rate rises and the consequence of heightened geo-political conflict.

Yet throughout, Paragon has continued to deliver outstanding results … growing the loan book, widening margins, controlling costs and witnessing continued resilience in the high-quality customer base.

Higher interest rates are a significant factor in banking and you will see it is changing the shape of our business. We believe this is a net positive … not a negative … and is something which we will come back to during the presentation.

We are also on a journey to transform our technology platforms, seeking to strengthen the relationships we have with our customers and intermediaries, delivering even greater levels of information and insight whilst improving operational efficiency. A lot has been done but there is more technology change underway and, I believe, the best is yet to come.

But let me turn briefly to the results announced today.

Slide 4: Strong operational and financial performance

As you can imagine we are absolutely delighted with this year's outstanding performance, reflecting the growing specialist franchise of the Group and the continued strong progress in our strategic development.

All of our key metrics are either in line with or above guidance.

The loan book growth was above our expectations set at the beginning of the year, with new lending outperforming in a weaker market … where we have been able to take market share … and where we have seen improvements in our customer retention strategies.

NIM expanded to over 3% on the back of the rise in interest rates and the structural shift in income driven by our diversification strategy.

Operating costs were below guidance and helped drive down the cost: income ratio further to 36.6% driven by tight cost management and some early benefits of our digitalisation programme.

The deposit book has increased by over 24%, benefiting from changing market dynamics, including the switch to fix where we have always had a particularly strong presence.

The credit performance was again excellent notwithstanding the environment and only required a charge of 12 basis points for the year, with a prudently positioned balance sheet provision of 49 basis points.

Underlying operating profits increased by over 25% to £277.6 million, the highest we have ever recorded and which delivered a Return on Tangible Equity of 20.2%. There are clearly some benefits arising from the transition to a higher rate environment some of which are temporary … but some are permanent … and consequently we expect to be capable of delivering a higher Return on Tangible Equity than the 15% target in the future … more of which later.

Our internal capital generation is strong as are our capital ratios, supporting our growth ambitions and facilitating the announcement of a further £50 million buyback announced today on top of the £100 million completed in the last financial year.

These are outstanding results of which we are rightly proud, and Richard will now go through them in detail.

Richard Woodman, Paragon

Slide 5: Financial review slide

Thank you. As Nigel has just mentioned, Paragon's performed extremely well over the past year and generated some very strong results. In addition to my usual suite of slides I'll spend a bit more time on our net interest margin this year.

Slide 6: Income Statement

But I'll start with the overall Income Statement where total income in the year rose by 20% to £466 million. Operating costs rose to £170.4 million, as guided, delivering an overall cost to income ratio of 36.6%.

Impairments rose slightly in the year, primarily as a result of the inputs to our multiple economic scenarios, and overall coverage ratios rose by 5 basis points to 49 bps.

Underlying profits were 25.4 percent higher year on year at **277.6** million.

I talked about fair values this time last year, after a strong gain from our pipeline hedging, as rates rose. The unwind of the adjustment was £77.7 million in 2023, with the balance of the previous year's gain expected to amortise pretty evenly across the coming four years.

The strong growth in operating profits was further supported by our share buyback in 2023. As a result, underlying earnings per share, which exclude fair value items, rose to 94.2 pence.

Slide 7: Segmental results

Moving on to our segmental performance, the Group's two operating segments saw increased profitability in the year, at both the pre and post impairment levels.

Most of this growth was driven by increases in total income, particularly on the net interest line.

The central area, which incurs the costs or benefits from surplus liquidity, also had a strong year.

Slide 8: Net Interest Margin

My next slide covers our net interest margin. If you recall, we have said before that with no structural hedge, our net interest would rise by around ten million pounds for every 1% increase in rates, and we've seen this clearly in 22 and 23.

In the final quarter of 23 we've started to protect this position against falling rates, by hedging the Group's net free reserves. Around £300 million of this hedge had been put in place at the year end, increasing to over £600 million now. Eventually we expect the full £1.2 billion to be hedged.

This hedge is very straightforward, being provided by our fixed rate loan book rather than any complex derivatives.

This hedging limits the upside should rates rise further from here, but protects the downside if rates fall. The average tenor of the hedge will be around four years.

In addition to the greater earnings on our net assets, as rates have risen,the scale of the premium over Sonia for new asset pricing has reduced, whereas the funding position relative to Sonia has widened. The asset side reflects demand and affordability constraints at higher rates and the liability side benefit still allows us to offer more attractive savings pricing to our customers than the traditional, larger deposit takers.

At Paragon our margin management focuses on product margins, not specific asset-side or liability-side spreads.

Finally on this page I've highlighted our group-wide EIR balance of just over £20 million. Given the interest in this topic we have given a few more sensitivities in our accounts this time around.

I have some further margin detail on my following slide…

Slide 9: Net Interest Margin (2)

Our core NIM accretion guidance has been in the 5-10 basis point per annum range for some time, reflecting our diversification strategy and the run-off of legacy assets (primarily the legacy buy-to-let and Idem Capital loans).

If we grounded that progression in 2019 (and look through the Covid-dip in 2020) our expected NIM for 23 would have been somewhere between 249 and 269 basis points. The 309 we reported for the year therefore represents a material overperformance. Up to 25 basis points of this has arisen from the higher returns on our equity as rates have risen.

If rates fall (and product mix and margins are maintained) this would naturally reverse, however, our continued diversification and actions like adding our net free reserve hedge are intended to protect this outperformance.

Slide 10: Operating Expenses

On operating expenses, the year end cost outturn was in line with expectations and translated to a cost to income ratio of 36.6%.

The biggest area of cost growth continues to be on our tech spend as we progress with our digitalisation plans. The vast majority of this investment is expensed along the way rather than being capitalised. The digitalisation programme is set to continue for at least a couple more years, with efficiency savings and capacity creation franking that investment over time.

Our impairment modelling leans on a combination of portfolio performance and expected credit losses as modelled under IFRS9, the latter calculated in a series of different economic scenarios.

Slide 11: Economic Outlook

We continue to model four economic scenarios and have maintained our scenario weightings at their 2022 levels.

The chart summarises the key movement in assumptions for 2024, and shows this graphically for house prices, which continues to be a key driver.

However, we are in an environment where rates have risen, inflation has been high, GDP is depressed and house prices are lower. When running our multiple economic scenarios from here we see a tighter range of outcomes than we have historically.

The table on the top right continues to show the impacts of single scenarios - with the range between the 100% upside and 100% severe scenarios generating a £36.8 million spread.

Twelve months ago this spread was over £53 million and a year before that it was £59 million - suggesting much of the anticipated deterioration from a poorer economy is already embedded in the Group's balance sheet.

Slide 12: Impairments

In terms of actual impairments, these flow from our economics and are summarised in the top table on the chart.

Whilst overall provisions and coverage ratios are below their 2020 Covid peak, they remain high. The lower level of volatility I just mentioned, together with a generally less febrile environment when compared to our 2022 year end, have allowed us to reduce the level of judgmental overlay being carried.

In addition, we have upgraded our IFRS9 modelling in the year on the SME portfolio - with the latest generation of the SME model being materially more sophisticated than the last, leaning on additional data, improving our confidence in the outputs and reducing the need for overlays.

The bottom centre table shows where the impairment provision would be if we used our original MES weightings and held no overlays, again demonstrating this lower volatility.

Finally on this page, I've included our usual behavioural score analysis.

This shows the legacy buy to let customers' credit scores falling slightly for the first time in many years. We have also seen higher arrears on that portfolio, where the loans are variable rate trackers and have therefore seen rate increases with each base rate hike.

Slide 13: Capital movements during the period

My capital movements slide details the main influences in the movement in the CET1 ratio to 15.5% at the year end.

Profits were a little higher year on year in CET1 terms, adding 2.8% compared to 2.6% in 2022. New lending growth utilised 0.6%, the dividend 1.1% and the share buyback 1.3%. The biggest year on year movement came from fair values, which used 0.8% of CET1 in 2023, having generated 2% the previous year.

Slide 14: Group Capital

Summarising the Group's capital position, we carry a surplus over our regulatory requirement of over £300 million and have three years before we need to refinance our Tier 2 bond.

This capital surplus is more than sufficient to finance our planned lending growth and reserves capital for a July 2025 Basel 3.1 implementation - however, this is on a precautionary basis as we continue to pursue an IRB accreditation.

We have continued to make progress with our IRB application, leaning on great data and strong modelling skills, but accreditation and timing decisions rest firmly with the PRA.

Slide 15: Capital Management

Lastly, I'll cover capital management. We continue to deliver strong dividend growth and today's £50 million buyback announcement means we will have completed or announced £483 million of share buybacks since starting the programme in 2015.

The £100 million buyback last year was delivered at an average discount of almost 5% to the year-end TNAV, supporting the earnings accretion and in turn the growth of the dividend.

It is worth noting that current buybacks do have a dampening effect on NIM given the higher rate environment - unlike the buybacks from 2015 to 2020 where the low rates meant little in the way of opportunity cost at the time.

I'll now hand you back to Nigel.

Nigel Terrington, Paragon

Slide 16: Business Performance Review

Thank you, Richard. Let me turn our attention to how the business has progressed against our key strategic priorities and provide you with our view on the outlook for the period ahead.

Slide 17 - Strategic Pillars

We have shared with you previously how we focus on these priorities and how they are interconnected and supported by our structural pillars of a strong customer focused culture, our passionate and committed people who hold such incredible values, and strong financial foundations with a high-quality customer base, strong capital and significant liquidity.

Turning now to how we have performed against our individual strategic priorities.

Slide 18: Strategic Priorities Delivery

As expected, new lending volumes were tempered this year as we prioritised margin and risk. However, we outperformed the market and delivered a loan book growth of 4.7%. Whilst the market has been subdued we are starting to see some optimism beginning to emerge. Furthermore, we see more resilience in the specialist markets and believe they will continue to outperform the mainstream markets in the years to come.

Our diversification strategy is an important ingredient in exploiting operational leverage and broadening the sources of income. Commercial Lending now represents 37.5% of new lending and its profit contribution is over £113 million, up from £44 million in 2020.

Our digitalisation transformation has accelerated this year. We now have 84% of our core and support systems based in the Cloud. And we are systematically transforming our customer facing platforms across every corner of the Group, enhancing our customer experience and further improving cost efficiencies and operating leverage. 2024 will see the delivery of a number of new exciting platform changes that will continue to strengthen our market position. AI may be still in its infancy but we already have a number of pilots underway.

Internal capital generation has been particularly strong this year, where the Group delivered a 2.8% accretion to CET1. This is a powerful and sustainable strength of the Group and provides the ability to support growth and enhance returns to shareholders. With today's announcement we will, once complete, have returned a total of £483 million via buy- backs since 2015 whilst also delivering £465 million by way of dividends … a total of £948 million returned to shareholders.

We see capital management as a core strategy and a particularly attractive opportunity given the current share price relative to TNAV, even after today's favourable share price movement.

Finally, we continue to make good progress in doing the right thing. We have improved our operational emissions further, reducing them by 42% since 2019 and we are on course to achieve Net Zero by 2030. Our financed emissions are very much in the hands of our customers and therefore more difficult to deliver, particularly given the change in government policy this year.

Nevertheless, our strategy is unchanged and we continue to offer a number of products to support our customer's own sustainability plans and requirements and we will continue to provide, develop and extend these into the future.

Slide 19: Operating model equilibrium - driving sustainable longer-term returns

We have delivered good structural growth over many years whilst dealing with the run-off of the pre-Financial Crisis legacy portfolio which inevitably acts as a drag on earnings.

As I have said, our focus is on specialist lending markets which we believe will outperform mainstream markets into the future. However, at the heart of what banks do day-to-day is the trade-off between growth, return and risk.

At Paragon we think about this a lot, always trying to strike the right balance, driving forward our strategic objectives whilst maintaining the equilibrium that works through the cycle ... not just when times are good.

History shows that any single measure can be delivered in the short term but history also shows that taking a short term view of things is dangerous, especially when you are a bank.

Of the three disciplines we will always prioritise risk and return over growth, especially in weaker economic cycles.

It is why we focus on consistent and stable long-term growth, not growth at any cost. And this has enabled us to achieve our 15% Return on Tangible Equity target and has provided us with the ability and confidence to revisit this target today.

We are clearly mindful of the current environment and while customer demand has weakened over the last year, margins are better and our customer franchise is stronger ... so that when the cycle turns we will be well positioned to respond.

Turning now to the operating performance of each of the business lines.

Slide 20: Continued focus on professional landlords driving loan book growth

Housing market activity has reduced this year by 23%, back to levels last seen around the time of the Financial Crisis. The Buy-to-Let market has not been immune with mortgage lending across the sector reducing by 32% year on year. However, it is clear that we have outperformed and achieved market share gains … a reflection of the continuing shift in the professionalisation in the Buy-to-Let market and the strength of our specialist franchise.

The mortgage market has been disrupted at the beginning of our financial year and again in the final quarter. If you recall that last September and October, following the mini-budget, banks effectively withdrew from the sector as they could not price their funding costs with any confidence. With good and prudent hedging we protected our customers and margins resulting in a step up in conversion levels and strong first half volumes.

We have seen interest rate volatility throughout the year with some 7 increases across the 12 months alone. As highlighted at the half year, we expected 2023 to be a year of two halves and, this indeed, is what happened. The second half has seen lower external volumes, particularly as we have remained disciplined on pricing.

However, this is a cyclical dynamic we have all seen before. It will change and importantly the demand for rented property is as strong as ever and professional landlords are taking an increasing share of this market. After 2 years of negative sentiment, landlords are starting to show signs of optimism. It is too early to call this feedback a trend but perhaps it is not surprising given interest rate expectations and continuing strong rental demand.

Notwithstanding the weakness in the market, we have seen strong levels of customer retention, with some 80% of customers with maturing fixes going onto to take a new product with us, enabling the mortgage loan book growth to exceed 5% with our post financial crisis book, largely focused on professional landlords growing by over 13%. So, while external volumes and the pipeline are lower, the dynamics of our ability to generate further growth in income remain healthy.

There is clear evidence that amateur landlords which are more likely to be focused in our legacy book have been exiting the market, whereas professionals have been looking to invest and benefit from the excess of rental demand over supply.

Indeed over 40% of our new business flow is typically from a house purchase rather than a remortgage. We see our landlords generating healthy rental yields, particularly in the specialist property segments, where we are a market leader benefiting from the expertise that our in-house property valuation team provide.

There is therefore a clear bifurcation in customer behaviour that can be seen in the redemption chart in the middle where, despite strong growth in the so called new book, the legacy portfolio has contracted by 14.5% to £3 billion. It will, over time, become a smaller part of the whole.

So, whilst 2024 will be a softer market, given our focus on professional landlords we expect to outperform the sector and we remain confident of the long term growth opportunities.

Slide 21: Proven resilience of business model through-the-cycle

We continue to use extensive data analytics in our Buy-to-Let business, supporting our comprehensive underwriting process, in life portfolio monitoring as well as the IRB programme where the extent and depth of our data is unrivalled in the UK and which acts as a clear differentiator in our decision-making processes, including those for IRB.

Arrears have ticked up over the last year but from a very low base and remain well inside industry average. Much of this increase is located in the legacy book, largely variable rate and largely amateur landlords. The average LTV on the portfolio stands at 62.8% and only 3.6% is greater than 80% LTV.

We are conscious that affordability has been in the spotlight in this higher interest rate environment. We have always operated conservative stress testing in this area and have applied it rigorously throughout, including employing tests over and above regulatory requirements. Our current debt service ratio, the ICR, sits at 190%, even at current rates.

Although loans coming off five year fixes are seeing rates move up meaningfully, rental yields have also increased materially. Rents have increased by 10.5% over the last 12 months and by 31% over the last five years. If you simply look at our pipeline it has a rental yield of 6.7%, a mortgage charge rate of 5.2%, and an LTV of 67%, delivering the ICR of 190%.

Further, it needs to be understood that the ICR and LTV are interconnected such that should interest rates rise without a compensating benefit to rents, our credit assessment will demand a lower LTV to adjust the position and equalise the cash flow coverage.

We will now look at our Commercial business lines:

Slide 22: Commercial Lending provides increased diversification

Commercial Lending has been the means by which we have been able to diversify our business over a number of years, in pursuit of our key strategic priorities. Whilst Commercial Lending represents 13% of the balance sheet, it is 38% of new business volumes and importantly 32% of income.

Additionally, Commercial Lending is not one homogenous product line but a number of different businesses providing further diversification in itself … and, within SME, there is a broad spectrum of customers, including SMEs, corporates and even the UK Government … and a range of sectors from construction to logistics, from agriculture to education, manufacturing to transport and indeed many others.

Turning now to each Commercial Lending Line.

Slide 23: Development Finance

As signalled previously we expected that our Development Finance division was likely to see weaker activity in 2023 due to the combination of supply chain disruption, cost growth and the uncertainty of the environment, including the potential softness in house prices.

Nevertheless, the existing facilities continued to roll out their build programmes and supported robust cash drawings and average balances leaving the loan book higher, approaching 4% year on year.

The portfolio is performing well … a product of the high quality developers we choose to work with and the rigorous standards we apply to the underwriting. Structurally, the business is very well positioned, with a team of deeply experienced professionals that will be ready to react when market conditions allow.

Slide 24: SME

Notwithstanding the environment, our SME division performed robustly with stable origination flows and a 5% increase in the loan book to £758 million. The competition has been pricing aggressively but we have been disciplined, instead choosing to prioritise risk and return over growth.

We have continued to invest in new technology in this area. 80% of new business goes through our new lending business portal, which assesses over 4,000 pieces of customer data with each application, including access to customers' current account information as part of the underwriting and in life monitoring process. Further technology changes in SME will be delivered over the next year and in 2025.

Despite higher business insolvencies across the UK as a whole, the portfolio is performing incredibly well and there is no evidence of credit deterioration or any concerns emerging from the early warning indicators.

Turning now to the remaining areas of the Commercial division.

Slide 25: Motor Finance & Structured Lending

Our Motor Finance loan book growth was strong, up 14% year on year. With success being particularly evident in the leisure vehicle markets, one of the more strongly performing sub-sectors we target. The portfolio is performing very well and, as with SME, we are seeing no credit deterioration in the book or in the lead indicators.

Finally Structured Lending, which provides asset backed lending to non-bank specialist firms has had a stable year in terms of activity, delivering good customer retention and good profitability. The new business pipeline is strong and we anticipate healthy growth in the year ahead. As seen elsewhere the credit performance here is exemplary.

Our Commercial Lending divisions are regarded as more cyclical in nature than Mortgages but have performed particularly resiliently in this more challenging economic environment and, with a NIM of over 7%, it provides the Group with a strong risk adjusted margin and structural NIM benefit as there is much further growth expected in the years ahead.

Whilst a lot of people are calling the top of the interest rate cycle, we all know credit stress can be delayed.

However, the business is well positioned to deal with these challenges and we will therefore maintain our cautious risk appetite, prudent provisioning coverage levels and continue to apply close in life monitoring across the various portfolios.

Slide 26: Strong deposit growth with improved cost of funding

Our Savings division has been a significant beneficiary of the rising interest rate environment … where our cost of funds has moved from circa 100 basis points above Sonia to now being sub-Sonia. We have also seen a significant shift in customer demand with a material increase in flows into fixed term products.

Since September 2022, there has been a £58 billion switch from Easy Access and Personal Current Accounts to Term Deposits across the market. If you compare the position to pre-Financial Crisis - a time of comparable interest rate levels - term deposit flows should remain healthy albeit the pace of change has already started to slow as the peak of rates appears to have been reached.

The deposit book is up over 24% standing at £13.3bn at year end and has continued to grow strongly in the current financial year. We have continued to strengthen our franchise, enhancing flows in our direct-to-market proposition and through our third-party platform relationships like Hargreaves Lansdowne, Monzo, Revolut and many others.

New technology has already played an important role in the development of our Savings division and will continue to be a crucial driver to growth, helping to broaden the proposition in the future.

Of course, we can also access wholesale funding where the Group has a long history in the securitisation markets and, whilst pricing has improved, it still remains unattractive at present. However, it remains open to us to access this funding source tactically as and when conditions improve.

You will have seen we have issued Residential Mortgage- Backed Securities this year but they have all been fully retained and will be used as collateral for contingent funding lines including Repo facilities.

The strength of our liquidity position and the strength of our Savings franchise has meant that we can accelerate the repayment of the TFSME programme. We expect to have repaid £400 million by the end of the month and will look for opportunities to continue to repay the central bank facilities well ahead of the end date in 2025.

As we look forward we are expecting the deposit beta to continue to close as TFSME is repaid and this impact is fully embedded in our NIM guidance for 2024.

Slide 27: Conclusions

So in conclusion, 2023 has witnessed an outstanding financial performance. Notwithstanding the significant interest rate volatility and the month-on-month rate rises leading to a weaker economic backdrop and a subdued housing market … new business flows have been robust, we have gained market share due to the strength of our franchise and enhanced customer relationship management has supported good loan book growth.

For 2024 we are guiding to Buy-to-Let lending in the range of £1.3 billion to £1.6 billion and Commercial Lending of £1 billion to £1.2 billion … but we expect stronger growth thereafter as the cycle turns again.

NIM has widened, partly due to the structural mix in the balance sheet and partly due to the transition to a higher interest rate environment. This higher rate environment is still playing out and despite the rising deposit betas we expect to hang on to much of these gains and are guiding to NIM of 3.0-3.1% for 2024. Furthermore, we are building a capital hedge that will protect returns should rates fall in the years ahead.

The credit performance continues to be resilient and operating costs are being well controlled notwithstanding the ongoing technology investment programme. Here we are guiding to operating costs not exceeding £180 million, an increase of 5.6%.

The 2023 underlying operating profit is the highest in the Group's history. As has been seen we generate strong levels of capital and the buy-back programme has been enhanced this year and shows our ongoing commitment to managing our capital base for the benefit of shareholders.

To date we have resisted revisiting our Return on Tangible Equity target until Basel 3.1 and IRB are resolved.

However, we now appear to be in a more permanent higher interest rate environment and it is appropriate this target is revisited. And we will do this in 2 stages. Today, we are guiding to a new medium-term target of 15-20% and expect 2024 to be towards the top end of that range. We will subsequently revisit this range once Basel 3.1 and IRB outcomes have been determined.

Whilst the economic backdrop is likely to remain subdued in 2024 we are firmly of the view that specialist lending markets will continue to outperform the wider sector and we are confident in our long term ambitious growth plans.

We continue to want to diversify our business, spreading the sources of income and defraying the fixed cost structures that inevitably exist in a highly regulated sector.

We believe Basel 3.1 could well prove to be challenging for some small and mid-tier banks.

Whilst we await the final outcomes,we are also increasingly turning our attention to the opportunities that may emerge from the long expected … but perhaps much needed, consolidation in the sector. We are incredibly well positioned in this regard.

So, while 2024 may prove to have a weaker economic backdrop, our business is in great shape. We have a high quality customer base and a strong balance sheet and we stand ready to react to opportunities and any challenges as and when they arise.

So, thank you ladies and gentlemen. We are now happy to take questions.

Q&A

Right so we'll take the questions in the room first and we're going go to the calls afterwards. Can I just ask … you've got a microphone … and otherwise you won't get picked up. So yeah, Perlie. There's a microphone. I think you have to hold a button with it.

Perlie Mong, KBW

Yeah, hello it's Perlie from KBW. So, I guess just two questions. The first is on credit … so especially in the commercial loan book, because if I look at your stage 3 balances it seems to have gone from somewhere like 23 to 64, something like that. So, it's quite substantial in the half but in the presentation all of the commercial segment seems to be performing well, so just wondering exactly why that has gone up so much and I guess if you look at the entire stage 3 book that's got about 30% (half and half as well) but, of course, you have also released some of your overlay … so just your thinking around the credit provisions.

And then, I guess the second question is on your comments about optimism returning to the market. I mean, I don't know whether the buy-to-let book is that similar to the normal mortgage book but, broadly speaking, there's about a third rolling off each year for the wider market, and so, how much of the book has rolled through and how much is there still to come because presumably you know like, as you mentioned, it's still, you know, five year mortgages still rolling off to substantially higher rates. And, I guess part of reason why it's done so well is that, as you also mentioned that, rental yield has been very strong and I guess you know at 10.5% that's higher than wage growth for the year already and wage growth looking to slow a little bit … so where's the optimism coming from if that makes sense?

Nigel Terrington, Paragon

Okay. So, let me deal with that … and you deal with the provision thing in a second.

So just dealing with that. So, we've got about £1.9 billion pounds rolling over from fixed rates into a refix over the 12 month period.

When you look at that and you look at what you might call the payment shock, you can see that the average rate - don't forget, buy-to-let rates don't tend ever to be as low as residential mortgage rates … so recent CACI data pointed to the fact that about 50% of fixed rates in the resi market that are rolling over are coming from a sub 2% level.

The average rate of the fixes that are rolling over in the next 12 months is 3.67% and, yes, that means if you look at the average rate in the pipeline which is 5.2% that's still a big increase … it's just over 40% … but over the last five years, you've seen rental increases go up by over 30%.

So yes, whilst those numbers show a higher level of market rate increases, I think the rental increase is significantly higher and significantly mitigates that payment shock aspect.

Let me just talk about the quality of the book and then you (Richard) go through the provisions.

So, if you look at the buy-to-let book, there's a kind of a two parts to that portfolio – the £9 billion plus new book and the £3 billion legacy book.

The arrears increase is located in the legacy book. It's a variable rate book so it's seen 14 base rate rises.

The new book is the more professional-focused landlords. Actually, if you looked at it year-on-year, there is a down on that book. You know, it might astound you to believe that but the quality is there.

When you look at those arrears, we have a very, very, close in-life monitoring process. We know those arrears, those customers that are in arrears and we provide help to them.

We provide support, we know the details of that intimately.

What we also have is very significant asset coverage so, when you look, you can see the average loan to value on that portfolio. I appreciate averages are only one data point … you have to look at the distribution as well … but, you also have a 62% - 63% average loan to value.

And also bear in mind, whilst the arrears have gone up, we’re still significantly below industry averages … so, so it’s not one I'm losing sleep over but I'd probably say the commercial book is perhaps counter-intuitive because, in many ways, you’d kind of expect the commercial book to be a little more cyclical in nature.

When you look the development finance book, the business is one where you’re financing a series of projects that started a couple of years ago and they're running off now … or start in 12 months and they got another year or 18 months to run.

Each of them is a tightly managed process all in itself. What we're seeing is the property sales process … when they're coming up to that, there’s probably sometimes a bit of extension on the build programme … there's forever a constant to-ing and fro-ing with the planning authorities … but there is an aspect here where the key thing to look at is … what prices are our customers achieving versus the estimated valuations that we put in at the beginning. And they have continuously, month-in, month-out out-performed those original valuations and remain very stable so, we're very confident of that position.

When you look at SME and things like the motor finance business, we have things where we use a combination of the arrears monitoring that takes place within the in-life aspects, but then we also have access to customer data. So, it ranges from using the credit reference agency data that drives our behaviour scoring models, right the way through to the current account data so, when we make a loan, we can go in and access current account information. This is not something you know … go back in history … we were ever able to do, and it was one of the great detriments between us and the clearers. They had that data. We didn't.

Now, we get access to it. So, we use it at the point of underwriting and we use it as a point of monitoring. So, every month, we go in and we look at the customer’s current account information, what's happening? Are we seeing, you know, cash flow being maintained, are we seeing unusual behaviours in terms of payment levels? So, it's a fantastic tool and is one of the great benefits of our digitalisation programme that have been brought through.

So, if that’s okay, do you want to cover the provision point now?

Richard Woodman, Paragon

Yes sure. There’s a couple of points. Firstly, for the development finance piece, our provisioning leans effectively off a RAG status that we would have for the different loans that link to that extension. So, we often see the loans that would be in a higher stage for IFRS 9 purposes that don't actually result in losses.

So, just in terms of the allocation, similarly, in the second-half … we've re-calibrated our SME model. It's a lot more sensitive … you've got more in the way of indicators of increased credit risk that we would put in. It's a much more sensitive model as I say which again drives that allocation for stage 1,2,3 … but, we're not actually seeing greater levels of default.

If you look at the disclosures right at the back of the pack on the credit side, you'll see the arrears levels for the asset finance book and they're very, very small … less than a percent. So, the performance is extremely strong but IFRS 9 staging drives some of that allocation.

It may well be that a loan is technically in default but you're not going to make a loss. It may still have a 60% loan to value. So, there's a difference between, if you like, the probability of default element which more links to the staging and the absolute loss that comes through.

Nigel Terrington, Paragon

Could I just remind you to use the microphone.

Benjamin Toms, RBC

Can I just ask a question on your new structural hedge please?

I guess investors might be familiar with the large UK banks and their hedges on equity and non-interest bearing deposits. Can you just give me a bit more colour about how your hedge differs from those traditional structural hedges and any risk that you're taking? Presumably the risk here is if the swap curve steepens from the point at which you locked in the hedge.

And then, secondly, on the weighting of your loan book between commercial and buy-to-let. I think you've historically talked about the re-weighting of that book and you can see organically that that's happening towards commercial. Is the organic pace that you're going at enough? Or, now that you've got a bit more capital in your stack, could potentially we see some inorganic to help speed up that process?

Richard Woodman, Paragon

So, you've got our treasury team in the back of the hall here who can answer your questions afterwards in a bit more detail, but we're doing it on a very straightforward basis.

So, we've got around £1.2 billion, or just over £1.2 billion of tangible net assets, and these are the ones where historically as rates have risen we've had the benefit and if rates fell we would effectively … because most of our assets are actually … ultimately, they're interest bearing in one form or another … so, if rates go up you get more, if rates come down you earn less.

So, what we're doing now is where we would normally hedge our fixed rate loan book, fixed rate mortgage, in which case it rates fall you'd pay less, if rates went up you'd receive more. By not doing that, that provides effectively the hedge for the falling rates.

So, you're quite right. If rates did lurch higher, there's an opportunity cost that we'd be facing. I think our view is at this stage in the cycle, it's a better time to be putting the hedge on. We're not calling it a full structural hedge because if rates were down at 0.5% again, I don't think we would be putting the hedge on. So, it's just you know, we've got the opportunity at this stage in the rate cycle to, we believe, protect the margin that we've made, if you like, as rates have gone up.

So, as I say, there's opportunity risk but not complete downside risk.

Nigel Terrington, Paragon

So, onto your second question. We have long had a strategy to diversify the business. We think it's good, prudent business management to have a diversified portfolio. In addition to that, I think I also highlighted the fact that we've got … you know … banking is a highly regulated sector and it creates high fixed cost structures that go with it … so, it's better to find other ways of generating additional lines of revenue.

Now, so, that's a kind of a long-stated strategy. We've made four acquisitions in the past which was kind of the core of that diversification strategy and we then built some organically from that and then we've grown that further.

To make it clear … you know … whilst, we know we have been and continue to be interested in opportunities to achieve inorganic growth, it's not because we lack ambition or potential for the organic growth.

It's clearly a cyclical, weak point in the economy at the moment but it will change and we expect to see continued, strong, medium-term growth coming across all of our sectors into the future and we're very well positioned for that

But, I think, as I said earlier with a few words, this environment we do see as more challenging for the small and medium-sized banks because Basel 3.1 is going to layer additional layers of capital depending on what ultimately comes through. It will layer additional levels of capital on a sector that is already quite heavily capitalised and that will put more and more demands on that sector to think about what the right strategy is for their businesses.

So, we think it can potentially act as a catalyst to create more opportunities but we remain ambitious in our growth plans, whether that be primarily organic … but we will supplement it and develop our strategy further if the right opportunities came along.

And, we definitely have a decent amount of capital with strong internal capital generation as well.

Gary Greenwood, Shore Capital

I had two questions.

One is just a clarification on your hedge. Just mechanically, how does your hedge work? Does it imply therefore duration sort of around about five years, given most of your fixed rate products are five years?

Richard Woodman, Paragon

Yeah. I' think I said an average of four so we'll have a spread. A lot of it would be five, but we do two year fixes as well.

Gary Greenwood, Shore Capital

And then, just, I guess a more philosophical question around cost of equity. It's good to see the increased guidance on return on equity to 15- 20% which … these are stocks trading at a discount to book … and that's not unusual in the sector at the moment … nearly everything is trading at a discount to book … even with a number of banks earning returns above 10%. So, it appears that the market is implying a cost of equity that's probably 20% or higher at the moment. So, I'm just interested how you're thinking about cost of equity on a longer term basis? And then also in terms

of your conversations you have with regulators, the government etc … are they cognisant of the sector rating and what the implications are of that with regards to capital allocation?

Nigel Terrington, Paragon

Yeah. So, cost of equity. I've read the books, seen the film and I still don't understand it.

It's a methodology using a bunch of assumptions. You can kind of make the number up to whatever you want it to be frankly and I don't understand cost of equity.

You spoke about implied cost of equity of 20%. There's probably tax adjustments to be made to get to that figure but, either way, it feels like it's a very high number relative to a business that has consistently delivered year-in, year-out strong performances, with a pretty low risk profile and I know we just get caught in the wider impact on the sector. Yeah, no one, I mean nobody seems to like the equity markets. Nobody likes the UK. Nobody likes the banking sector. Nobody likes landlords and so, you know, we are in the kill zone here. So, despite our performance, you know, we've got all of that backdrop to deal with.

I'm not sure what more I can say about cost of equity. I mean everyone has got a view. Everyone has got an opinion.

Gary Greenwood, Shore Capital

Do you think the regulators, the politicians are cognisant of what the valuation implies in terms of what lenders should do in terms of capital allocation? I mean, in theory, if all banks are stuck with a price to book below 1x, they should all be shrinking their balance sheets … which, of course, they're not but that's what they should be doing rationally … which wouldn't be good for the economy.

Nigel Terrington, Paragon

The regulator's job is to keep the system safe, not to advise banks as to how they should run their business. But, in one sense, there's a lot of capital in the banking system already and the fact that most banks are looking at buy-back programmes of … public entities of one form or another … still means at the end of the year particularly as capital generation in the banking sector is strong, you've still got the same amount of capital available in the banking sector. So, I think there's plenty of capital in the banking sector. I mean Basel 3.1 might regulate that a bit but I don't think it's the job of the regulator to tell us how to run our business.

I think, the politicians probably could do with thinking about what risk appetite they want the system to run and how they could use the banking system in order to support growth in the economy.

I mean, we've long held the view that there's lots of things they certainly could do with the mid-tier banks to support growth just from that sub-sector relative to the whole, but it will get me into a whole ball game of political debate there which I probably shouldn't do because my political advisers up there will turn around and like yank me off the stage very quickly.

Sanjena Dadawala, UBS

Could you give a bit more detail into your NIM guidance for the year, including assumptions on the policy rate and the timing and what you expect on the deposit dynamics? And then, if you could, like even further out, how you think things will play out … specially, given that the sector as a whole has TFSME refinancing coming up?

Nigel Terrington, Paragon

We're not going to go beyond 2024 in terms of guidance.

I think there's too many variables beyond that. You've certainly identified one … TFSME.

We expect TFSME to have an impact on deposit betas and we've allowed for that in our guidance. I don't think people are going to wait till the last day in 2025 to start repaying so I think, you know, you'll start to see further repayments taking place in 2024 and not just from us … I mean, I think from others.

But, you know, beyond 2024 we're not going to be … I think it's too … well, we never go beyond one year anyway but, I think, there's so many variables in the longer term over NIM that it's probably not one to get into too much detail.

Richard Woodman, Paragon

In terms of the rate profile, we've got rates starting to drop from … probably into our Q3. Now, I know the market is probably pricing those as being a little lower.

One of the things to bear in mind in terms of the way we manage margins and, it goes back to before we had the bank where everything was wholesale funding, everything was matched … and so everything was hedged …and we've applied those same principles with the liability side of the balance sheet as well as the asset side. So, a lot of our fixed rate bonds are swapped. And actually, the more important element for us in terms of our developing margin is that after-swap cost of those liabilities.

So, it may have been coming into this last year that we've just reported … at the end of 2022 … I think we had about 58% of our deposit book that was on a fixed rate basis.

As rates have gone up … because we've hedged those … actually, they've become quite expensive through the year because actually, they float up with the new rates.

But similarly, the loans that we've now been putting on … and we're now up to around 65% of the book that is fixed rate bonds … if rates start to drop, actually by swapping them to a variable rate, we will start to benefit.

And so, the forecasting for a bank that takes that approach is a little bit different to the way you'll be looking at margin progression for the biggest banks who tend not to do that.

So, it just makes it a little more complex from a point of view of people who follow a normal clearing back model in terms of in terms of NIM progression.

I think the point is that we very much focus on product margins so, if there's a dynamic where we're making a little bit more potentially because the way that the deposit beta is coming through … we're up to 64% at the end of the year … if that carries on tightening a little bit, we would expect the flip side of that to come through in asset pricing and asset pricing has widened since September in terms of position against swap.

So, that market is working in a fairly balanced way at the moment. And that's what we've put into our models and we've also assumed that we have the hedge fully put in place I think by about February. So, from that point, we'll continue to benefit if rates do drop.

Jason Napier, UBS

Two please. First on costs. You have the distinction of being one of the smaller banks who is not missing on costs. I wonder if you can talk to the various moving parts around re-platforming, de-layering and so on because we've got others in the sector whose spend on things like cyber and so on seems to have taken us by surprise as being higher than we'd expected.

And then, secondly, in a similar vein, you've spoken for a while about the monthly downloads of credit bureau data and so on. One of your peers increased their provisioning on the back of data they believe they see from that same source. That suggests that customers are taking debt elsewhere and becoming ever more levered into a weaker environment. If you could just talk about what you're seeing on that front that would be helpful as well. Thank you.

Nigel Terrington, Paragon

So, in terms of costs, we don't have the heavy infrastructure branch network to worry about and we have therefore always sought to make the cost: income ratio kind of an opportunity target to try and make ourselves more efficient relative to the competition. And it is, after all, one of the key things we can control.

We commenced a technology change programme a couple of years ago and as you can understand these things don't happen overnight. There's a long gestation period to the project planning, to the execution, implementation. And, we're doing it on a sequential basis and a modular basis, so it's not like one weekend is going to be a big bang … and we're all going to be like Monday morning … it's all going to be great or maybe not if it doesn't work. So these kind of things are just getting rolled out. It is a very prudent and a very cautious way of doing it.

The other thing that you'll see is, if you look at, the amount we capitalise is very low. If you put us on a stage side-by-side with others in the industry and then see how much of their project costs they get to capitalise, it's significantly more than us. We've got £4.4 million on the balance sheet, that's not even the figure we did in the year. The rest is expensed. Now, again, that's a very cautious way of doing things … so a lot of the project work, despite it being a project, is just getting expensed as we go through.

And so just bear that in mind when … I'd like to say that one day these projects will finish. We know that won't happen, there will be other projects that will come in … but this is a significant re-platforming.

It is a big, big change programme for us … kind of every facet of our customer facing life is being changed. So, I think that probably rolls out, kind of in bulk terms, probably by 2025 … but thereafter, you know, I'm sure AI and machine learning … there will be all sorts of other things that will be kicking in at that point.

Now, you'll notice we don't have a cost: income ratio target and that's deliberate because I think it's too difficult a science at the moment to try and predict what that will pan out to be because the rate of change of technology is so fast at present … you've got to be able to see that to happen.

On the way through, we also want to make sure our businesses is in the right shape. So you'll see, in there, we restructured … we did a bit of restructuring during the year and that's just to make sure we looked at the organisational design, we looked at the shape of the business, we looked at the management layers and we decided to redesign it … and, you know, that inevitably involved taking out some costs, so that was dealt with in the year.

But, you know, the year before we also had IRB costs. So, we don't like throw these in as exceptional items every year. There are always costs running in the business and they're all designed to improve the business, improve the efficiency, improve the regulatory frameworks that we operate under … all of these things … but we don't try and draw them out to be one-off costs every year.

Richard Woodman, Paragon

But the tech spend has ground higher. We're probably up 80 or 90% over the last four or five years in terms of the run rate, in terms of the scale of the overall investment there.

But, it's still coming through and delivering that good cost: income ratio and not the scale of increase in overall costs that we're seeing elsewhere.

Sorry Jason, what was your second question?

Yes, so on the impairment pages, we show that behavioural score analysis across our customer books. Those behavioural scores … the level of indebtedness, credit card utilisation … as you'd imagine, the great raft of data that we get from the agencies and the performance we see from the customers themselves, will go into those models. And, in the main, year-on-year, we're seeing an improvement on each portfolio.

We've seen a slight deterioration this year for the first time on that variable-rate, legacy portfolio … but those loans have gone from paying 1.7% - 1.8% 18 months ago to not far shy of 7% now. And so, you would have expected a little bit in the way of … a little bit of stress, because they're just tracker loans. But, in the main, we haven't seen that over-indebtedness as a particular feature but that's probably down to the class of customers we've got,

Robert Sage, Peel Hunt.

I think you made reference to AI in your introductory comments and I was just wondering if you could expand a little bit in terms of what you see in possible applications in your business in terms of how that goes forward.

The second point is quite technical. Close Brothers just did an AT1 issue and I see that you're renewing your authorisation to do it and I was just thinking in terms of how likely is that, what the timing might be? Is it something you're likely to do once you see IRB or the outcome of Basel 3.1?

Nigel Terrington, Paragon

Okay. So, in terms of AI, we've been using it in the business for a while. We have it in our cyber security operations, ensuring that … we've got good technology watching and monitoring and being able to identify any heightened risks that may emerge.

We have it in our SME business where we access 4,000 pieces of customer data and that's basically pulling data from various external sources into a core database and then doing some analysis over it. That's artificial intelligence in action literally with our customer information as we speak today.

And we've also been using it to write code in our IT development team. We don't just let the computer loose, we actually have it peer-reviewed by a human being. So, it's live and working already in our business.

We've got separately a bunch of projects running, kind of experimenting with how it is … ranging from using it to do contract reviews, through to speech to text … being able to allow the computer to listen to things and then turn it into detailed minutes, reports or actions.

And it's an experiment so we'll see. It might turn out to be gobbledegook or it might turn out to be absolutely amazing … but, there's a range of projects going on and I think that the teams in the business are very excited about the opportunities that could arise from it.

It's got a way to run. I mean … you know … no good presentation is complete without mentioning AI but I think there's a long way to run to ensure you can let it loose on a regulatory system … with a regulatory business … but we do see the opportunities as quite exciting.

We renew the AT1 requirements every year so, in that sense, you might regard it as a free option. What we have is no immediate plans but because … if you look, we've got a very strong CT1 position, we don't need it and, if we issued one today, all it would do is reduce earnings.

But, when you look at the capital stack, it's a sensible tool that a bank could use … but there's no point in diluting earnings when you don't need it.

Portia, I think you had a question.

Portia Patel, Canaccord

You touched on politics and I can understand if you don't want to comment because you've got your political advisors here but, obviously, the election is probably going to be a key theme for next year so just interested in any thoughts, hopes, expectations for the next 12 months in that regard?

Nigel Terrington, Paragon

Definitely taking the 5th on that one. Stability, certainty all of those things … but you would hope for that all the time.

We're not political, we run a business. Our job is to run the business whoever is in charge. We engage with the current government, we engage with the Labour Party and so it's our job to work with them to try and optimise and get the best solutions possible for the business. Beyond that, I will not get drawn.

I think that probably draws to a conclusion the questions in the room.

Now, what we're going to do is try and take any calls from the phones and then we'll do some questions from the webcast if there is any.

…. there's no other questions so we will leave it there.

As I said, Richard has kept the rest of today and tomorrow available to talk to you. It's really important that we give you the best opportunity to make sure you've understood these results as best as possible so Richard is at your disposal.

Thank you once again. We're around … so if anybody wants to have a chat after this, we are happy to do so as well.

Otherwise let me wish you a great festive period. Have a great break and we look forward to seeing you in six months time.

Thank you very much.