Close Brothers Group plc

Half Year Results 2023

Edited transcript*

Tuesday 14th March 2023

Adrian Sainsbury, Group Chief Executive Officer

Good morning and welcome to the presentation of Close Brothers' 2023 half year results. I'll start with a brief reflection on the key elements of our Half One performance. Mike will then take us through the financials. I'll then come back to cover business performance and our strategy. At the end, you'll be able to ask questions, either via the telephone conference line or over the webcast, which you can submit during or after the presentation.

This has been a challenging six months, with our half year results significantly impacted by Novitas and the UK economic outlook creating uncertainty for our customers. Although we continued to see good levels of loan demand and a resilient underlying credit performance, the volatile environment has been reflected in higher forward-looking provisions and challenging market conditions for CBAM and Winterflood.

Our first half results were impacted by a significant increase in provisions in relation to Novitas, resulting in a material reduction in operating profit. However, the underlying performance of our business has remained resilient.

In Banking, we saw 5% income growth with a strong net interest margin, and were particularly encouraged by the continued increase in new business volumes in our Commercial business.

In Asset Management, we generated net inflows of 6%, with a strong contribution from our new hires, although Winterflood's performance continued to be impacted by the slowdown in trading activity.

We've maintained strong capital, funding and liquidity positions, with our CET1 capital ratio at 14%, remaining above the group's medium-term target range of 12-13%.

We're also pleased to declare an interim dividend of 22 ½ pence per share, reflecting the group's underlying performance and confidence in our business model.

We've accelerated our efforts to resolve the issues surrounding Novitas Loans, with a focus on ensuring good customer outcomes. Let me briefly take you through the background on that business, our decision to wind it down and the financial impact on our Half One results.

* This transcript has been edited to correct minor factual inaccuracies.

Novitas was a provider of finance for the legal sector we acquired in 2017. We decided to put this book in run-off and withdraw from the legal financing market in 2021.

Some of the key attributes of our model have proven not to be evident in the Novitas business – we like businesses where 1) we have the in-house lending expertise, 2) there is a track record of performance and 3) where there is underlying security of the loans.

Cases were taking longer than expected to move through the courts and when they did, there was a higher-than-anticipated failure rate and lower recoverability under the insurance policies. It became very clear that Novitas was not aligned with our Close Brothers' model.

We continuously evaluate our businesses and initiatives to ensure they are aligned with the key attributes of our model and I'm confident there is no read-across from Novitas to the other books in our portfolio.

We've taken steps to resolve the Novitas situation – we've initiated legal action against one of the insurers relating to the recoverability of funds for failed cases. We took a £25 million provision in the first five months of the financial year, largely reflecting the expected longer time frame for recovery for loans related to the litigation.

As announced back in January, we've also now booked an additional £90 million provision, which assumes a material increase in the case failure rates and a cautious view on the assumptions for recoverability.

This takes total provisions in relation to Novitas to £183 million and represents a 75% coverage ratio on the gross loan book of £245 million, leaving us with a £62 million net loan book. We're confident this adequately reflects the remaining risk of credit losses.

There's also expected to be an impact on income going forward, from £36 million in Full Year 22 to £8 million in Full Year 24.

While we're extremely disappointed with these developments and the impact they've had on our performance, we believe it's the right course of action to take and the financial strength of the group leaves us well placed to move forward with the delivery of our strategic priorities.

I'll now hand over to Mike to take us through the financials and then I'll come back to talk about our business performance and strategy.

Mike Morgan, Group Finance Director

Thank you Adrian, and good morning everyone.

Clearly, this period's headline numbers have been materially impacted by the additional provisions taken against Novitas. This was the primary driver of the reduction in the adjusted operating profit to £13 million and the decline in adjusted EPS to 6.1p for the first half.

Notwithstanding this significant impact, the underlying performance of the group has remained resilient.

Income was up 1% as 5% growth in the Banking division offset reductions in the market-facing businesses. Costs increased 2% as higher staff costs in Banking and ongoing investment more than offset lower variable costs in Asset Management and Winterflood. And on a pre-provision basis, profit was down 2% at £175 million.

Excluding the P&L impact of Novitas, we generated a return on tangible equity of 12.5%.

The board has declared a 22.5p interim dividend, up 2% on last year. This reflects the underlying performance, confidence in our outlook and our commitment to deliver sustained dividend growth.

Moving on to the divisional performance.

In Banking, performance was significantly impacted by higher impairment charges in relation to Novitas, as well as forward-looking provisions reflecting weaker economic forecasts and a rise in arrears in Motor Finance. As a result, profit reduced 88% to £15 million.

Profit in Commercial increased 5% excluding the impact of Novitas. Profits in both Retail and Property were down year-on-year.

In Asset Management, we generated healthy net inflows, although profit reduced 41% to £9 million, as stable costs were more than offset by lower income.

And Winterflood's performance was adversely impacted by the continued market-wide slowdown in trading activity and difficult market conditions, with profit down 73% to £2 million.

Turning to the Banking division. This period has seen a challenging market backdrop, creating significant uncertainty for our customers. Nevertheless, we have maintained our commitment to lending through-the-cycle, whilst retaining our pricing discipline.

As Novitas has had such an impact on the first half, I'll cover these numbers on an 'ex Novitas basis' to give you a better idea of our underlying performance.

We saw 7% growth in income to £350 million, reflecting the strong margin and year-on-year loan book growth, and the net interest margin increased to 7.8%.

Expenses rose by 9% to £182 million as we continued to progress our strategic investment programmes and incurred higher staff costs from inflation-related salary increases.

On a pre-provision basis, profit rose 5% to £168 million.

Impairment charges increased to £48 million, which corresponds to an annualised bad debt ratio of 1.1%.

As a result, adjusted operating profit excluding Novitas reduced 21% to £120 million. And the P&L impact of Novitas in the first half was a loss of £105 million, primarily driven by the impairment charges.

Moving onto the loan book, which declined marginally in the first half but grew 1% when excluding our businesses in run-off.

Excluding Novitas, our Commercial book grew 2% with good demand in Asset Finance more than offsetting a seasonal decline in Invoice. This growth was achieved despite the impact of CBILS lending running off.

Our Retail book contracted 1% when excluding the Irish Motor Finance business. The UK Motor book was stable, although we saw a 2% decline in Premium, reflecting first half seasonality.

Property grew 3% as we saw strong drawdowns from our healthy pipeline and repayment levels began to normalise.

We are actively working to identify incremental and new opportunities in both our existing and adjacent markets. We are confident in the outlook for the loan book over both the short and medium term and remain well positioned to deliver disciplined growth.

Now onto our net interest margin. Our specialist, relationship-driven model and disciplined approach to pricing have enabled us to maintain a strong net interest margin.

Excluding Novitas, we achieved a NIM of 7.8%. This reflects our pricing discipline on new lending and the optimisation of our liability mix in the rising rate environment. We also saw 14bps of one-off benefits from mark-to-market swaps.

Looking forward, we are well positioned to maintain a strong net interest margin as we prioritise pricing over volume growth. However, we expect cost of funds will remain elevated in the next financial year.

Moving onto costs in the Banking division. There was a 5% increase overall, as we progressed our investment programmes to support our strategic objectives and exercised rigorous cost control over our cost base.

Business-as-Usual costs increased to £148 million, driven by higher staff costs, as we awarded salary increases in light of the inflationary environment.

Investment costs rose to £35 million, as we progressed our strategic programmes and initiatives. This also included £18 million of depreciation.

We also incurred £4 million of costs relating to Novitas as we continue to wind down the business.

As previously highlighted, we expect costs relating to our investment programmes to stabilise over the next financial years, although related depreciation charges will continue to increase.

And while our investment programmes remain critical to support our Banking high touch model, we have intensified our focus on cost discipline and efficiency, especially in light of recent inflationary pressures. We have initiated a number of strategic cost management actions. These, combined with our cost discipline, focus on creating capacity to accommodate growth, inflation and investment, whilst ensuring that we preserve our fundamental model attributes of service, expertise and relationships.

We have commenced a multi-year technology transformation programme focused on strategic IT services, and a programme simplifying our Retail operations that will create efficiencies whilst delivering customer and control benefits. We also continue to evaluate additional opportunities for efficiency across the Banking division, with a view to delivering positive operating leverage over the medium term.

Turning now to our credit performance. The annualised bad debt ratio was 3.6% as we recognised £115 million of impairment charges in relation to Novitas.

Excluding Novitas, the annualised bad debt ratio of 1.1% reflected weaker macroeconomic variables, particularly in the Retail business, as well as a rise in arrears in Motor as our customers faced cost of living pressures.

Notwithstanding this, we have not seen a significant impact on credit performance at this stage, with actual realised losses outside of Novitas equivalent to just £10 million in the period.

Nevertheless, we continue to closely monitor the evolving impacts of rising inflation and cost of living on our customers. We remain confident in our loan book, which is predominantly secured or structurally protected, prudently underwritten and diverse.

Now taking each of our Banking businesses in turn, starting with Commercial. The numbers in Commercial were clearly significantly impacted by the impairment provisions in Novitas. So therefore, I'm going to run through the performance on an excluding Novitas basis, to provide you with a view of the underlying performance.

We saw strong income growth of 12%, as continued good customer demand and higher new business volumes drove loan book growth and increased activity driven income. Costs grew 11% from higher staff costs and investment spend on our Asset Transformation programme. As a result, pre-provision profit was up 14% as we achieved positive operating leverage in the business. Impairment charges rose £6 million to take into account the weaker external environment. And overall, profit was up 5%.

Moving onto Retail, where we saw income up 3% driven by year-on-year loan book growth and our strong margin. The net interest margin rose to 8.2% in the first half as we adhered to our model of pricing discipline, passing through higher rates on new lending in Motor Finance. Costs were up 10% as we invested in the simplification programme I talked about earlier, which will create efficiencies whilst delivering customer and control benefits, as well as higher staff costs, particularly in legal and compliance.

We saw an increase in impairment charges. This was driven in part by the rise in arrears in Motor, which is to be expected in the current environment, and is in line with comparable industry trends, as well as by the weaker macroeconomic outlook. We remain comfortable with the quality of our portfolio, which is underpinned by our underwriting discipline and prudent level of provisions. Overall, profit reduced to £14.7 million.

And finally, Property, where strong drawdowns from our healthy pipeline and a normalising of repayment levels drove good loan book growth. Income was stable as we saw good levels of fee income and maintained a strong margin. Costs reduced by 9% as we maintained our strict cost discipline. And as a result, pre-provision profit was up 4%, reflecting the positive operating leverage in the business. We also saw a rise in impairment charges to reflect the weaker environment, particularly projected lower house prices. Overall, profit reduced to £33 million.

Turning now to Asset Management.

Managed assets increased 3% since the end of July to £15.7 billion, driven by positive net inflows, partly offset by negative market performance. Total client assets were up 2% to £16.9 billion. We delivered annualised net inflows of 6%, with a strong contribution from new hires, despite ongoing uncertainty impacting investor sentiment.

Operating income decreased 7% to £71 million, reflecting lower average AuM due to markets and lower client activity. The revenue margin decreased to 83bps, primarily due to flows into our lower margin investment management products. Expenses were stable at £62 million, with lower variable compensation offsetting higher staff costs and investment in new hires. As a result, adjusted operating profit decreased 41% to £9 million and the operating margin decreased to 12%.

And now onto Winterflood. Income was down 21% to £39 million driven by lower trading revenue, reflecting a market wide slowdown in trading activity and a change in the mix of volumes.

During the period, average daily bargains declined to 61,000 as low investor confidence and macroeconomic uncertainty impacted retail trading activity. And the significant decline in trading in our higher margin sectors is evident from the reduction in total number of bargains seen in both the AIM and Small Cap sectors.

Nevertheless, diversification in trading sectors has helped to navigate the difficult market conditions, with Fixed Income benefiting from volatility in bond markets. And the growth in income from Winterflood Business Services continues to balance the cyclicality seen in the trading business.

Costs reduced by 10% to £37 million, reflecting lower variable staff costs. As a result, operating profit declined 73% to £2 million.

Winterflood has a strong market position, a long track record of trading profitably in a range of conditions and remains well placed to take advantage of future trading opportunities when investor appetite returns.

Moving onto our balance sheet. We maintained a strong balance sheet and continued to adopt our prudent approach to managing financial resources.

Our total funding increased to £11.9 billion, well in excess of the loan book. We continued to "borrow long and lend short" with the average maturity of allocated funding at 18 months, ahead of the loan book at 16 months.

We manage liquidity conservatively, with our Liquidity Coverage Ratio at over 1,000%. We had £2.1 billion of treasury assets at 31st January, with the majority held with the Bank of England.

We have a diverse funding base, with an established presence across wholesale markets, along with our mix of retail and non-retail deposits.

Although market rates increased materially in the period, we were able to mitigate this through actions taken to optimise our liability mix, resulting in an overall cost of funds of 2.6%. And as I mentioned previously, we expect our cost of funds to remain elevated in the next financial year.

We increased our total deposit base to £7.3 billion and grew our retail book, which now makes up 49% of all deposits.

And our credit ratings remain strong, with Moody's rating Close Brothers Limited Aa3, helping to support our ongoing issuance plans.

Turning now to our strong capital position. Looking at movements in the period, our transitional CET1 capital ratio was 14.0%, down from 14.6% at 31 July 2022. The movement mainly reflected the impact of Novitas on retained earnings and a decrease in risk weighted assets.

We maintained a significant buffer of 550bps headroom above our minimum regulatory requirement of 8.5%.

Our leverage ratio remained strong at 12.0%.

On IRB, we continue to engage with the regulator and have submitted additional documentation as part of the Phase 2 process, although the timing remains under the direction of the PRA.

And finally turning to our capital framework, which articulates how we are thinking about excess capital. We are targeting a CET1 capital ratio range of 12% to 13% over the medium term, which will allow us to maintain a buffer to minimum regulatory requirements while also retaining flexibility for growth.

Our primary objective is to deploy capital to support disciplined loan book growth in Banking, and to make the most of strategic growth opportunities.

The board remains committed to our dividend policy, which aims to provide sustainable dividend growth year-on-year, while maintaining a prudent level of dividend cover.

And we will consider future capital distributions to shareholders in the absence of alternative growth opportunities.

We remain committed to further optimising our capital structure, including the issuance of debt capital market securities, if appropriate.

Thank you, and I will now hand back over to Adrian.

Adrian Sainsbury

Thanks Mike.

I strongly believe that we have the right model to progress our strategy.

We remain committed to our disciplined approach to lending through the cycle – this is reflected in our strong NIM, as well as in the underlying asset quality and performance of our loan book.

Our specialist expertise and focus on service and relationships really differentiate us. This continues to be reflected in our customer satisfaction scores and high levels of repeat business.

We've a distinctive culture at Close Brothers, a relentless customer focus and long-term approach to everything we do are embedded in our organisation. And I truly believe that this is one of the most important assets, which is very hard to replicate.

The strengths of our model have been evidenced though many cycles and are also reflected in our long-term dividend track record.

As we move forward from Novitas, we're well positioned to progress our strategic priorities to protect, grow and sustain this valuable business model. We're focused on resuming our strong track record of earnings growth and returns by focusing on disciplined growth, cost efficiency, and capital optimisation.

We see investing through-the-cycle as key to protecting our model and enhancing its strengths. We view these programmes through two lenses. First, those focused on maximising our income generation, and second, those focused on resilience and efficiency.

We've seen our investment programmes deliver real benefits across the organisation and I'll take you through two examples shortly.

As Mike said earlier, it's also critical that we maintain cost discipline, especially in this inflationary environment. We've a number of strategic cost management initiatives. This includes rationalising our IT infrastructure and operational enhancements and simplification in our Retail business. And we continue to evaluate additional opportunities for efficiency and remain committed to achieving positive operating leverage over the medium term.

This intensified focus on cost discipline will create capacity for investment, and support growth in our business. On the right hand side of this slide, you can see this in practice.

We've concluded our Motor Finance transformation programme, which enabled us to make the most of growth opportunities in the second hand car market, to enhance our digital capabilities, and evolve our dealer and customer proposition.

We also continue to benefit from our customer deposit platform, which has enabled us to broaden our Savings proposition. We've seen an 80% increase in our Retail Savings book since the launch of the platform. This has enabled us to optimise our funding mix and minimise the impact of higher interest rates on our cost of funding in Half One.

We're delivering on our strategic growth agenda and continue to actively evaluate potential opportunities that are aligned with our business model.

In Banking, we see a significant opportunity to broaden our sustainable finance offering, as the UK heads towards a net zero carbon economy. At the Full Year, we set an initial green finance ambition to provide £1 billion of funding for battery electric vehicles over the next five years. And in Half One, we've lent over £90 million.

Our recently hired materials handling and agricultural equipment teams are executing deals and have built healthy pipelines. We've been piloting a specialist buy-to-let extension with our existing customers, which has proven successful and see good prospects for this product. We continue to grow in the Asset Based Lending space, identifying syndication opportunities and partnering with other lenders. We've also hired a new team focused on providing bespoke term loan structures to SMEs requiring growth and investment finance.

In Asset Management, we remain committed to building on our excellent track record of growing client assets organically through our successful hiring strategy, as well as through in-fill acquisitions.

We also continue to see significant growth potential in Winterflood Business Services. Assets under Administration reached £12.4 billion, already exceeding our £10 billion target for this year, with a strong pipeline.

Behaving responsibly is fundamental to our purpose, strategy and culture. As a signatory to the Net Zero Banking Alliance, we've committed to lowering our operational and financed emissions, and have continued to develop our transition plans. CBAM has also made strong progress, becoming a signatory to the Net Zero Asset Managers initiative.

Over 40% of our company car fleet is now fully electric and, as I said earlier, we've funded over £90 million of battery electric vehicles in the first half.

We've also been focused on developing further our sustainability data and reporting.

Our inclusion agenda is also very active and we're running a number of initiatives focused on diversity, inclusion and social mobility.

In summary, this has been a challenging six months, but I strongly believe that we've the right model to move positively into our next chapter.

Last week's external events serve as a good reminder of the benefits from our prudent approach to the management of our financial resources. Just to remind you, we run prudent levels of capital, funding and liquidity, with a strong CET1 capital ratio. We borrow long and lend short and have a Liquidity Coverage Ratio of over a thousand per cent.

The strengths of our model have been evidenced through many cycles and remain unchanged. These include our long-term relationships, the deep expertise of our people, and our commitment to excellent customer service.

I am confident that our focus on delivering disciplined growth, cost efficiency and capital optimisation will enable us to resume our strong track record of earnings growth and returns.

Thank you, and we would now like to open up for any questions you may have.

Q&A session

Question 1

Benjamin Toms, RBC

Morning, Ben Toms from RBC, thank you for taking my questions.

Firstly on Winterflood, just £2 million of profit in the half, which is, I guess quite low versus historic levels. However, there's only one loss day. I'm just a bit surprised at how low the loss day number is in the context of the profitability of the business. It implies a lot of days where you just breakeven. Is that a fair assessment? Is the loss day metric really that useful in assessing how well the business is performing? It would be good just to get a little bit more colour on the weakness here, please.

And then secondly, on the dividend, you reiterated the intent to pay a sustainable and progressive dividend this year. Because of the Novitas write off, I guess this guidance implies that a payout ratio will be meaningly over 100%, assuming a 1/3 2/3 dividend structure that's in line with previous years. I appreciate that the full year dividend is a question for the board at the end of the year, but are management comfortable that the regulator will allow a bank to pay out this level of earnings? I guess we should take some comfort from the bank's extremely strong liquidity coverage ratio. Thank you.

Adrian Sainsbury

Thanks, Ben. Two good questions and I'll address them both. Starting with Wins, the loss day number of one is correct, and your assertion that there haven't been many significant profit days is also correct as well. What would I take from that? I think it shows the absolute strength of the risk management framework in Winterflood in these very difficult sets of market trading conditions, how well they manage the books that they have.

Remember that we're a market maker and not a proprietary trader, but clearly to make a market, you have to hold some stock. And in difficult markets, where markets open down, clearly that's not an easy start to the day. So one loss day shows the very strong risk culture of the business. We're well-placed for any uptick when it comes and as we highlighted clearly where our higher margin products are, AIM and Small Cap, those markets have been impacted more. So when we see a return to more normal trading conditions, that will clearly help us.

You're also correct, the profit at £2.3, £2.4 million is pretty much an historic low. And clearly we see that as a cyclical sort of bear downturn sort of position that we would expect to recover in time.

If I move on to the dividend, the 22 1/2p, 1/2p up on Half One last year for the interim, really shows the confidence that we and the board have in the outlook for Close Brothers and also the trading performance of the core businesses. We've very much seen Novitas as a ruled off position and when we're considering the dividend, we should consider the underlying core business performance.

As you rightly say, historically, apart from in Covid in April 20 when we cancelled the interim, we have paid one third interim, two thirds final pretty much, and I recognise that a number of the analysts in the market may put that in their spreadsheet. Again, you are correct Ben, that our board will make that decision at the year end, depending on performance at that time and outlook in the markets. And absolutely, you are also correct that we will discuss those things with the regulator. I have normal regulatory calls every quarter and that would be a standard topic that I would have with the regulator and we will consider that discussion at the year end. Thank you, Ben.

Another phone question, I think.

Question 2

Portia Patel, Canaccord

Morning, this is Portia from Canaccord. Thank you for taking my question. I just wanted to clarify your outlook for the net interest margin. So given cost of funds have doubled in the period and your comments that the cost of funds should remain elevated, should we interpret your outlook as NIM compression over the next 12 months, or do you expect to maintain the underlying NIM at around 7.8%? Thank you.

Adrian Sainsbury

Thanks, Portia. If I look at the wider concept of the NIM and what we've seen, if I look back to September, when we did our full year results for 2022 and the interest rate rises were coming through, there was a lot of discussion in the market on whether we would be able to sustain the NIM at this level. So I think our Half One NIM of 8%, 7.8% excluding Novitas, is a good performance. It also clearly compares favourably to the UK average, which is well below 3% as well.

There are clearly a number of components that made up the NIM in the first half. There's our yield performance on our lending and clearly, as Mike illustrated, we worked hard in our businesses, notably Motor and Asset, to pass on those rates into the market to maintain our pricing discipline and therefore maintain the NIM.

On the other side of the balance sheet, on the liabilities, our investment in the deposit platform has clearly helped us and we have a wide range of products along the way.

So, 8% headline, 7.8% excluding Novitas, and we highlighted a 14 basis point one-off help on mark-to-market on euro swaps as well. So the underlying is 7.7%. The market consensus for the full year is around 7.7 and I'm comfortable in that number for the full year. The chart that we showed on NIM shows that historically, we've had a range of 7.4 to 7.6%. And I think looking out further, after full year 23, around that sort of range is probably the right sort of range.

It's uncertain where the funding markets are going to go from here. As you rightly say, our cost of funds in full year 22, 1.3% accelerated to 2.6% in the first half. And we will work hard in our deposit mix and our yield on our asset bases, to maintain the NIM in that market. Overall, a strong NIM and we've also maintained good loan book and new business volumes throughout the business. Thanks, Portia.

Question 3

Gary Greenwood, Shore Capital

I've got three questions, if I can. So the first one is on Motor Finance, where I think you said the arrears had sort of picked up. So I just wanted to sort of ask there about affordability and whether that's something you worry that the regulator might look a little bit more closely at if arrears continue to increase in that industry, so that was the first one.

The second one was around the revenue margin in Asset Management, which fell quite sharply. I think you put that down to mix effects, but if you could just sort of expand on what's happening there and sort of whether you think that will reverse out over time or whether that's now a new norm.

Then the last one was on corporate deposits and in light of what we've seen with SVB, I was just wondering whether it's going to be more difficult for smaller banks like yourselves to now attract and retain corporate deposits. Thanks.

Adrian Sainsbury

Thanks Gary, let me take those in turn. On Motor Finance, we flagged at the full year period in September 22, that Motor arrears were ticking up and that we've clearly highlighted again now. It is a component of the £48 million of provision in Half One, excluding Novitas. We have a very conservative approach to how we look at the market. If I describe our customer base, we're writing a slightly better customer score since pre-Covid, so the customers are pretty similar quality, but clearly the economic environment is slightly worse. If you look at market trends in arrears in the motor finance market, we would show favourably compared to the peer group there. And if you look at our overall coverage on the Motor book, it's now a little over 4%, which is prudent as well.

You raise a very valid question on affordability and where this might go next with the cost of living crisis. And quite clearly the regulator is very interested, the FCA, from a conduct perspective, on how we look after our customers. That is very important to us as we move into the Consumer Duty, and we have a very strong approach to how we look after customers in forbearance. So, it's an important topic for us and I think we're well provided on our Motor book.

On the revenue mix in in the wealth management business, CBAM, we highlighted the reduction in the margin and it is a couple of things there, I would say. It is a bit of mix, so if we have the whole offering of advice with the investment and funds afterwards, clearly you get a better margin on that than just investing alone or advice alone. And with the markets falling as well, the average market level was lower in the first half, that clearly impacts the income, which has a direct feed-through into the margin that you achieve on the business that we're writing.

Let's have a look on the last point at the Silicon Valley Bank point that you were alluding to overall, and corporate deposits was your question. But if I may, I'll give a slightly wider answer to that to explain how well-placed we are on those sort of issues. So, there's no look-through for our business to what's happened in America in the last few days. I'd say what a great time – we've described our investment thesis as having three clear ticks on capital, liquidity and funding, having a liquidity coverage ratio of over 1,000%, the UK bank average is about 200%, and our 'borrow long lend short' model has real strengths here.

We highlighted in the presentation that our corporate deposits are around £3.7 billion and our retail deposits are around £3.6 billion. The majority of our retail depositors would benefit from the government insured FSCS £85,000 guarantee, whereas the corporate depositors wouldn't. And that is the basis of your question.

Importantly, as Mike highlighted, we have strong credit ratings – we're in the AA category equivalent with Moody's, we've got a split rating with Fitch having us on the single A category. Those ratings are important to corporate depositors, but notwithstanding that, we don't have ratings triggers in those deposits either.

Just to follow through with the full Silicon Valley Bank answer, widely reported, is the investment holdings of government treasuries and other bonds in Silicon Valley was seven times their equity base. You can see in the back of our RNS on page 57, that our holdings of sovereign debt has reduced from a little over £400 million at the end of July 22 to around £201 million now, broadly 1/7th of our capital base. So there's a sort of difference in leverage there of 49 times. And also, we fully hedge that debt that we have, the government sovereign debt that we have. So we're very well placed. We've seen nothing changing in the deposit markets in the last few days for our business. And you'll have also seen that in the half, we saw our deposits increase.

Mike Morgan

Just one build if I may on the first point, on credit more generally, we talked about an underlying ratio of 1.1%, Gary. The actual losses in the first six months are £10 million on the whole book of £9 billion, so very low. That provision is built up through modelling and the macro environment, so actually only £10 million of losses.

Question 4

Investor

We've got two investor questions here. First is, are you able to provide the percentage of the loan book that is secured and by each division? And the second question is, have you got the long-term bad debt ratio prior to 2008 in a higher interest rate environment?

Adrian Sainsbury

Thank you. The percentage loan book secured by each business. Let me try and work that through. We don't actually disclose by division, but I'll try and give some guide as I go through the businesses.

Very clearly, we say that part of our model is having secured lending and 90% of our loan book of just over £9 billion is secured or structurally protected.

If I start with the Retail business, typically that would be on a used car. At origination, the car is typically three years old, and we're typically lending a loan of around £8,000. So it's a used car and there, we have the security directly of the car.

In Premium Finance, it's a different market to standard unsecured lending to consumers. We're lending to a consumer, one of 2.5 million or 250,000 SMEs on their insurance policy, and typically we will have refundability of the policy. We lend typically in ten instalments for the insurance premium, we will have the refundability of the insurance policy, and in certain cases, we have access to have refundability to the broker who's introduced the business. And we also have the end consumer or SME who are responsible for the lending.

In Property, very clearly, we're lending to mid-sized house developers, we have conservative LTVs compared to the market, so the business is all secured in this instance.

In the Commercial business, we have a wide range of different businesses in Commercial, lending on different businesses. In Asset Finance, we have businesses that lend on HGVs, commercial vehicles, that would be the security in place. In the top end of leasing, we would have, for example, more structured arrangements, and in some of those situations it's more structural protection rather than direct security. And in Invoice Finance, the security is the receivables of the SME.

So, in summary, as I've illustrated, there's security or structural protection in all the businesses that we have.

Mike Morgan

Just in terms of the long-term bad debt ratio, it is a good question because clearly, we are in a higher rate interest environment. Probably the bigger factor though, is that the accounting standards have changed. So, if we go back pre-2018, you're only accounting for losses when they actually came through, whereas under the IFRS 9 accounting standard, we have to look out to the future and account for loans, whether they have defaulted or not, based on our models and our experience.

In 2009, our bad debt rate was 2.6%. That's the information I have in front of me – I don't have information going back to the sort of higher interest rate environment, which I think, what is probably most like where we are now would be early 90s, I don't have that information. But what I can give you is that in 2008, it peaked at 2.6%. And then of course in the pandemic, it was 2.3% in FY 20.

Question 5

Investor

We have another question from an investor. Why was the weakness in the Novitas business model not picked up in original due diligence? And what are the learnings for future acquisitions?

Adrian Sainsbury

Thank you, an excellent question. As we highlighted, we purchased Novitas in May 2017 and clearly, we did due diligence at the time. And as we've highlighted, the business has not worked out as we expected. A number of things have changed since we purchased the business and clearly, I would much have preferred that we hadn't purchased that business. The losses that we've incurred are not attractive to our investors and are not part of the Close Brothers approach or model.

If you look back to May 21, we held an Investor Day that's available on our website and at that time, we launched our Model Fit Assessment Framework that identifies the key criteria, the key traits, that have made Close Brothers successful in the past and will make it successful in the future. And I mentioned a little earlier that we apply these criteria to each of our businesses to check they still fit the model, and also on new acquisitions importantly, or new business initiatives, we check that they met the model.

As I mentioned at the very start of today's session, Novitas has proved, as it's progressed, not to meet the model in certain areas. The track record clearly is not strong enough. The security that we thought we had in due diligence, which was behind the insurance policies, was not strong enough as well. And a really important one is, the expertise was with a third party; with our businesses, we like to have that internal expertise, assessing the credit along the way.

Now, clearly, as Novitas progressed, the cases didn't succeed as expected and the recoverability rate wasn't there. So, it's not been a good experience for our company and it's not something we will have in a future chapter.

Mike Morgan

Can I just build on that, Adrian, because these are provisions, not losses at this stage, and we fully intend to go after the three insurers. We've initiated legal action against one of them and we will have conversations with the other two as well. But these are provisions at this stage, not losses.

<u>Question 6</u>

Perlie Mong, KBW

Hello, hi, thank you for taking my questions. I've got a couple. The first one, just going back to Novitas, so I understand that you have taken legal proceedings with the After the Event insurers. Can I just check that, have you had previous experience of going through legal proceedings with the other insurers and what has your experience been in that? So, that's the first one.

The second one is on Winterflood Business Services. So very good progress there, your assets under administration is over £12 billion now. Just wondering, when could we expect to see more of an income impact in the Winterflood line?

And then a third one, very quickly as well. You just mentioned Consumer Duty and I'm just wondering, obviously, you are probably like way ahead of everybody else in terms of how you treat the customers, etc. But the larger banks may be less likely to pull back on lending to customers because of Consumer Duty and obviously, they have the capital to not do that. And, in that case, how would you think about growing into a downturn? Would it be, for example, via more acquisitions?

Adrian Sainsbury

Thanks Perlie, excellent questions, let me have a look. Just to be clear on what we're doing in Novitas, and Mike mentioned, these are provisions. The reason they're provisions is we believe the insurers should be covering their obligations on this as well. To be clear, we're taking litigation with one insurer at the moment, it's actually the largest insurer in the arrangement that we have on the litigation funding. We've commenced that litigation and we've obviously taken legal advice, and that's based on how we're progressing on that litigation. With the other insurers, and there's broadly two major other insurers, we're in discussions with them and clearly, we will see how that progresses and what we may need to do, to then look at how we best recover the provision that we have there.

On WBS, it's a good story. We announced a £10 billion target for assets under administration for this financial year, we achieved that at the Q1 23 stage and we're now at £12.4 billion, up from £7.2 billion at the year end. We see good scope and there's a good pipeline for future growth. And clearly growth can come in a number of ways, our existing clients, of which there are broadly 50 high quality financial houses, can bring more funds onto the platform and we can win new clients. And we have another, I can make another statement where I'm confident we have a strong pipeline for WBS.

Your question also alluded to, when will we see that come in more to income and profit? We don't disclose at the individual business line within Winterflood, the profit. But we did make a statement a couple of years ago that WBS had gone through breakeven. It's a highly scalable platform and we would expect the profit and the revenues to improve and increase from here as we bring on further clients.

Your final question on the Consumer Duty. We're preparing well for that. Meeting our regulatory obligations is really important to us. And in fact, Mike and I were at our board meeting yesterday and we had a credit training session, sorry we had a Consumer Duty training session, with one of the major accountancy houses, and that concluded that we're well-placed relative to other banks on our journey of meeting compliance. The deadline for existing businesses is the end of July of this year.

Your contention then was that the other banks may not pull back like they did after the financial crisis. And we’ve talked about this a number of times with the market and our shareholders before. I don't think we've seen, since 2008 and 09, anything like the credit conditions that applied there. The marked economic downturn in 2020 and 21 due to Covid – clearly GDP went down enormously, I think it was around 11% in 2020, but we didn't have a credit event in the market, largely because of the various support schemes the government had, CBILS and bounceback for SMEs, furlough for consumers, the stamp duty holiday for the property market, all of those things staved that off.

Now we still achieved good growth during that period, well in line with our model. And as we've said, the loan book growth this year is 5% year-on-year, if we exclude the run-off businesses of Motor in Ireland and Novitas. Also over that period, we've replaced about £300 million of the CBILS run-off. So I'd say our growth is quite interesting at this stage of the cycle, but there isn't any credit event in the market as we stand.

Now clearly there's unhelpful news in America at the moment and I think the regulators in the UK have done well in that situation and hopefully we won't have an issue. We are ready for whatever the market may develop and we've talked before about the playbooks that we have, that build the learning from where we've been successful in previous downturns, whether it's the GFC, whether it was the dot com bust around 2000, those sort of times where we really succeeded. Who knows what the other banks will do at that time? Not all banks, of course, have secured portfolios, like the previous answer, we're 90% secured. And clearly, credit problems can surface more quickly in unsecured portfolios, so it's hard to know. We're well placed. Do I see a 20% opportunity immediately? Clearly not. But we will be well placed, whatever the conditions.

Mike Morgan

And it's interesting because, you know, that may be the case on the larger banks, Perlie. But interestingly, one of the points that was pulled out yesterday was that some of the smaller players are actually pulling out of the market because of the regulatory burden that's placed upon them. So, there could be opportunities presented there for us.

Adrian Sainsbury

Thank you, and I think we have no further questions, so thank you for your time this morning. Have a good day. Thank you.