Banking

Delivering disciplined growth

Key Performance Indicators

Net Interest Margin
Per cent

2021	**7.7**
2020	7.5
2019	7.9

Bad debt ratio
Per cent

2021	**1.1**
2020	2.3
2019	0.6

Return on net loan book
Per cent

2021	**2.6**
2020	1.3
2019	3.3

Key Financials[1]

	2021 £ million	2020 £ million	Change %
Operating income	**631.7**	586.0	8
Adjusted operating expenses	**(329.1)**	(303.4)	8
Impairment losses on financial assets	**(90.1)**	(183.4)	(51)
Adjusted operating profit	**212.5**	99.2	114
Net interest margin	**7.7%**	7.5%	
Expense/income ratio	**52%**	52%	
Bad debt ratio	**1.1%**	2.3%	
Return on net loan book	**2.6%**	1.3%	
Return on opening equity	**13.7%**	6.5%	
Closing loan book	**8,444.5**	7,616.7	11
Average loan book and operating lease assets	**8,253.0**	7,854.3	5

1 Adjusted measures are presented on a basis consistent with prior periods and exclude amortisation of intangible assets on acquisition, to present the performance of the group's acquired businesses consistent with its other businesses; and any exceptional and other adjusting items which do not reflect underlying trading performance. Further detail on the reconciliation between operating and adjusted measures can be found in Note 3.

A strong performance, delivering disciplined growth as we maximised market opportunities.

Return on opening equity
13.7%
2020: 6.5%

Banking adjusted operating profit increased 114% to £212.5 million (2020: £99.2 million), reflecting strong loan book growth at a strong net interest margin, rigorous cost discipline and a significant reduction in impairment charges. Statutory operating profit increased to £207.2 million (2020: £97.2 million) and includes adjusting items related to the impairment of goodwill and intangible assets on acquisition as a result of the strategic decision to permanently cease loan origination at Novitas, as well as the exceptional gain related to the VAT refund from HMRC.

The loan book grew 10.9% over the year to £8.44 billion (31 July 2020: £7.62 billion) driven by high new business volumes, particularly in the Asset Finance and Motor Finance businesses, and was further supported by the demand seen under the CBILS scheme. The return on net loan book increased significantly on the 2020 financial year to 2.6% (2020: 1.3%).

The reported net interest margin of 7.7% increased on the prior year (2020: 7.5%) reflecting our continued pricing discipline, as well as lower cost of funds. Our specialist, relationship-driven model and consistent, disciplined pricing position us well to maintain a strong net interest margin going forward.

As a result, operating income increased 8% to £631.7 million (2020: £586.0 million).

Adjusted operating expenses increased 8% to £329.1 million (2020: £303.4 million) as we continued to invest through the cycle to protect, grow and sustain our model whilst maintaining a rigorous focus on cost discipline. Business as usual ("BAU") costs increased by 3% to £255.1 million (2020: £248.3 million), primarily reflecting higher performance-driven compensation. Investment costs increased 34% to £74.0 million (2020: £55.2 million) as we progressed our strategic projects and incurred related depreciation charges.[2]

Our multi-year investment programmes include ongoing transformation projects in Motor Finance and Asset Finance and our transition to IRB, alongside enhancements to our operational and cyber resilience. We continue to exercise cost discipline and expect spend on investment programmes to stabilise over the next financial years, although related depreciation will continue to increase.

Overall, the compensation ratio increased marginally to 29% (2020: 28%) primarily driven by an increase in staff expenses related to higher performance-related costs. The expense/income ratio remained stable at 52% (2020: 52%).

Impairment charges decreased significantly to £90.1 million (2020: £183.4 million) as we experienced strong underlying credit performance across Commercial, Retail and Property, as well as a reduction in Covid-19 provisions. The bad debt ratio of 1.1% (2020: 2.3%) reflected an increase in provisions against the Novitas loan book, which accounted for a significant portion of the impairment charge for the year.

The performance of the forborne book continues to be encouraging. At 31 July 2021, the total balance of loans classified as forborne and subject to Covid-19 concessions had reduced to £455 million (31 July 2020: £1.4 billion).

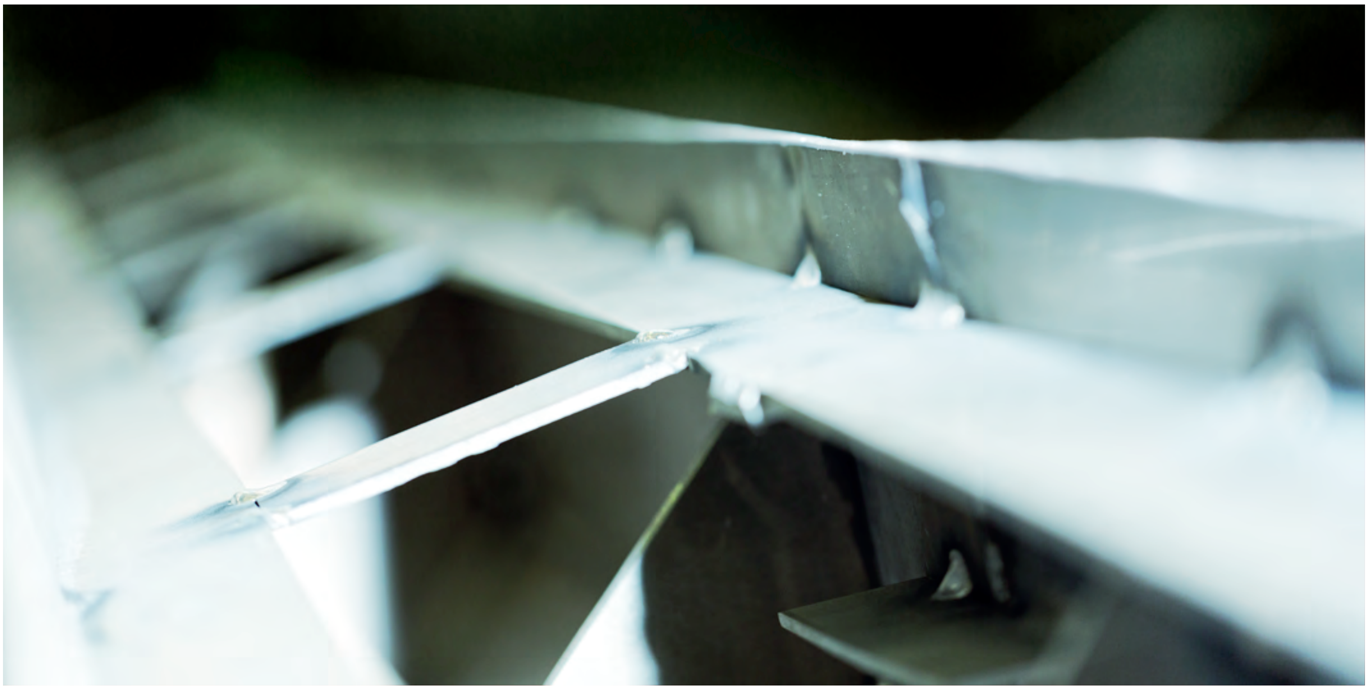
There was a marginal increase in overall provision coverage to 3.2% (31 July 2020: 3.0%) which included reductions in Covid-19 provisions, reflecting improved macroeconomic outlook and encouraging performance of the forborne loan book, more than offset by a significant increase in provisions against the Novitas loan book.

We believe this represents an appropriate level of provision, reflecting an improved but still uncertain economic outlook.

Return on opening equity increased significantly to 13.7% (2020: 6.5%) reflecting the strong performance of the business over the year, as we maximised market opportunities in the current environment to deliver disciplined growth.

2 Related ongoing costs resulting from investment projects are recategorised from investment costs to BAU costs after one year. For comparison purposes, £2.1 million has been recategorised from investment costs to BAU costs in the 2020 financial year to adjust for investment projects' ongoing costs that commenced prior to the 2021 financial year.

Banking continued



Loan Book Analysis

	31 July 2021 £ million	31 July 2020 £ million	Change %
Commercial	**3,968.1**	3,048.0	30
Asset Finance	**2,844.6**	2,167.4	31
Invoice and Speciality Finance	**1,123.5**	880.6	28
Retail	**2,974.3**	2,834.5	5
Motor Finance	**1,924.4**	1,749.4	10
Premium Finance	**1,049.9**	1,085.1	(3)
Property	**1,502.1**	1,734.2	(13)
Closing loan book	**8,444.5**	7,616.7	11
Operating lease assets[1]	**222.9**	221.9	–
Closing loan book and operating lease assets	**8,667.4**	7,838.6	11

1 Operating lease assets of £1.3 million (31 July 2020: £2.9 million) relate to Asset Finance and £221.6 million (31 July 2020: £219.0 million) to Invoice and Speciality Finance.

Loan book growth continues to be an output of our business model, as we focus on delivering disciplined growth whilst continuing to prioritise our margins and credit quality. We saw a strong year of growth following the initial Covid-19 impact, with the loan book up 10.9% in the year to £8.4 billion (31 July 2020: £7.6 billion), reflecting high levels of new business. Growth in the Commercial and Retail loan books was driven by strong customer demand, particularly in the Asset Finance and Motor Finance businesses, with the Property loan book contracting.

The Commercial loan book increased 30% to £4.0 billion (31 July 2020: £3.0 billion), reflecting growth across both businesses. The Asset Finance book grew strongly, up 31% to £2.8 billion (31 July 2020: £2.2 billion), driven by strong new business volumes, which were supported by demand under the CBILS government lending scheme.

At 31 July 2021, over £1.14 billion had been lent across more than 5,700 loans under the government support schemes in the Commercial and Property businesses, with the vast majority of lending via CBILS. In addition, £144 million across 686 CBILS loans has been credit approved and can be drawn down until 30 November 2021 for asset finance agreements. We are also approved to lend under the Recovery Loan Scheme, but anticipate volumes to be substantially lower than lending via CBILS.

The business is well positioned to capitalise on continued demand for asset financing.

Current growth initiatives in the Asset Finance business include those aligned with the increasing focus on green energy, electric car fleets and renewables.

The Invoice and Speciality Finance loan book increased to £1.1 billion (31 July 2020: £0.9 billion), reflecting good demand under the government schemes, and improving utilisation levels in line with the progressive reopening of the economy, albeit these remain below those seen prior to Covid-19. We expect the growth trajectory in Invoice Finance to follow the economic recovery.

The Retail loan book increased 5% to £3.0 billion (31 July 2020: £2.8 billion), with growth in Motor Finance more than offsetting a slight reduction in the Premium Finance loan book. The Motor Finance book increased 10% to £1.9 billion (31 July 2020: £1.7 billion) as we experienced high levels of new business during the year, with record volumes following the easing of lockdown restrictions. This reflected a combination of pent-up demand and an increasing use of finance in the second-hand car market, supported by our investment in the Motor 2020 programme. The Irish Motor Finance business accounted for 21% of the Motor Finance loan book (31 July 2020: 26%). The Irish market continues to recover from the initial Covid-19 impact, with new business volumes up year-on-year, albeit lower than pre-Covid-19 levels. We continue to see strong fundamentals in the second-hand car market and are exploring opportunities for growth through the shift to Alternatively Fuelled Vehicles.

Commercial adjusted operating profit

£52.8m

2020: £4.8m

Banking: Commercial[1]

	2021 £ million	2020 £ million	Change %
Operating income	**288.9**	246.6	17
Adjusted operating expenses	**(158.2)**	(142.6)	11
Impairment losses on financial assets	**(77.9)**	(99.2)	(21)
Adjusted operating profit	**52.8**	4.8	1,000
Net interest margin	**7.7%**	7.6%	
Expense/income ratio	**55%**	58%	
Bad debt ratio	**2.1%**	3.1%	
Closing loan book	**3,968.1**	3,048.0	30
Average loan book and operating leases	**3,730.5**	3,240.8	15

1 Adjusted measures are presented on a basis consistent with prior periods and exclude amortisation of intangible assets on acquisition, to present the performance of the group's acquired businesses consistent with its other businesses; and any exceptional and other adjusting items which do not reflect underlying trading performance. Further detail on the reconciliation between operating and adjusted measures can be found in Note 3.

The Premium Finance book remained broadly stable at £1.0 billion (31 July 2020: £1.1 billion) as Covid-19 restrictions have impacted customer behaviour, with the suspension of driving tests and decline in the new car market reducing demand for car insurance policies. Following the removal of Covid-19 restrictions, we would expect demand for the funding of motor insurance policies to recover.

The Property loan book reduced to £1.5 billion (31 July 2020: £1.7 billion) as we saw high repayment levels, reflecting strong unit sales by borrowers due to the release of pent-up demand and buyers taking advantage of the Stamp Duty temporary reduced rates and Help to Buy incentives. This was more than offset by the uptick in drawdowns seen, particularly in the second half of the year, which were broadly in line with pre-Covid-19 average levels. Our pipeline of undrawn commitments remains solid and the Property loan book trajectory will continue to reflect the rate of repayments as well as new business volumes.

We remain confident in the quality of our lending, which is predominantly secured or structurally protected, prudently underwritten and diverse.

Commercial

The Commercial businesses provide specialist, predominantly secured lending principally to the SME market and include Asset Finance and Invoice and Speciality Finance.

Adjusted operating profit increased to £52.8 million (2020: £4.8 million), driven by strong levels of income and a decrease in impairment charges, following the elevated levels seen in 2020 as a result of Covid-19. Statutory operating profit was £35.9 million (2020: £3.1 million).

Operating income of £288.9 million (2020: £246.6 million) was 17% higher than the prior year, driven by the strong growth in the loan book across both Asset Finance and Invoice Finance. The net interest margin increased marginally to 7.7% (2020: 7.6%), primarily reflecting the lower cost of funds and increased fee income in the Invoice Finance business.

Adjusted operating expenses increased 11% to £158.2 million (2020: £142.6 million), mainly driven by higher volume and performance-driven compensation, increased headcount and investment in the Asset Finance transformation programme. The expense/income ratio decreased to 55% (2020: 58%) as growth in operating income more than offset the cost increase.

Impairment charges decreased 21% to £77.9 million (2020: £99.2 million), corresponding to a bad debt ratio of 2.1% (2020: 3.1%). A significant portion of the impairment charges reported in Commercial related to an increase in credit provisions against the Novitas loan book, reflecting the latest assumptions on the case failure and recovery rates in this business. The underlying credit performance of the rest of the Commercial loan book remains strong.

The provision coverage increased to 4.2% (31 July 2020: 3.9%) reflecting a significant increase in provisions against the Novitas loan book, which more than offset the benefits of loan book growth, improved macroeconomic scenarios and weightings and the encouraging performance of the forborne book.

In July 2021, the group decided to cease permanently the approval of lending to new customers across all of the products offered by Novitas, a wholly owned subsidiary of Close Brothers acquired in 2017, and withdraw from the legal services financing market.

We will remain focused on supporting Novitas' existing customers, working with their solicitors as well as insurers and intermediaries, to ensure we manage the existing book in the best interests of customers. As of 31 July 2021, Novitas had a loan book net of provisions of £181.5 million, representing 2.1% of the group's total loans. The future trajectory of the Novitas loan book will depend on the rate of drawdown on existing loan agreements, as well as the rate of repayment on outstanding loans.

The Commercial loan book is predominantly secured, with minimal exposure to higher risk sectors and those impacted most severely through the recent crisis, such as travel and leisure, hospitality or oil and gas. Our loans are conservatively underwritten with prudent LTVs, supported by our specialist expertise in the underlying assets and long-standing industry relationships.

At 31 July 2021, 7% of the Commercial loan book by value (31 July 2020: 26%) was classified as forborne and subject to Covid-19 related concessions, with balances of £287.4 million (31 July 2020: £832.8 million). These concessions are principally in the form of payment deferrals with fees and charges waived in the Asset Finance business, and flexing of repayments percentages and overpayments on invoice discounting and factoring facilities. The majority of those customers classified as forborne at 31 July 2021 and subject to Covid-19 related concessions had resumed payments.

Banking continued

Retail

The Retail businesses provide intermediated finance, principally to individuals and small businesses, through motor dealers and insurance brokers.

Adjusted operating profit for Retail increased over 100% to £71.9 million (2020: £34.9 million), reflecting good levels of operating income and a significant reduction in impairment charges, following the Covid-19 related provision increase in the 2020 financial year. Statutory operating profit was £83.5 million (2020: £34.6 million).

Operating income increased 1% on the prior year to £219.8 million (2020: £218.4 million), in spite of a marginal decline in net interest margin to 7.6% (2020: 7.7%), largely reflecting lower rates as a result of broker consolidation in the insurance sector and the waiving of fees due to Covid-19 forbearance in Premium Finance.

Adjusted operating expenses increased 9% to £138.0 million (2020: £126.9 million) and the expense/income ratio increased to 63% (2020: 58%), reflecting volume-driven costs and ongoing investment in Motor Finance, as well as increased regulatory-driven expenditure. Good progress continues to be made with the Motor Finance transformation programme as it nears completion, with the programme aimed at improving the service proposition, enhancing operational efficiency, improving our credit acceptance process and increasing sales effectiveness.

Impairment charges decreased significantly to £9.9 million (2020: £56.6 million) with a bad debt ratio of 0.3% (2020: 2.0%), reflecting a strong credit performance. The provision coverage ratio decreased slightly on the position at the end of the last financial year to 2.2% (31 July 2020: 2.5%), which reflected the performance of the forborne loan book and strong new business volumes.

We remain confident in the credit quality of the Retail loan book. The Motor Finance loan book is predominantly secured on second-hand vehicles which are typically less exposed to depreciation or significant declines in value than new cars. Our core Motor Finance product remains hire-purchase contracts, with less exposure to residual value risk associated with Personal Contract Plans (“PCP”), which accounted for only c.12% of the Motor Finance loan book at 31 July 2021. The Premium Finance loan book benefits from various forms of structural protection including premium refundability and, in most cases, broker recourse for the personal lines product.

At 31 July 2021, 2% of the Retail loan book by value (31 July 2020: 9%) was classified as forborne and subject to Covid-19 related concessions, principally in the form of payment deferrals, with balances of £49.2 million (31 July 2020: £251.0 million). The majority of those customers classified as forborne at 31 July 2021 and subject to Covid-19 related concessions had resumed payments.

Retail adjusted operating profit

£71.9m

2020: £34.9m

Property operating profit

£87.8m

2020: £59.5m

Banking: Retail[1]

	2021 £ million	2020 £ million	Change %
Operating income	**219.8**	218.4	1
Adjusted operating expenses	**(138.0)**	(126.9)	9
Impairment losses on financial assets	**(9.9)**	(56.6)	(83)
Adjusted operating profit	**71.9**	34.9	106
Net interest margin	**7.6%**	7.7%	
Expense/income ratio	**63%**	58%	
Bad debt ratio	**0.3%**	2.0%	
Closing loan book	**2,974.3**	2,834.5	5
Average loan book	**2,904.4**	2,822.6	3

1 Adjusted measures are presented on a basis consistent with prior periods and exclude amortisation of intangible assets on acquisition, to present the performance of the group's acquired businesses consistent with its other businesses; and any exceptional and other adjusting items which do not reflect underlying trading performance. Further detail on the reconciliation between operating and adjusted measures can be found in Note 3.

Property

Property comprises Property Finance and Commercial Acceptances. The Property Finance business is focused on specialist residential development finance to established professional developers in the UK. Commercial Acceptances provides bridging loans and loans for refurbishment projects. We do not lend to the buy-to-let sector or provide residential or commercial mortgages.

Our long track record, expertise and quality of service ensure the business remains resilient to competition and continues to generate high levels of repeat business. We continue to see success from our regional initiative, with the regional loan book now making up over 50% of the Property Finance development portfolio.

The business delivered an operating profit of £87.8 million (2020: £59.5 million), up 48%, as impairment charges reduced significantly from their elevated level in 2020.

Operating income increased marginally to £123.0 million (2020: £121.0 million), in spite of the reduction in the loan book, as the net interest margin increased to 7.6% (2020: 6.8%), driven by an accounting reclassification, the unwind of modification losses, and lower cost of funds.

Operating expenses were 3% lower at £32.9 million (2020: £33.9 million) as we maintained our focus on cost discipline. The expense/income ratio reduced slightly to 27% (2020: 28%), as the decline in operating expenses through disciplined cost control more than offset the stable level of operating income.

Banking: Property

	2021 £ million	2020 £ million	Change %
Operating income	**123.0**	121.0	2
Operating expenses	**(32.9)**	(33.9)	(3)
Impairment losses on financial assets	**(2.3)**	(27.6)	(92)
Operating profit	**87.8**	59.5	48
Net interest margin	**7.6%**	6.8%	
Expense/income ratio	**27%**	28%	
Bad debt ratio	**0.1%**	1.5%	
Closing loan book	**1,502.1**	1,734.2	(13)
Average loan book	**1,618.2**	1,790.9	(10)

Impairment charges decreased to £2.3 million (2020: £27.6 million), resulting in a bad debt ratio of 0.1% (2020: 1.5%) reflecting a strong credit performance and improved macroeconomic forecasts, partially offset by an accounting reclassification. The provision coverage ratio remained broadly stable at 2.6% (31 July 2020: 2.5%).

The Property loan book is conservatively underwritten with a maximum LTV of 60% at origination on residential development finance, which accounts for the vast majority of the loan book. We work with experienced, professional developers, with a focus on mid-priced family housing, and have minimal exposure to the prime central London market.

At 31 July 2021, 50 customers (31 July 2020: 187 customers) accounting for 8% of the Property loan book by value (31 July 2020: 18%) were subject to Covid-19 related concessions, principally in the form of fee-free extensions for residential development loans where we remain confident in the quality of the underlying borrower and security.