Close Brothers Group plc

Half Year Results 2022

Edited transcript*

Tuesday 15th March 2022

Adrian Sainsbury, Group Chief Executive Officer

Good morning and welcome to the presentation of Close Brothers' H1 results. I'll start with a brief review of the key highlights of our performance, and then Mike will take you through our financials. I'll come back and cover our business and strategy updates, and at the end of the presentation we'll be happy to take your questions either over the telephone line or over the webcast, which you can submit during or after the presentation.

In the first six months of the year, while we all continued to navigate the restrictions and disruptions caused by Covid-19, we also saw the UK economy start to recover following the successful vaccination programme. This translated into increased customer activity in Banking and continued growth in Asset Management, but also a challenging market environment in the segments where Winterflood operates.

Against this backdrop, we delivered a good financial performance with stable income and a strong ROE of 12%. In Banking, income was up 12% as we delivered loan book growth of 8.2% year-on-year at a net interest margin of 7.9%.

Our underlying credit performance was strong, benefiting from provision releases and reflecting our consistent underwriting criteria. Excluding Novitas, the bad debt ratio was 0.2%. As previously announced in July 2021, the group decided to cease permanently the approval of lending to new customers across all of the products offered by Novitas and withdraw from the legal services financing market.

In Asset Management, we saw positive momentum with net inflows of 8% and Winterflood saw reduced trading opportunities following the exceptional highs experienced in the Covid-19 period.

We've maintained a strong capital, funding and liquidity position, with our CET1 capital ratio of 15.1% significantly above the minimum regulatory requirements. I'm also pleased to declare an interim dividend of 22 pence per share, returning to the pre-pandemic level. This reflects our strong underlying performance and our continued confidence in the business model.

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

The external environment is currently clearly volatile, directly impacting our market-facing businesses, CBAM and Winterflood. Nevertheless, we are confident in the quality of our lending. Our Banking loan book is predominantly secured, prudently underwritten and diverse, and we remain encouraged by both the short and medium-term growth opportunities across the group.

At our Investor Event in June 2021, we set out how we plan to build on the core strengths of our business and take it forward responsibly. In the first half, we've made good progress against our strategic priorities to "Protect", "Grow" and "Sustain" our model.

The disciplined application of our prudent underwriting and pricing is key and evidenced by our strong underlying credit performance, as well as our high net interest margin. We also continued to invest to protect our business model and maintain our operational and financial resilience. Our multi-year investment programmes are progressing well and delivering tangible benefits across our businesses.

In the first half, we've continued to deliver disciplined growth at strong margins in Banking and increase AUM in CBAM. We remain focussed on maximising the growth opportunities in each of our markets with an expanded offering in Asset Finance, new strategic partnerships in Motor Finance and continued growth in both income and client assets in WBS. We're also actively working to identify new opportunities to deliver disciplined growth.

On our sustainability agenda, we've also made good progress, which supports our ambition of "helping people and businesses transition towards a lower carbon future".

I'll now hand over to Mike to take us through the financial results.

Mike Morgan, Group Finance Director

Thank you Adrian, and good morning everyone.

As Adrian said, we have delivered a good first half performance. Group adjusted operating profit was up 1% to £130 million, reflecting strong top line growth in Banking and positive momentum in Asset Management. This was offset by reduced trading opportunities in Winterflood following the exceptional highs seen during Covid-19.

We delivered adjusted earnings per share of 64 pence and a return on opening equity of 12.2%. We maintained a strong capital, funding and liquidity position, with a CET1 capital ratio of 15.1%, providing significant headroom against minimum regulatory requirements. And as Adrian mentioned, the Board has declared a 22 pence interim dividend, returning to the pre-pandemic level and reflecting our strong underlying performance and our continued confidence in our business model.

In Banking, we achieved 8.2% loan book growth year-on-year at a net interest margin of 7.9% with an annualised bad debt ratio of 1.1%, primarily reflecting impairment charges related to Novitas. In Close Brothers Asset Management, we saw annualised net inflows of 8% and in Winterflood, we incurred only one loss day despite extreme market volatility.

Looking first at the income statement. Income was broadly stable at £472 million with strong growth across both Banking and Asset Management, offset by a reduction in Winterflood.

Expenses were flat at £294 million as the continued investment across Banking and Asset Management was offset by lower variable costs in Winterflood. Impairment charges reduced to £48 million reflecting the benefit of provision releases and strong underlying credit performance across our businesses. And we achieved adjusted earnings per share of 64 pence, stable on the prior year.

Moving on to the divisional performance. Overall, adjusted operating profit was marginally up at £130 million. In Banking, profit was up 26% to £120 million, as 12% top line growth more than offset the continued investment in our key strategic programmes, with lower impairment charges reflecting provision releases and strong underlying credit performance across our businesses. We saw significantly higher profits in both Commercial and Retail, with Property marginally up.

In Asset Management, we saw continued growth. We delivered strong net inflows and an 18% increase in profit to £15 million, with growth in income more than offsetting the cost of investment to support the long-term growth strategy. And Winterflood saw reduced trading opportunities, with profit down 74% to £9 million.

And now onto the balance sheet. We maintained a strong balance sheet and remain focused on our prudent approach to managing financial resources. Our total funding increased to £11.3 billion and is well in excess of the loan book. We continued to "borrow long and lend short" with the average maturity of allocated funding at 23 months, ahead of the loan book at 17 months.

We manage liquidity conservatively, with current levels higher than the pre-Covid position. We had £1.7 billion of treasury assets at 31st January, with the majority held with the Bank of England. Our established presence in all wholesale markets, along with our mix of retail and non-retail deposits, supports our diverse funding base. Our credit ratings remain strong, helping support our ongoing issuance plans. And we reduced our cost of funds, down circa 30bps on last year, supported by our diversified funding strategy and continued access across both wholesale and retail markets.

Our deposit platform continues to support the growth and diversification of our funding base. We now have balances of around £1.2 billion in our Notice Account product range and approximately £300 million in Fixed Rate ISAs. And we also have around 50% of our retail deposit customers registered for our online portal.

Turning now to our strong capital position. Our business is highly capital generative, with significant headroom above the minimum requirements.

Looking at movements in the period, our CET1 capital ratio was 15.1%, down from 15.8% at 31st July 2021, reflecting the reversal of the 50bps benefit from the previous treatment of software assets and a partial unwind of IFRS 9 transitional arrangements. Excluding these regulatory changes, our CET1 ratio would have been flat at 14.2%. This gives us 750 basis points of headroom above the minimum requirement for CET1, although there are known headwinds to future requirements.

Our leverage ratio remained strong at 12.2%. And following the submission of our initial IRB application in December 2020, we continue to engage with the PRA and await feedback before moving to Phase 2.

Now on to the Banking division, which delivered a strong performance overall and achieved positive operating leverage.

We saw 12% growth in income to £346 million, driven by loan book growth at higher margins. We maintained our focus on pricing discipline, allowing us to deliver a NIM of 7.9%.

Expenses increased 10% to £177 million as we continued to invest in strategic programmes to "Protect, Grow and Sustain" the model, whilst exercising rigorous control over Business-as-Usual costs.

Impairment charges reduced to £48 million reflecting the benefit of provision releases and strong underlying credit performance across our businesses. The bad debt ratio was 1.1%, primarily reflecting impairment charges of £39 million related to Novitas. Excluding these, the bad debt ratio was 0.2%.

As a result, adjusted operating profit increased 26% to £120 million.

Moving onto the loan book, where we saw growth of 1.9% in the first half, and 8.2% year-on-year. Our Commercial book was up 4%, reflecting good demand and new business volumes in Asset Finance, as well as increased utilisation in Invoice Finance.

We also saw a 4% increase in Motor Finance driven by strong new business levels, as demand for used cars continued, supported by benefits from our investment in the business. The Premium book declined as we saw continued subdued demand for the funding of insurance policies from consumers, exacerbated by seasonality.

Property was also down as high repayments, driven by the buoyant house market, more than offset drawdowns. Although we continued to see strong new business volumes, with our pipeline surpassing £1 billion in February.

We remain well positioned to deliver disciplined growth, and we are confident in the outlook for the loan book over both the short and medium term.

Now onto our net interest margin. We reported a NIM of 7.9% as we maintained our pricing discipline and benefited from a reduction in our cost of funds to 1.1%. Our specialist, relationship-driven model and consistent, disciplined pricing mean we are well positioned to maintain a strong NIM for the remainder of the year.

However, we expect a slight negative impact from rising interest rates, mainly as a result of interest rate floors within our Property business. As such, the implication of a 50 basis point parallel upwards shift in interest rates is a £9 million adverse impact on our profit until the reference rate reaches 1%.

Moving onto costs in the Bank. There was a 10% increase overall, as we continued to invest to support our strategic objectives of protecting, growing and sustaining our business model. We maintained rigorous control over our cost base, with Business-as-Usual costs up 4%, reflecting increased performance-related compensation, regulatory spend and growth in headcount.

Investment costs increased to £41 million as we progressed our strategic programmes and incurred related depreciation. Adrian will touch more on how this investment is delivering tangible benefits across our businesses.

Although we achieved positive operating leverage in the first half, we expect costs to be around 5 to 7% higher in the second half due to the planned spend on investment programmes and depreciation, as well as wage inflation.

We remain focused on delivering sustainable positive operating leverage over the medium term.

Turning now to our credit performance. We saw a strong underlying credit performance across our businesses.

The bad debt ratio of 1.1% reflected significant charges related to Novitas as we updated loss rate assumptions, which were informed by experience of the credit performance in the business.

Excluding Novitas, the bad debt ratio was 0.2%. This reflected the benefit of provision releases, as we saw reduced forborne balances and improved macroeconomic scenarios and weightings, and strong underlying credit performance. As a result, our provision coverage ratio excluding Novitas was slightly down at 2.2%.

While we consider this a prudent level of provision, we are mindful of the highly uncertain external environment and its potential impact on our customers and credit performance. Nevertheless, we remain confident in our loan book, which is predominantly secured or structurally protected, prudently underwritten, diverse and with approximately 99% of our loan book exposure to the UK, Republic of Ireland and the Channel Islands.

Moving on to Asset Management, which saw continued growth and delivered positive operating leverage in the first half. We generated annualised net inflows of 8%, reflecting higher investment-only inflows, including those from our recent portfolio manager hires and financial advisers. These inflows were partially offset by negative market movements, primarily during the global equity market declines seen in January.

As a result, managed assets were up 1% to £15.8 billion, with total client assets also up 1% to £17.2 billion.

Operating income increased 14% to £77 million reflecting favourable market conditions and higher investment management income from growth in our assets.

The revenue margin decreased to 89bps, as we saw higher flows into our investment-only products and lower advice and dealing fees.

The growth in income more than offset the 13% rise in expenses to £62 million, which was primarily driven by increased staff costs and new hires to support our growth strategy.

As a result, adjusted operating profit was up 18% to £15 million. The operating margin increased to 19%.

And now turning to Winterflood. Where concerns in relation to inflation and rising interest rates, the emergence of the omicron variant and global geopolitical events have all negatively impacted both market conditions and investor sentiment.

Income was down 49% to £50 million reflecting a moderation in trading activity and a change in the mix of trading volumes.

Expenses reduced 36% to £41 million driven by lower variable compensation following reduced activity.

As a result, operating profit declined 74% to £9 million, reflecting reduced trading opportunities following the exceptional highs of the Covid period. Nevertheless, Winterflood navigated the period well.

Despite the extreme market volatility, which saw the AIM market down 12.5% in the first half, there was only one loss day, demonstrating the expertise and experience of our traders and their focus on risk management.

Staying with Winterflood, we can see the decline in monthly operating income over recent months, driven in part by the moderation in retail trading activity, with total bargains down 15% compared to the first half of 2021.

Trading volumes have reduced since the highs experienced during the pandemic, but remain ahead of pre-Covid levels. However, as you can see on the charts, total bargains in the higher margin markets of AIM and Small Cap are down significantly on the prior year, reflecting the change in mix in our trading volumes.

Winterflood are well placed to continue trading profitably and take advantage of returning investor appetite.

So, as you can see, we delivered a good performance in the first half of the year.

And I will now hand back over to Adrian. Thank you

Adrian Sainsbury, Group Chief Executive Officer

Thanks Mike. Also at our June Investor Day, I talked in detail about what differentiates us and puts us in a very strong place to continue to deliver on our long-term track record.

Our performance is supported by our consistent pricing and underwriting criteria, by the prudent management of our financial resources and by our diversified portfolio of businesses, with specialist expertise and focus on service and relationships in each of the sectors in which we operate. We have a distinctive culture at Close Brothers, a relentless customer focus, and long term approach to everything we do, which is embedded throughout our organisation. And I truly believe this is one of the most important strengths of our model.

Once again, these strengths have supported our strong underlying performance in the first half, enabling us to maintain our long track record of excellence in customer service, loan book growth, profitability and dividend progression. The interim dividend of 22.0 pence has returned to the pre-pandemic level, reflecting our half one performance and also the continued confidence in our business model. While dividend decisions in the 2020 and 2021 financial years reflected the unprecedented uncertainty caused by Covid-19, we aim to return to delivering long term, progressive and sustainable dividend growth into the future.

It's essential that we continue to protect our model to ensure its core differentiating strengths aren't compromised. As demonstrated by our strong balance sheet, liquidity and funding position, we remain committed to preserving our financial strength and the resources to fund our strategy. And we continue to invest to protect our business model and maintain our operational and financial resilience.

As I mentioned, we're seeing our multi-year investment programmes deliver tangible benefits across our organisation, supporting our growth agenda. This includes the successful extended product offering of our savings franchise, following our investment in the customer deposit platform, with the total balance of our fixed rate ISAs now at circa £300 million, supporting lower cost of funds and funding diversification.

In our Motor Finance business, following the deployment of a new underwriting platform as part of the Motor Transformation programme, we've seen an increased customer acceptance rate from 54% to 56% and most importantly, at our existing underwriting criteria and risk appetite.

Whilst loan book growth remains an output of our model, we're confident in our outlook over both the short and medium term. I'll run through some of the opportunities we're seeing across the group as we continue to build on our long growth track record and take our business forward. And we're working hard behind the scenes on pursuing our growth agenda and further penetrating the markets where we operate.

We're also actively working to identify new opportunities to deliver disciplined growth in line with the strategy set out at our Investor Event. I look forward to updating you on progress in due course.

We’ve continued to make good progress on helping to address the social, economic and environmental challenges facing our business, employees and our customers. We're focussed on promoting an inclusive culture and engaging our employees with our next Employee Opinion Survey currently being conducted across the group. I look forward to updating you on the responses in the future.

In line with our ambition “to help people and businesses transition towards a lower carbon future”, we're progressing well with the assessment of our indirect Scope 3 emissions. In the first half, we completed an initial assessment of the climate sensitivity of our loan book and our risk standards and policies now have climate considerations embedded, which will be reviewed in line with our business strategy and transition plans.

I’ll now take you through an update on each of our Banking businesses and how they're maximising the current market opportunities.

We continue to see good demand across our SME businesses. In Asset Finance, following the CBILS opportunity closing in 2021, we've seen good new business volumes, particularly in Transport, Contract Hire and Energy.

The business is well positioned to capitalise on continued demand for asset finance. Current growth initiatives include those aligned with the increasing focus on the renewable energy sector and electric car fleets, and we've also recently hired a specialist materials handling team.

In Invoice Finance, we've seen strong sales volumes and increased utilisation as the economy started to reopen. Our number of SME customers has also increased, supporting loan book growth in the period. We continue to tap the opportunities in the Asset Backed Lending space, raising visibility with private equity sponsors and the wider intermediary community.

In Brewery Rentals, our direct-to-outlet container rental product, E-Keg plus, has seen customer numbers doubling in the last three months, allowing the business to open up a market segment previously unavailable to us.

Although Invoice Finance utilisation remains below the levels seen prior to Covid, as the economy recovers, we expect growth in this business to closely follow economic activity.

In Motor Finance, strong new business volumes continued into the first half, reflecting ongoing demand for finance in the second-hand car market and rising vehicle prices, as well as the benefits from our investment in the sales capability. Our investment in the Motor Finance Transformation programme has enabled us to further develop our proposition, providing unique data insights to dealers and to take advantage of heightened demand for used cars.

As illustrated on the chart, new business volumes have remained high and above the pre-Covid average, with record volumes achieved in Q2 2022.

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. We've also entered a new strategic partnership with AutoTrader as we expand our routes to market.

In Premium Finance, in addition to the usual January seasonality, we saw subdued activity in the consumer market as Covid-19 restrictions continued to impact demand for insurance policies in the first half. We expect demand for the funding of motor policies to recover following the removal of Covid related restrictions.

In Property, the UK market remained buoyant, with heightened house sales volumes leading to higher repayments by our housebuilder customers. Although drawdowns were up on the prior year, this was offset by strong repayment levels. We continue to see strong new business levels and achieved a record undrawn pipeline, surpassing £1 billion in February.

We focus on residential developments of family housing where there's a strong structural demand and continue to see good demand in the regions outside of London and the South East, with the regional book making up around 50% of our development portfolio. Other growth initiatives include a focus on identifying and capturing the next generation of developers, as well as expanding our regional presence and bridging finance offering.

The Asset Management division saw positive momentum in the first half, achieving an annualised net inflow rate of 8%. This reflected continued demand for our integrated advice and investment management services, despite the ongoing impact of Covid-19 weighing on client sentiment and inflows across the industry. We've seen net inflows from our advisers, 3rd party IFAs and our own portfolio managers, with strong contributions from our investment in new hires over recent years.

Continued investment in systems and technology supports scalability of our back and middle office functions, with most of these technology investments expected to be behind us by the end of calendar year 2022.

Sustainable investment management strategies remain a key area of focus across the industry, and we continue to broaden our range of sustainable investment propositions, with our sustainable funds gaining further traction.

We have an attractive, vertically integrated and multi-channel distribution model, which underpins our success and positions us well to benefit from structural growth trends in the wealth management industry. We will continue to drive growth both organically and through the continued selective hiring of advisers and investment managers, and through in-fill acquisitions.

I'd like to welcome Eddy Reynolds as the recently appointed chief executive of CBAM. Eddy has over 30 years' experience in the fund and wealth management industries, bringing with him outstanding experience and knowledge, and will lead CBAM through the next stage of its development.

On behalf of the executive committee and the Board, I would like to thank Martin Andrew for his significant contribution to the group during his 16 years at CBAM.

And finally, Winterflood, which saw reduced trading opportunities following the exceptional highs experienced during the Covid-19 period. As Mike touched on earlier, trading volumes have moderated and there has also been a change in the composition of trading income.

Winterflood continues to diversify its revenue streams and explore growth opportunities, balancing the volatility seen in the trading business.

WBS, which provides outsourced dealing and custody services for asset managers and platforms, has delivered another strong performance, generating £5.1 million of income and growing its assets under administration to £6.8 billion. We're confident in accelerating the growth trajectory of WBS, with a good pipeline of clients expected to support further significant growth in assets under administration and income in this business.

As a daily trading business, Winterflood is highly sensitive to changes in the market environment, but remains well positioned to continue trading profitably, taking advantage of returning investment appetite.

Looking ahead, we're mindful of the highly uncertain external environment, including the impact of increasing geopolitical tensions and rising inflation of our customers and wider financial market conditions.

Nevertheless, we remain well placed to continue delivering on our long term track record of profitability and disciplined growth.

Our proven and resilient model and strong balance sheet, combined with our deep experience in navigating a wide range of economic conditions, leave us well placed to continue supporting our colleagues, customers and clients over the long term.

Thank you, and I'd now like to take any of your questions. We're going to start with a question on the telephone line.

Q&A session

Question 1

Benjamin Toms, RBC

Good morning both and thank you for taking my questions. Two for me please, firstly on costs, you gave Banking cost guidance of 5% to 7% growth half-on-half, which I think implies Full Year 22 cost growth in the Banking division of about 10% to 11%. Is the half two implied run rate of around £310 to £350 million the right base for 2023? Or will a proportion of the increase in costs fall away?

And then secondly, I note in your release that you mentioned there's no direct exposure to the Ukraine crisis. How are you thinking about the indirect exposure? I appreciate that it's quite early days, but is it potentially one of those environments where other banks step away and you lean into risk with an acceleration in lending? Thank you.

Adrian Sainsbury

Thanks, Benjamin. I'll start with the Ukraine question and I'll then move on to costs, and I'll ask Mike to build on that as well. You're quite correct. So as I mentioned on Ukraine for the lending book that we have, 99% of our exposures are broadly in the UK, the Republic of Ireland and the Channel Islands, with the remainder Western European countries. So, second order effects are likely to be more significant in the bank for us. So I see that predominantly as inflationary impacts on consumers and SMEs, input costs going up, that will impact consumer cash flows and SME cash flows in all likelihood. Clearly dependent and let's all hope that there is a quick resolution to the challenges and the horrors that are taking place in Ukraine at the moment. So those second order impacts will impact customers, the cash flows, the affordability, the repayment capability could be impacted in that area.

We've talked about this a number of times on our calls previously on how Close Brothers prepares for those sort of potential credit events in the market. We run playbooks on how we would operate and how we've operated in the past, let's say, in the GFC or the Dot-com boom, where we looked very clearly and early when there were credit challenges in the market to protect the group's position, then to look at how we resource up in different areas and then lean in to take advantage of the opportunity by helping our customers in those challenging situations. Now, very clearly, in past discontinuities in the market, we have relatively outperformed and I'd expect us to do that again in such a scenario. That's partly because our loan books are largely secured or structurally protected, over 90% is in those categories, whereas a number of other banks have more unsecured portfolios and some of the recent start-ups don't have experience in operating in that sort of more challenged credit environment. So, whilst I obviously don't wish for that sort of environment, it's our responsibility at Close Brothers to be well prepared for any scenario, to be able to deliver for our customers and shareholders at that time.

If I move on to the costs, you're quite correct in the Bank, the cost guidance we're giving for half two is a 5% to 7% uplift. It is worth noting that in half one we did have positive operating leverage of 2% in the Bank. We have made an inflationary salary rise in the Bank and for a lot of our Group employees as well, of about 3% at the time of February 2022. And we are continuing to invest in our major investment programmes. We have a long-term approach at Close Brothers, whether that's in terms of our dividend policy, supporting our customers, developing our culture, but also to our investment programmes. Stop-starting those investment programmes is not a good idea and these investment programmes, as we said, are already giving us tangible benefits. So, we're very rigid on BAU costs, well-managed, but we will continue to invest in our major programmes. Because the 5-7% is in half two, it won't have the scale of that uplift that I see, and we're not giving specific guidance for FY23. Mike, would you like to build?

Mike Morgan

I think you've covered it off. The wages inflation that you’ve spoken about, that will come through in the second half and that will clearly form part of next year's cost base. And as you say, we will continue to invest in the business. We've had a lot of benefits coming out of that and that would be our intention to continue. So, those will effectively form part of the cost base going into next year.

<u>Question 2</u>

Raul Sinha, JP Morgan

Good morning. I've got three questions, if that's okay. The first one is just a follow up on the cost side, in particular on the investment spend. I was wondering if we could get a little bit more colour in terms of the big projects that are likely to drive the step up in inflation spend, if there is one in the second half of the year, and also if you could comment a little bit on the depreciation impact as that comes through over this year and into next year? Hopefully that should be quite visible to you already.

The second question is just around the very helpful disclosure on interest rate impact due to the Property floor, so thanks for that. I was wondering if you could give us a little bit more colour on how the headwind from higher rates turns into a tailwind as rates go above 1%? Perhaps if you could talk us through the mechanism of how that works through the deposit base, that would be really interesting.

And then thirdly, I was wondering whether or not you've made any assumption changes to your IFRS 9 models for higher inflationary impact on the economy and whether you have any thoughts of how they would react to perhaps more inflationary pressures on their customers.

Adrian Sainsbury

Thanks, Raul. I'm going to do these in reverse order. I'll start with the IFRS 9 one, so as you will have noticed, there are two aspects here. One is the weighting of the scenarios and you’ll recognise that at 31st January that we moved 10% from the downside scenarios to the upside, so we broadly have on the Moody's scenarios 40% of the baseline scenario, 30% in upside and 30% in downside scenarios as well. So that was a 10% shift from the July year-end. Clearly, the world has moved on a little bit from the 31st January, so we will recognise those changes when we meet as a credit committee in future periods going through half two. There is another side within the weightings because Moody's every month provides increased or more relevant data, more up to date data on areas like inflation and interest rate predictions as well, and those will feed in much more quickly than the change in the weightings that we have on the scenarios.

On the interest rates impact, as Mike said in his presentation, broadly a 50 basis point increase or decrease has an impact of £9m or 0.1% on NIM. And bear in mind our NIM moved from 7.7% a year ago to 7.9% now. So that equates broadly to 0.1% NIM impact of a 50 basis point move. That impact, as Mike indicated, is broadly impactful up to 1% of base rate because of some floors we have in our Property contracts and after a 1% rise, so rises after then, we would more naturally move on to the customers as the base rate increases.

It's also worth recognising within our books the majority of our lending across the loan books is at fixed rates and is matched with our deposit base as well, or our funding via swaps. For example, we would enter in a hire purchase agreement with a SME customer for three years, that would be at a fixed rate throughout the term of the agreement. So a base rate rise wouldn't impact that customer and we would have match funded that position. So this is more an impact down the road as the book starts to get rewritten and we rewrite agreements at different rates in the market at that time. Clearly, as the tailwind thereafter 1% partly depends on what the market position is, the competitive position is at that time. In previous periods of this sort of area where interest rates have risen, we've been able to pass on the rates into the market as the base rate has increased as well, and I’d expect us to be able to do the same again largely and protect the NIM.

On the cost investment and the major programmes that you asked about, one of the slides shows some of these and where we're investing across our strategy of “Protect, Sustain and Grow”. So in “Protect”, we have an ongoing cyber investment programme, we have the data centre programme as well, those are important investments to protect the business. Clearly, cyber at the moment, with some of the Russian dialogue, is of ever-increasing importance. Also, on the “Protect”, not driving revenue is our IRB programme, which Mike touched on. We're in well progressing discussions with the PRA on our application and that will proceed in the coming periods and we'll talk to you about the progress of the IRB in time. The spend on that programme clearly is increasing during the programme.

And then I move on to the programmes that are more about customer proposition and growth for the future. So, we touched a few times during the presentation on the Motor investment spend. That is coming towards conclusion and has given significant benefits in terms of the proposition to the car dealers that we offer the used car finance through and our end customers, and that's enabled us to increase the accept rates on those agreements or those proposals rather, by around 2% at the same credit quality as we've had historically.

In Asset Finance, the investment is proceeding and is more in the middle of the programme I would describe it as, and the spend is therefore enhancing as we move through it. That spend has been very useful to increase the sales tooling, similar in the Motor business as well for our sales force, and enabled us in the CBILS work that we did, the CBILS lending on the government scheme, where we lent around £1.2 billion to SMEs with 80% government support. We were able in a very agile way in April and May 2020 to build a front-end that enabled customers applying for a CBILS agreement to effectively self-validate their application, which is very good data for look back when the British Business Bank will look, have the scheme terms being properly followed all the way through.

The other major spend that we have is in the Asset Management business. That's been a transformation move to all of our systems onto IRESS, which is coming towards the conclusion towards the end of 2022, as well as offering propositional benefits to our customers and clients as well, and that's helped a little with the operating margin, which, as Mike mentioned, has improved about 1% in the latest period.

<u>Question 3</u>

Robert Sage, Peel Hunt

Thank you for taking the questions. I've got two questions, if I can, the first of which concerns the Securities business, which I suspect no surprise that the revenue is down. What I do notice though is that the efficiency ratio, costs as a percentage of income, have gone up quite smartly in the first half of the year and sort of looking into the second half of the year, I was wondering what sort of management action you might be tempted to take here, whether there might be scope for further reducing the variable costs, whether there's perhaps something more structural? Or do you sort of simply wait for the market conditions to improve in this segment?

The second question, looking at the slowdown in lending growth in the first half of the year and given also the corresponding reduction in equity share prices, I was wondering whether inorganic initiatives to stimulate growth might be coming more onto your radar screen at the moment or whether we should still be looking predominantly at an organic-driven growth strategy?

Adrian Sainsbury

Thank you, Robert. On Winterflood first, I think it's worth putting in perspective how the markets have behaved in January and February. So, January 2022 was the worst performance by the S&P since 2009, and AIM is broadly down 12.5% since July 2021. So, that’s the sort of market that we've been operating in. It's also worth noting that Wins has only had one loss day in the half to January 2022, which I see as reflective of the risk management approach that we have throughout the business. We have an expert team and a very good position in all of the markets that we trade in, and we want to protect that for the future. We see this as a highly valuable franchise, and Winterflood has a very good leadership team, very good head traders and very good development throughout the business.

On the cost profile, there is a very direct correlation in the variable pay of the team in Winterflood, with the revenue and profits that are generated and that has fed straight through. So that's where the reduction in the variable costs has come from. Now clearly there are also some fixed costs in the business that we are mindful of, but we need those costs for the proprietary business that we have, the office we have, for example, in Covid, we opened a new contingency site in Brentwood rather than perhaps a more standard BCP site in Leatherhead, which is not such a good trading site. We have a second trading floor offering real resilience to the business. These things are important for the future, so those costs are important to support the future franchise of Winterflood, whilst I'm mindful of the BAU costs and that comes right through in the variable pay.

On the slowdown in lending growth in half one, 8.2% year-on-year I think is a reasonable number, whilst you quite rightly say in half one itself, the loan book growth is 1.9% in the six months. I think it's worth looking at the split out of those businesses first when you interpret those numbers.

So Asset Finance, Invoice Finance and Motor Finance all grew at 4% and then the other two businesses, Premium, partly seasonal, was down 2% and we would expect that to bounce a bit more with people having access to more motor policy requirement, with Covid restrictions, there's been less demand for motor policies, and there could be some more premium inflation in future. Unfortunately, as people drive more, there are more accidents, that could feed through to premium rates as well.

In Property, that's the real driver of the loan book being a bit lower at 1.9% I'd say. It was down 3% or £51 million in the first six months. That's from the very high transaction levels of house sales and as we've indicated, we have a very strong pipeline of undrawn commitments going through £1 billion for the first time.

I think, importantly, the reason I focussed on the loan book growth there is because it's an output for us of our maintaining the strong credit quality that we have, the underwriting criteria and our pricing position. Those are the key reasons that we have the loan book output there. That does not drive me to say we should start doing inorganic opportunities, that should not be a driver of us looking at that sort of activity. However, of course, we look at all options in the market, and I'm very keen that the executives, in line with our Investor Day in June, progress extensions of the model, as well as driving their business in the best way possible in line with the "Model Fit Assessment" we've discussed.

Thanks, Robert.

<u>Question 4</u>

Jason Napier, UBS

What's the trajectory for costs excluding Winterflood beyond the second half of 2022 given investment and growth plans?

Adrian Sainsbury

Mike, do you want to take that and broadly, I would say I answered that in the previous question in terms of the 5% to 7% being largely inflationary, feed through of investments with programmes starting towards the second half as well. Areas such as travel and expenditure will naturally increase, we've got a direct sales force, we've got an auditing force that go and see customers, with lockdown lifting they'll be seeing more of them as well. Mike.

Mike Morgan

Yes, and we've always said over the long term, we would want to see operational leverage across the book. We've seen that in the first half, in the second half, as those inflation increases come through then that will change around. But over the long term, we want to make sure that our income and costs are growing in a commensurate manner.

Jason Napier

The second question, any areas of the loan book that would be at potentially higher risk from either 200 basis points higher interest rates or elevated energy input costs?

Adrian Sainsbury

Good question, Jason, let me think through that one on my feet quickly, and I'll just go through the portfolio and think about a 2% base rate rise and the energy input costs. As I mentioned, first of all, a lot of our book, the majority of our book, is at fixed rates, so the interest rate doesn't feed through in terms of the cost of servicing the Close Brothers loan quickly for a Premium Finance customer, a Motor Finance customer, or an SME borrowing on an HP (Hire Purchase) agreement in Asset Finance, as an example.

However, consumers and SMEs could have other facilities elsewhere that will be impacted by an interest rate rise. I think as dramatic in my mind is the inflationary rise, that will be the energy costs, the NI rise from April, the impact of other input costs for SMEs as well. All of those things I think could touch on consumer behaviour and consumer cash flows. On energy in particular, for SMEs it will be heavier industries that will see more of the input cost from the energy rise. For example, we don't have a lot of fossil fuel extraction or mining or heavy industry like cement, those aren’t industries that we're largely in.

However, we do have a significant truck HGV funding business in the Asset Finance and also our Vehicle Hire business. Those customers will be buying diesel and clearly diesel as an input cost would go up as well. So I think there could be some impact in that business.

I think consumers generally will see their cash flow stretched. I would say that some of the facilities we have supporting, for example, insurance policies within the Premium Finance business, and motor policy in the Premium Finance business, are effectively mandatory spends, those are important policies for consumers. So when they're faced with the choice of who to pay, they may elect to pay that rather than an unsecured loan at that time as well.

So I think the impact of the inflationary rise, an interest rate rise, and energy rise is hard to predict. They'll be second order on our businesses. And again, we're well prepared because we have largely a secured business, a structurally protected loan book. And this is the expertise I touched on that we've seen in other credit distressed markets, where the Close Brothers expertise in the front office and the credit teams, has enabled us to relatively outperform. And that's what our playbooks are for.

Jason Napier

What's the rate of runoff to be expected in the Republic of Ireland book? Will existing customers automatically renew elsewhere? And what other potential options are there for the Republic of Ireland?

Adrian Sainsbury

Thanks, Jason. So, the book is largely around €400 million. Interestingly, in recent years, the Republic of Ireland book has been growing at a slower rate than our UK motor book. That's important because the UK motor book is at a higher margin. So the agreement we've had with our partner in Ireland has been broadly since 2011, and will come to an end towards the end of June 2022. It's a relatively modest part of our loan book overall, at around 5% of the Bank’s loan book and 19% of the Motor Finance book to put it in context. The run-off profile, the term of the loans, is very similar to the UK book, so that would be a natural run-off of three to four years that we would manage along the way. We're looking at a range of options on how we might continue in the Republic of Ireland Motor industry, and the Republic of Ireland remains an important market to us. Broadly, when we've said 99% of our loan book is in the UK, the Republic of Ireland and the Channel Islands, 7.5% of that is the Republic where we already also offer invoice finance, premium finance and asset finance, as well as motor there. So I'm very keen that we continue to find a way to offer motor finance following the end of this partnership.

Question 5

Gary Greenwood, Shore Capital

Can you remind us of the various headwinds that you see to capital going forward and are you able to quantify these? Notwithstanding those headwinds, would you consider a share buyback to take advantage of recent share price weakness?

Adrian Sainsbury

OK, I'll hand on to Mike. I'll start off on the changes that we've seen. So, at 15.1% CET1, we're broadly 750 basis points over the regulatory minimum, and I recognise that's a significant headroom. I would say, with the geopolitical tensions and the highly uncertain market that we've touched on, having significant headroom is a good thing as we stand today. I'm also mindful that we have a simple capital stack, so a lot of other banks have AT1. We don't have AT1 in our stack, so that's an option available to us, if we consider it for the future.

We've given a broad rule of thumb previously that loan book growth of around 7%, all things being equal in terms of mix, is broadly credit neutral and we've said we were 8.2% year-on-year, 1.9% in half one of this year as well. So that gives a guide from where we are. The transitional moves we've seen to move to 15.1% is from the software assets falling off in line with regulatory requirements, circa 50 basis points, and IFRS9 transitional relief falling away at about 25 basis points. That equates for broadly 75 basis points of the reduction we've seen year-on-year. So those are the broad moves, and we also will have in coming periods in the future, the impact of the benefit of IRB as well. Mike, would you like to build?

Mike Morgan

I think, Gary, you touched on the headwinds there, obviously IFRS9 transitional relief will continue to roll off, so we'll see that come through. But also, the regulator has made it clear the countercyclical buffers will start to load back on. We believe there's going to be 1% this December and a further 1% next year. That broadly relates to about 75 basis points for each of those for us, we think, so you're looking at about another 1.5%. We expect those buffers to increase.

Adrian Sainsbury

Thank you, and I look forward to seeing you hopefully in person for our Full Year results in September. Thank you and have a good day.