Preliminary Results

Tuesday, 26th September 2017

Preben Prebensen, Chief Executive

Good morning everyone and welcome to the presentation of our 2017 results. As usual I'm here with Jonathan Howell, the Group Finance Director. And with us today we also have Adrian Sainsbury who's the MD of our Lending businesses, Mike Morgan, the CFO of the Banking Division, Philip Yarrow, the Chief Executive of Winterflood, and Martin Andrew who runs Asset Management. And as usual we'll be available to take questions at the end of the presentation.

We're pleased to report another good performance for the 2017 financial year. We achieved good growth in profit, with adjusted operating profit up 13%, and we're proposing a full year dividend per share of 60 pence, continuing our long track record of progressive dividend growth.

All our businesses performed well. In Banking we've maintained our strong margins and underwriting discipline in a competitive market. Winterflood had an excellent year, benefiting from strong retail investor trading activity. And Asset Management has made further progress with good net inflows and higher profits.

We remain strongly committed to our established business model which is focused on maintaining prudent underwriting, strong margins and a sound financial position in all market conditions. And we have a clear strategy to protect, to improve and to extend this model to deliver long-term value for our customers, our employees and our shareholders.

Now I'd like to hand over to Jonathan who will take you through the results.

Jonathan Howell, Finance Director

Thank you, Preben, and good morning everyone. As Preben said we've delivered another set of good results. Overall adjusted operating profit increased 13% to £265m with all three divisions performing well. Adjusted EPS was up 3% and RoE remained strong at 18%, despite an increase in the effective tax rate due to the banking tax surcharge.

We are pleased to announce today a 5% increase in the full year dividend to 60 pence. This reflects confidence in our business and our progressive dividend policy.

All segments performed well given their respective market conditions. In the Banking division profit was up 9% to £244m, this was driven by Property Finance where profit increased 24% to £92m.

In Retail Finance profit was flat at £79m with slower growth in Motor Finance at this point in the cycle. And in Commercial Finance profit increased 4% to £73m with continued low bad debts. Winterflood grew profit by almost 50% to £28m driven by higher retail trading. And finally Asset Management delivered good net inflows and adjusted operating profit of £17m up 21% on last year.

Looking now in more detail at the income statement. Income was up 11%, driven by growth in our lending businesses and higher trading income from Winterflood.

Expenses also increased 11% to £460m, this reflects ongoing investment in infrastructure and new business initiatives in the Banking division and higher variable costs in Winterflood due to the strong trading performance.

The effective tax rate increased to 26%, this reflects the 6% full year impact of the banking tax surcharge. Despite the higher tax rate we achieved a 3% growth in EPS and maintained a strong RoE at 18%.

Our balance sheet remains simple and transparent, and the majority of assets and liabilities relate to our lending activities. Our loan book is now at £6.9bn and is diverse, mainly secured and short term with an average maturity of 14 months.

We also hold £1bn of treasury assets, principally on deposit with the Bank of England.

We have a prudent level of total funding at £8.8bn which covered 127% of the loan book at the year end. We also maintain a prudent maturity profile where we borrow long and lend short. The average maturity of funding for the loan book is over 20 months.

Our funding is diverse and includes both retail and corporate deposits, as well as secured and unsecured wholesale funding, providing resilience and flexibility. Last year we issued both a £250m senior bond and £175m of subordinated debt and maintained good access to all our funding sources.

Our business model is supported by a prudent capital position, and our strong profitability has allowed us to grow the loan book, invest in the business and pay dividends to shareholders over many years, despite rising regulatory requirements. Last year we generated £90m of CET1 capital, growing our capital base by 10% to £990m. However, we also saw an 18% increase in risk weighted assets to £7.9bn. This reflects the higher risk weighting on our property development book in line with EBA guidance.

The overall risk weighting of our loan book is now over 90%, which is reflected in our very strong leverage ratio at 10.7%. As a result the CET1 ratio reduced to 12.6% and the total capital ratio increased to 15.2% reflecting the issue of Tier 2 capital. Overall, although capital requirements have risen, we maintain comfortable headroom in our capital position.

Turning now to the Banking division, which continues to deliver both profit growth and strong returns. Income was up 9% to £555m with growth across all lending segments. Expenses also increased 9% to £272m as we continued to invest in the business. Half of this increase relates to new business initiatives and infrastructure spend. Staff costs also increased reflecting continued growth in the business. Despite this the expense/income ratio remains stable at 49%.

The net interest margin remains strong at 8.1%, despite ongoing competition in our markets.

And finally the bad debt ratio remained low and in line with last year at 0.6%, this includes £7.5m of one-off provision releases. Excluding these the underlying ratio also remained well below historical levels at 0.7%.

Overall the loan book grew 7% to just under £7bn. Although the asset and motor Finance loan books were broadly flat, premium and property continued to achieve good growth. This demonstrates the benefit of the diversity of our loan portfolio.

Property Finance was up 12% to £1.6bn, benefiting from its strong market position and continued demand for residential development finance, particularly in regional markets.

The Retail Finance loan book grew 8%, this reflects strong growth of 17% in premium finance with good new business from both new and existing brokers.

The motor finance loan book grew by 3% mainly driven by Ireland. And we continue to prioritise underwriting and credit quality.

The asset finance loan book remained flat as we continue to maintain margins and our strict lending criteria.

But we achieved good growth in invoice finance, and overall the commercial loan book increased 4% to £2.6bn.

Looking now at the key metrics across the Banking division. The net interest margin remained strong and broadly consistent across the businesses, ranging from 7.7% in Property to 8.5% in Retail Finance. In Commercial Finance the margin remains strong at 8.0% despite ongoing price competition.

Bad debts have remained low, reflecting the current favourable credit environment and low interest rates. The higher bad debt ratio in Retail Finance reflects an increase in both premium and motor finance from very low levels last year. And in Property Finance we reported a small net recovery due to provision releases.

Expense/income ratios were broadly stable, despite ongoing investment and new business initiatives in Commercial Finance.

Turning now to Winterflood, which delivered a strong performance, benefiting from good retail trading activity throughout the year. Income increased 30% to £107m, with higher trading profit across all sectors and particularly on AIM.

Volumes were high with bargains per day up 26% and trading was consistently profitable with only one loss day in the year.

Expenses increased 24% to £79m reflecting higher variable costs and settlement fees as a result of the improved trading performance.

Overall Winterflood achieved profit of £28m, almost 50% up on last year.

And finally, we made further progress in Asset Management.

Operating income was up 11% driven by an increase in client assets.

Managed assets grew 11% to £8.9bn reflecting both strong net inflows of 9% and rising markets.

And total client assets increased to over £11bn also benefiting from the acquisition of two small advisory businesses.

Expenses increased 10% to £86m, reflecting the hiring of advisers and acquisitions to support long-term growth.

Overall operating profit increased 21% to £17m.

Thank you.

Preben Prebensen

Thank you, Jonathan. As you know, Close Brothers has a long-established model which is focused on ensuring our business is sustainable and profitable at all stages of the cycle. This model builds on the expertise of our people who deliver consistently high levels of service, building deep and sustainable relationships with clients and intermediaries. We focus on specialist markets which are not well served by traditional banking groups. Our lending is predominantly secured with conservative loan to value ratios and high margin.

Most importantly we apply our lending criteria consistently, which means we lend at the same LTVs and similar net interest margins in all market conditions. We also take a prudent approach to managing our funding, liquidity and capital even in the good times.

All of this supports our long track record of consistently supporting our clients and delivering good returns to shareholders in a wide range of market conditions.

Our strategy is to protect, improve and extend this successful business model to maximise its potential for the long term. Our first priority, as always, is to protect our model. This means ensuring that we maintain the prudent underwriting, strong margins and disciplined approach which have supported our business over the years. In the current environment this is harder but more important than ever as we continue to face significant competition in several of our lending businesses.

At the same time the economic outlook for the UK is uncertain. In the last year we maintained a strong net interest margin, well ahead of the industry, at over 8% and we continue to lend at conservative and consistent loan to value ratios in all our businesses. As a result, we remain confident both in the quality of our loan book and in our ability to continue lending on similar terms if market conditions change.

We're also continuously looking for ways to improve our business, to strengthen our client offering, develop our people and make better use of technology. Our strong profitability means we can invest through the cycle, and we take a long-term view of the costs and benefits of this investment. At the same time we always prioritise in order to manage the growth in our cost base, and have maintained a stable expense income ratio at 49% in the banking division, despite several ongoing initiatives.

Lastly we're always looking for ways to extend our business model, both in existing markets and by entering new specialist segments. An example is the Irish market where we've seen strong growth in recent years, and Ireland now accounts for around 10% of our overall loan book, with a presence in motor, asset, premium and invoice finance.

And we're continuing to progress a number of early stage business initiatives across the group, some of which I'll touch on later.

This chart, which many of you will recognise, shows our long track record of growth and profitability across a wide range of market conditions. As you can see we've grown consistently over many years, reflecting both the continued expansion of our existing business and the benefit of new business initiatives. However, we consider growth to be an output of our business model and do not have a growth target, and as a result our growth rate has fluctuated over the years in response to changes in supply and demand. This year growth has slowed to 7% reflecting the high supply of credit at this stage in the cycle.

What hasn't changed is the discipline that we apply to our lending, both in terms of the margins and underwriting, which is why our key ratios have remained relatively consistent over the years.

As you can see our bad debt ratio is currently below the ten-year average at 0.6% which reflects the current favourable credit environment, with a stable economy and low interest rates. But our underwriting discipline and strong margin mean that we're also well positioned to continue lending profitably and consistently if these conditions do change.

Looking now at each of our business segments in turn, and starting with Retail Finance. Here we lend to over two million customers through a network of around 7,000 motor dealers and 1,700 insurance brokers. These intermediaries value our service-led offering and the support we provide for their businesses.

Our premium finance business is currently performing strongly, and the specialist and technology intensive nature of this business continue to support our strong market position.

We've also made significant investment in this business over the last few years to improve our service offering to brokers and end customers, supported by a new contact centre and customer portal. This investment has contributed to a significant increase in new business, with the loan book up 17% in the last financial year.

On the other hand the Motor Finance business has seen a significant increase in competition in recent years. As you'll know this market has attracted widespread focus, particularly in relation to the growth in new car finance through Personal Contract Plans or PCPs. To remind you, our core business is the second-hand car market where the dominant product is still hire purchase, and PCP only accounts for around 15% of our motor loan book.

In the current environment our priority remains to maintain our disciplined underwriting and strong margins. As a result, growth has slowed but we remain very confident in the credit quality of our book. We apply the same prudent approach as in the rest of our lending, with typical LTVs of 75% to 85%.

For PCPs we also set our guaranteed future values at 85% of the predicted value, which means car prices have to fall 15% more than expected for the car to be worth less than the loan at maturity. Overall, we're comfortable with our risk profile in the Motor business.

We're now also initiating a programme of investment in this business to further strengthen our service-led proposition and operating efficiency to ensure that our business remains competitive in the longer term.

In the Commercial segment we provide secured financing solutions through a range of products including asset finance, specialist leasing solutions and invoice finance. We distribute these products both directly and through credit brokers, and have over 27,000 small business customers in the UK and Ireland. We have an extensive local distribution network with over 200 direct sales people in 26 regional offices. This allows us to build strong personal relationships with borrowers and generate strong repeat business.

However, competition in this market remains active and we're seeing increasingly aggressive pricing and underwriting from both traditional banks and some of the newer challengers. In this environment our priority is very much to continue maintaining margins, disciplined underwriting and returns rather than chasing growth. And as a result the core asset finance business remained broadly flat in the last financial year.

At the same time we're pursuing a number of new business initiatives in this area. Last year we launched our technology leasing business which provides technology procurement, servicing and financing solutions for medium-sized businesses.

We also completed the acquisition of Novitas, a specialist provider of loans to law firms and their clients which had a loan book of around £40m at the year-end.

And finally we have this year obtained regulatory approval to operate in Germany, where we're evaluating appetite for our asset finance products – although this initiative remains at a very early stage.

Turning now to our Property business which has continued to perform very strongly with the loan book up 12% and profits up over 20% in the last financial year. Our Property Finance business specialises in short-term residential development finance to professional property developers. We do not lend to the buy-to-let sector or provide residential or commercial mortgages.

We have a strong market position built on your high service levels, expertise and long-established customer relationships. We've continued to see solid demand for our lending services in our core market which is new-build family housing with a typical unit price of around £500,000 where structural demand remains strong.

In the last few years we've also extended our offering to selected regional locations such as Manchester, Bristol and Edinburgh where we continue to see good growth opportunities. As a result around 30% of our loan book is now outside London and the South East.

We have many years' experience lending successfully in this market. We only lend to experienced professional developers at prudent LTVs, typically 50% - 60% of developed value.

At the moment we're seeing exceptionally strong credit quality in our property book, clearly helped by the current market environment. But our discipline, expertise and long track record means that we're confident in our ability to lend profitably in more challenging markets as well.

Turning now to Winterflood. To remind you Winterflood's core business is market making for retail brokers in the UK, dealing in around 15,000 securities and trading with over 600 retail stockbrokers, institutions and other market counterparties.

In the last year retail trading activity increased significantly helped by rising indices and trading opportunities created by market and political events. Winterflood has continued to make the most of these opportunities on a daily basis and its trading volumes increased significantly.

Trading was also consistently profitable with only one loss day in the year despite a number of significant market events.

These results again demonstrate the strength of Winterflood's franchise, the expertise of our traders, and strong risk management, all of which support its long track record of successful trading.

Winterflood's core customer base has always been retail brokers but we're also continuing to develop our offering to the Institutional market to make the most of any opportunities presented by MiFID II.

But fundamentally Winterflood is a daily business and as you can see from this year's results its short-term performance is strongly linked to retail trading activity.

Finally in Asset Management we focus on the UK private client market where we provide both financial advice and a range of investment management services, including both funds and bespoke portfolio management. We see significant long-term growth potential in this market and our strategy remains to continue growing the business over time.

The business has made good further progress in the last year. We achieved strong organic net inflows of nearly £800m or 9% of opening managed assets, with growth through our advisers, our bespoke portfolio managers and third party IFAs. We also completed two small acquisitions which added £450m of advised client assets and strengthened our presence in London and the Midlands.

As well as growing the adviser base we're also looking at ways to optimise its productivity to maximise growth and efficiency. During the year we also completed the transition to a single technology platform, leading to both a better client experience and improved efficiency and overall this business remains well positioned for further growth.

As you can see we've achieved a good performance in the last financial year and most importantly have maintained the discipline of our banking model.

Since the year-end trading conditions have remained stable but the longer term economic outlook is uncertain and although market conditions may evolve we remain fully committed to our proven business model which has supported our ability to trade successfully over many years. And we continue to protect, to improve and extend this business model.

In Banking we remain focused on maintaining our prudent underwriting and strong margins in a competitive environment.

For Winterflood we continue to maximise daily profitability. Although trading has remained strong so far it's always sensitive to changes in market conditions.

Asset Management has made good further progress in the last year and we remain focused on growing this business.

Overall, we're well positioned to continue trading successfully through the cycle, to support our clients and deliver value for our shareholders over the long term.

Lastly, I wanted to let you know that we'll be hosting an Investor Seminar on our Banking division on the 22nd November here at our offices. Please save the date for now and we'll send out more detailed information in due course.

Thank you and we're now happy to take questions.

<u>Q&A session</u>

<u>Question 1</u>

Toni Dang, Barclays

Good morning, three questions if I may. My first question is on your potential move to the internal risk based approach to AIRB, can you give us some colour on timeline of this if it does go ahead and perhaps some colour on the differentials between the risk weights of the loans on standardised versus IRB please?

My second question is on the PCP product; if there was a regulatory tightening around this product how would that affect your business and how will you be able to respond?

And my third question is on IFRS 9, could you please give us any more colour there of the quantum of the impact? Thank you.

Preben Prebensen

Jonathan do you want to take the first question on AIRB?

Jonathan Howell

It's a very, very good question Toni. Unfortunately I'm not able to give you very much concrete information. We are just at the initial phases of preparation for a proposed move to the modelled approach to AIRB and are just about to engage in preliminary discussions with the PRA on it. What I can tell you it's a two year or so process, multi-layered production of models on our part, refinement of those models and then provision of those for discussion and challenge with the PRA. So at this stage I'm not able to give you any quantification about what the impact could be.

What we can say though is that if we go right the way through the process a detailed modelled approach looking at historical data on the performance of our books and our portfolio of lending assets that we should be comfortable at the end of that we will get a clear and slightly more unambiguous assessment of the risk held in those books, and therefore the appropriate risk weighting, which you don't necessarily get under the standardised approach where it really is literally the EBA set out a rule and that fits every bank shape and size across the whole of the EU.

So good question but I'm afraid I can't give you too much more at this stage but we will keep you updated. It's a multi-year process.

In terms of IFRS 9, first of all it first applies to us from 1st August 2018 and because we've got a 31 July year-end we are effectively running seven months behind the major UK banks that have a December year-end. So there is a time lag in our implementation of that approach.

We have built the models. We are testing them, we're refining them and we're getting to the stage where we're just doing those final tweaks and the macro-economic overlay. What I can't give you at this stage is a clear, hard estimate. We've got further work to do. But what I can say is that we expect to be below the 45 basis points industry average that the EBA has estimated as the initial financial impact for the implementation of IFRS 9 in relation to capital. But of course we will give you detail as and when we have more confidence and certainty around our particular models.

The other thing that's worth saying that's very important, just like the rest of the banking industry we do anticipate and expect to be able to take advantage of some form of transitional arrangement. The Basel Committee are talking about it, the EBA are talking about it, the PRA are talking about it, nobody's come out with a definitive methodology but they are talking about an introduction of a three to five year transition programme which will spread the impact on CET1 capital.

Preben Prebensen

In the last couple of days the PRA came out and said that banks should use those transitional arrangements for undertaking those stress tests.

On PCP which was your second question, first of all just to remind you that we only began PCP in 2014, so relatively recently, it's only 15% of our book. We have low volumes of complaints. We've undertaken a detailed review of the product and sales processes and that review has not given rise to any significant concerns on our part.

Question 2

Arun Melmane, Macquarie

Just a couple of questions on margins, if margins were flat where did that come from is that the asset side or the liability side? Are you able to give me some sort of colour on where the movements were between the two parts?

Jonathan Howell

On margins first of all we've been more or less at this level now for about two years or so. It's comfortably within the range of our business model and is absolutely a priority alongside the quality of the underwriting at this stage in the cycle.

In terms of our total funding costs across the book we've seen a 30 basis point reduction during the course of the year from 2.0% down to 1.7% and that's almost entirely been driven by the decrease in base rates, the 25 basis point decrease in base rates that the Bank of England put through about a year or so ago.

The other thing that's worth pointing out: one is that in the markets that we lend in it's a relatively efficient market and so therefore any funding benefit that we achieve gets passed straight through to the market and similarly any funding challenge that we have normally gets passed straight through to the market.

And the other thing is our model of borrow long and lend short the average term of the funding allocated to the loan book is about 20 months. We've got to move significantly through into that 20 month period before we start seeing a clear impact on the average cost of our funding. So it takes time to come through but when it does come through quite often it's passed through.

Beyond that nothing more to add. I mean at the moment we don't have any directional steer but it is an important part of our business model to pay attention to those margins at this particular point in the credit cycle.

Arun Melmane, Macquarie

I had two more. So one is on the cost side of things. How much flex do you have on the cost given the level of investment to keep ROE flat if you go through a cycle of lower returns on property? How much delta do you have?

Jonathan Howell

Looking at division by division, the most important division to look at is the Bank. As we've always said, and it's important just to remind ourselves we have a high touch local distribution, high value add and local underwriting model, which just because of the structure of that business model means that we have less operational gearing than a centralised volume based low touch banking model, which many of the other banks are. So by definition we're going to have less operational gearing than those peers.

Half of the cost increase in the Bank, about £20m was down to infrastructure build in premium, treasury, and asset finance. And half of it was down to some of the new longer-term initiatives that are making a small loss or break even at this stage. The rest was business as usual costs increasing, as the size of the loan book and the size of the customer base increased over the last 12 months.

The important thing that we're very cognisant of is to balance the need to drive and maintain short-term earnings, hold back on investment and squeeze on operational costs, whilst at the same time making sure that we're putting enough aside and investing enough for the medium to long-term, a three to five year programme. And that's constantly a challenge that we will be facing and have been facing at different stages of the credit cycle. And it's very important to us that we maintain a properly invested business and a business that has a stock of new initiatives that enables us to trade through the cycle rather that other financial services organisations that go through periods of under-investing and under-building on the business which only will catch you up at some stage in the future.

So that's in the Bank. And then looking at the other divisions, Winterflood has a high variable cost rate and that will move with the performance of the top line and that's exactly what you saw during the course of this year. We had a 30% increase in top line. You see the Winterflood cost base I think increase by £15m and that's driven by variable costs relating to the bonus pool and also relating to clearing and settlement. And so that is very, very manageable wherever we are in the cycle, it's self-correcting.

Arun Melmane, Macquarie

And the last one is capital. I was just looking at the capital build between H1 and H2, it's roughly flat, so what's moving the dials there? Would you be able to give me a capital bridge?

Jonathan Howell

So the important thing on capital is the 12.6% CET1 ratio that we've reported. It's down on last year of 13.5%. That is wholly down to the higher risk weighting of assets in the property development book from 100% to 150%.

So the negative impact of that was about 1.2% on our CET 1 ratio which we reported at the half-year. Therefore, net of that we had an improvement, a capital generation of about 30 basis points during the course of the year.

So what has consumed capital during the course of the year has been that one-off adjustment primarily and then clearly the relative rates of growth in the various loan books. And the loan book with the highest risk weighting at the moment of 150%, or one of the higher growing loan books, is the property book.

Arun Melmane

In H1, H2 there was not much capital build between H1 and H2, is that just the risk weights eating up the capital?

Jonathan Howell

It would be a mixture of risk weights and differential growth in the various books at various points during the year.

Preben Prebensen

And as a rule of thumb at around this growth level we're capital neutral. So that's consistent.

Jonathan Howell

So this sort of single to high, 7% to 9% type of growth rates in the loan book at this level of profitability, at this level of dividend, we're more or less neutral, depending on as you know there are a whole number of levers on the final capital calculation. I mean just on capital it's just worth noting that at 12.6% CET1 ratio we're comfortably above our minimum regulatory requirement. So if you take our fully loaded, FY19 CET1 minimum regulatory requirement of 9.1%, and that's including the full 1% for the counter cyclical buffer, we've got a 350 basis points headroom.

And I think the other thing just to identify around capital with us is that with the high NIM, the 8% or higher range that we've been operating in, that in turn generates a high ROE. The bank is operating at over 20% ROE at the moment. It means that naturally on an organic basis we're generating capital at a fairly good rate and so as we highlight in the results we grew the CET1 capital base by about £90m which is a full 10%. And that's after paying the dividend.

Then lastly, if you're looking across the peers, if you look at all the large UK banks then at the half year reported there's some medium-term target for CET1 they were coming out at either 12 or 13%. So we are there. But I think it's worth bearing in mind that we have a significantly more conservative risk weighting of our assets. Again as we said, it's over 90% average risk weighting across the whole book. And also we have a lower minimum capital requirement than those banks, and that's driven by their ICG being higher, and it's also driven by their systemic risk buffer that they're required to hold. And that could be 200-300 basis points more capital requirement they have than us, and that's quite a good sort of benchmark for us. Then lastly, just cut through it all looking at capital with a leverage ratio of 10.7%, and I think most of the UK market at the moment are on sort of 4-6% type range.

Question 3

Vivek Raja, Canaccord

A couple of questions please. First one is on the Property Finance. Obviously given the increase in risk weights I can see that the margin's gone up in that, but have you actively been able to re-price that to capture some of the potential lost profitability, and is there further to go there? Or indeed speaking to one of your competitors, there is potentially scope I understand to reduce the risk density of that lending going forward. So I wonder if you could comment on that.

Then on the costs, the one business that you didn't talk about was the Asset Management. Obviously the compensation ratio's gone up there. I just wonder in terms of the cost management of that business, can you do anything better there?

And just lastly, in terms of the competitive intensity that you're talking about, particularly in Commercial Finance, I'm just wondering if you'd give a bit more colour on that? So what sort of risk appetite you're seeing from your competitors in the market in terms of advance rates, LTVs, and what do you mean you are stepping back from the market as a result of that?

Preben Prebensen

Let me lead with the property question. One of our competitors has immediately announced an increase in prices as a result of the risk weighting going from 100-150%. We immediately announced that we would not. The point about our business there is that it's consistent, and so our LTVs are consistent, our pricing is consistent, and we have a long-term bargain with our developers and they know that what we do is what we say we do, and we don't stop, we don't change, we don't lead the market. We certainly wouldn't opportunistically raise our prices as a result of the change in risk weighting. The other thing I would say is that even at that risk weighting this is a very handsome business. So that is not an issue. It was never an allocation issue, it's a capital management issue as we've described, but it is not an issue with respect to our appetite for that business.

In terms of the risk density of it, most of what we do is residential development lending. So we're not going to move into commercial lending, we're not going to move into mortgage lending, we're not going to move into things to look for lower risk weighting as a result of that change. I think we've talked about AIRB, we're engaged in discussions with the PRA. It's going to take a while, but obviously we would look to adjust that through a process of going through the model approach as opposed to not. But you won't see a change in what we do. We make very good returns even at the higher standardised weighting.

The question of costs in Asset Management: to a great extent this is conscious on our part. We've told you in the past that we've built the platform, we've built the model, and there is operating leverage in this business, and so as we add to assets you would see our margins expand over time as that operating leverage helps us. But we constantly play the opportunity to invest in people or in more advisers or in the odd acquisition, and the long-term value increase from that, against our ability to boost short-term margins. So the leverage and gearing is in that business, but we make decisions about long-term investment that will have an impact on that. So the jaws didn't open that much this year, we could increase them, we could expand our margins quite easily, but we actually consciously choose to invest in the business, and we see very good opportunities to do that.

Your third question was about the competition in Commercial Finance, I think Asset Finance in particular. What we're seeing in terms of underwriting away from us or pricing away from us, again our underwriting standards are not changing and our pricing is not changing. I think there's a distinction here between the number of competitors, which hasn't really changed, and the maximum supply of credit, which hasn't really changed, it's been high for some time, but actually what we're seeing in terms of them chasing the market and the consequences of that. Adrian, I don't know if you have anything to add on that?

Adrian Sainsbury

That's right, Preben. We've maintained the asset finance book exactly flat. The LTV has stayed the same. As you've seen, bad debt is slightly down in the year in that business as well. We have seen the broker business as the more competitive, and we've talked about that before, while the strength of our direct business has held firm this year again. So we're focusing on the the strong credit quality and the higher margins that we've seen before. That's where we focus.

Preben Prebensen

But there's no question that our competitors are chasing the market and reducing their underwriting standards and reducing their prices. No question. That's what happens at this point in the cycle and it's alive and well.

<u>Question 4</u>

Jason Napier, UBS

Two please. I appreciate that your loan portfolio is pretty short duration, and you've been very clear that run rate losses are well below long-term trends and I guess your expectations for the cycle. I'm just wondering whether there are any kind of leading indicators, short duration as they might be in terms of what you're seeing missed payments, early stage NPLs and so on, that you might share?

Then secondly, just to the point made earlier about capital generation and so on. There have been a number of sort of small acquisitions in the last 12 months. You made a clear point about remaining invested in the business and the breadth of it. I just wondered whether there are any areas of emphasis in terms of where you're looking to invest in future, and what sort of standards in terms of risk and return that you require when you make those sorts of investments, just so we can roll forward capital generation expectations. Thank you.

Preben Prebensen

I think in terms of the bad debt side and leading indicators, we're really not seeing any very clear signs of shifts there. In motor there was a bit of a tick up, but that's off a very low base, so we wouldn't extrapolate kind of materially from that. In property, I mean just to give you a bit of colour, we've written 1,900 loans since 2009, two of them have been impaired. So we're seeing really nothing there, that's in robust health. I would say that there is nothing that is signalling a shift from the benign environment that we've been in for some time.

I think the only thing we repeat, is we're at all-time lows, and so is everybody else, and all-time lows have a habit of turning into a more normal cycle. When that happens it's a relative bull point for us because we're so well underwritten and we have high margins, and we don't expect to behave differently in the next downturn compared to the 30 years that we've got behind us.

On your question about capital and M&A, and I think it was what is our capacity for M&A, how would we do it, how would we look at it. We don't expect significant M&A activity. If you think about the banking model, we've got such a distinctive one, it's very hard to find things that fit. We've actually acquired two small things in the eight years that I've been here in the Bank: one was a £100m book in invoice finance, which we paid £3m of goodwill for; and the other was the Novitas acquisition that we just made, which had a £40m loan book. So we don't expect M&A activity in the Bank. We look at everything but, by and large, it doesn't meet our standards. We don't expect to make acquisitions in Securities. We have Winterflood there which is in great shape, but we're not looking to make acquisitions in that area. That's consistent with what we've said for many years.

In Asset Management our focus is on small incremental acquisitions, if that. So we want to see that organic net flow rate continue in the kind of 6-10% range that we've been in for the last four years. That is bolstered by hiring people, some small teams, the odd small acquisition. That's where we're going to be. I think it's very unlikely that you would see us make a material move in Asset Management. The net effect of all of that is that it's not really part of the capital debate. We've got a small budget for it, it's in our numbers, and we don't see that as an issue.

Concluding comments: Preben Prebensen

Thank you very much. Thank you.