Close Brothers
Modern Merchant Banking

Preliminary Results 2019

Tuesday, 24th September 2019

Preben Prebensen, Chief Executive

Good morning and welcome to the presentation of our 2019 results. This morning Mike Morgan, our Group Finance Director, will be taking you through our financial performance. And I'll then provide an update on the Group and our strategy and outlook.

Also with us today are Adrian Sainsbury, who's the Managing Director of our lending businesses; Martin Andrew, the Chief Executive of Asset Management; and Philip Yarrow, the Chief Executive of Winterflood. And as usual we'll be happy to take your questions after the formal presentation.

Before moving on to the results we also announced this morning that after more than ten years as CEO I've decided that it's time for me to move on and it's time for Close Brothers to have its next leader. The Group is in very good shape with an excellent management team. We spend a lot of time on planning executive transition and have strong internal succession and clearly the Board will also do a full external search. I'll continue to lead the Group for the next 12 months during that process.

Now moving on to this year's results, we're pleased to report a very solid set of results for the 2019 financial year with strong returns and profitability. Profits continue to grow in our banking division though challenging market conditions for asset management and Winterflood led to a slight overall reduction of 3% in group adjusted operating profit.

Our equity base continued to grow with a CET1 ratio of 13% while ROE remained strong at 15.7%. And we're pleased to propose a full-year dividend per share of 66p, up 5% on last year, continuing our long track record of progressive dividend growth.

The specialism and diversity of our model continued to define our business and allow us to deliver profitable returns through the cycle. The Banking division maintained a strong net interest margin and low bad debts with continued loan book growth. Asset Management sustained good momentum with strong net inflows, notwithstanding subdued investor sentiment. And Winterflood continues to deliver solid profitability in a difficult market environment.

Looking ahead we remain committed to our prudent and disciplined model and to maintaining investment to protect, improve and extend our business over the long-term. And we're confident that our resilient model continues to enable us to support our customers and clients throughout a wide range of market conditions.

I'll now hand over to Mike to take you through the results in more detail.

Mike Morgan, Finance Director

Thank you, Preben, and good morning everyone.

As Preben said we delivered a solid set of results last year. In Banking our loan book increased 5.7% whilst maintaining our strict underwriting and prudent LTVs with all five banking business groups growing in the year.

Our strong net interest margin remained broadly stable at 7.9% reflecting continued pricing discipline and both asset management division and Winterflood successfully navigated challenging market conditions.

Adjusted operating profit reduced 3% in the period while adjusted earnings per share reduced 2% to 136.7p. ROE remained strong at 15.7% and our CET1 ratio increased to 13% with the leverage ratio also increasing to 11%. We're pleased to propose a 5% increase in the full-year dividend per share to 66p, in line with our progressive dividend policy.

Moving on to segmental performance. In the Banking division profits increased 1% to £254m, benefiting from our diverse portfolio of businesses. Profit in Commercial grew 14% driven by strong loan book growth and higher net interest margin across Asset Finance and Invoice and Specialty Finance. Profit in Retail has decreased 11%. This reflects good loan book growth offset by a reduction in margin as well as continued investment across our Premium and Motor Finance businesses. And property delivered profit of £95m, unchanged on the prior year, with lower fee income in the period and a lower net interest margin.

Asset Management delivered strong net inflows at 9% of opening managed assets although profit reduced 6% to £22m, reflecting difficult market conditions throughout the year and continued investment.

Winterflood achieved solid trading profitability in difficult market conditions with a profit of £20m, down 29% on last year due to significantly lower trading volumes.

Looking now at the income statement, income was up 1% to £816m, driven by growth in Banking and Asset Management, offset by lower trading income in Winterflood. Expenses increased 4% to £497m and this reflects the increased investment in the Banking and Asset Management. Credit performance remained strong with a 4% growth in impairment losses to £48.5m and a continued low bad debt ratio of 0.6%.

Overall adjusted operating profit reduced 3% to £271m with profit growth in Banking but lower profits for our market facing businesses. The effective tax rate reduced to 24% reflecting a small one-off tax provision release and we delivered £202m of profit attributable to shareholders in line with the prior year.

Our balance sheet remains simple and transparent and the majority of our assets and liabilities relate to our lending activities. We take a conservative approach to both the asset and liability sides of the balance sheet. We have maintained a prudent level of funding well in excess of the loan book at £9.9bn. We continue to borrow long and lend short with the average maturity of funding at 20 months, significantly ahead of the loan book maturity at 14 months. We maintained a prudent liquidity position while continuing to optimise the level and mix of treasury assets. At 31st July 2019 we had £1.4bn of treasury assets with majority held with the Bank of England.

Our funding base is well diversified and includes access to both retail and non-retail deposits as well as secured and unsecured wholesale funding. Despite mixed market conditions our credit ratings remain strong and stable with the banking subsidiary consistently rated Aa3 with a stable outlook by Moody's.

We continued to optimise our cost of funds which benefited from disciplined deposit pricing and renewal and increase of both our Motor and Premium securitisation facilities over the year.

We have also implemented our new customer deposit platform and introduced new products including new notice accounts for our Retail, Pension and SME customers. This helped us increase our total deposits by 3% to £5.6bn with 12% growth in retail deposits to £2.1bn in the year. We're looking to introduce an additional suite of saving products and a new online portal in this financial year.

Our continued profitability allows us to support loan book growth while maintaining capital ratios comfortably ahead of regulatory requirements. Our CET1 capital increased 8% to £1.2bn, reflecting continued profitability and slower loan book growth at this stage in the cycle.

Risk weighted assets also increased by 5% to £9bn, principally reflecting loan book growth. As a result the CET1 ratio increased to 13%. The total capital ratio also increased to 15.2% and our leverage ratio increased to 11%. Our strong capital position provides good headroom of 400 basis points to minimum CET1 capital requirements of 9%. And we remain committed to building capital for future flexibility.

We're also making good progress towards our IRB application. We have completed the development of our initial models which are now undergoing testing and validation. We currently expect to submit a formal application to the PRA next summer.

Moving on to the Banking division. We achieved good income growth of 4% to £603m, reflecting loan book growth across all businesses at continued strong margins. The net interest margin remained broadly stable at 7.9% reflecting continued pricing discipline. The slight reduction on the prior year reflects lower fee income and higher cost of funds.

Expenses grew 6% to £301m and the expense/income ratio increased marginally to 50%. This reflects an increase in investment across our businesses. Over two thirds of the cost increase relates to investment in strategic projects and new business initiatives. The remaining cost increase largely relates to continuous investment in operational resilience and technology making sure that our business remains safe.

Despite the increase in overall cost we continue to focus on improving operational efficiency and carefully managing other non-investment spend. Staff costs, which represent the majority of the cost base, remained flat on prior year despite a 6% loan book growth and continued inflation and the compensation ratio reduced to 28%. The bad debt ratio remained low at 0.6% which continued strong credit performance. And we delivered a strong return on the loan book of 3.3%.

Overall the loan book increased 6% to £7.6bn, with all of our five businesses contributing to growth in the period. This reflects our strong customer offering and our diverse business portfolio with growth in both our core businesses and newer initiatives.

The Commercial loan book increased 9% overall with good growth across the businesses. The Asset Finance loan book increase 6% supported by growth in specialist sectors such as Aviation and Marine and more recent product initiatives such as personal contract hire. Invoice and Specialty Finance increased 14% with continued growth in the core invoice finance client base and Novitas.

The Retail loan book increased 5% supported by good growth of 9% in premium finance reflecting a number of new significant broker relationships in the year. And 3% increase in the Motor Finance book which returned to growth following our recent investment to improve our sales capability.

And Property delivered modest loan book growth overall as good new business levels were offset by a significant level of repayments in the year. We continue to see good business growth in the regions, which is offsetting the slower markets in London and the South East.

Looking now at the key metrics across the banking division. Performance across the segments reflects the diversity of our businesses and their different market dynamics. The net interest margin in Commercial increased to 8.1% reflecting business mix with growth in higher margin products.

Bad debt increased to 0.8% compared to very low bad debts in the prior year but we continue to see good credit performance overall. The expense/income ratio reduced to 56% due to strong income growth in the period.

In Retail the net interest margin reduced to 8.1% partly due to lower fee income as well as growth in the lower margin Irish Motor book. Bad debts remained stable and the expense/income ratio increased due to the continued investment across both Motor and Premium Finance.

And, finally, the Property net interest margin reduced to 7.1% due to lower fee income and higher cost of funds. The latter reflects the higher base rate which directly impacted margin in this business due to the structure of our contracts. We continue to see strong credit performance across our Property portfolio with a bad debt ratio of 0%. The expense/income ratio increased to 27% reflecting the increase in technology investment across the Banking division.

Moving on to Asset Management which delivered strong net inflows at 9% of opening managed assets. Managed assets increased 12% to £11.7bn reflecting the good inflows as well as positive market movements, particularly in the second half.

Operating income was up 4% driven by good growth in investment management fees, supported by continued growth in assets. Income from advice and other services reduced due to lower new advice business levels which reflects the weaker market sentiment.

The revenue margin which is calculated as a two point average reduced to 93 basis points, reflecting the trajectory of market movements. A significant fall in the market and asset levels in the first half of the financial year resulted in lower average market levels throughout the year and this accounted for four out of five basis points reduction in the margin.

Expenses increased 7% to £99m, driven by continued hiring of advisers and portfolio managers and investment in technology and research capability.

Overall, the adjusted operating profit reduced 6% to £22m with an operating margin of 18%.

And finally, Winterflood, which delivered solid trading profitability with only two lost days in difficult market conditions. This reflects the expertise of our traders and strong management of daily trading positions. Income decreased 14% to £93m, impacted by significantly lower market volumes with average bargains per day down 18% on the prior year. Expenses reduced 9% to £73m reflecting lower variable costs.

Overall, Winterflood delivered an operating profit of £20m and despite difficult market conditions the return on equity remains strong at 20.7%.

I'm pleased with our solid financial performance over the last year and I'll now hand over to Preben. Thank you.

Preben Prebensen

Thank you, Mike.

Our purpose is to help the people and businesses of Britain thrive over the long term. This ambition is key to our strategy, our culture and how we manage our business. And we're committed to delivering long term value for all our stakeholders and the communities and the environment in which we operate.

Recognising the contribution of our talented and diverse employees remains a core priority for the Group. We were pleased to achieve strong employee engagement scores again this year, and we remain committed to a variety of initiatives and targets to promote diversity in our workforce.

We know that putting customers' interests at the heart of our business is central to our success, and our consistent, high-quality service and personal approach is reflected in the high scores that we achieve in customer and partner surveys across our businesses.

We're committed to making a lasting positive impact on the communities in which we operate, and charitable activities and community engagement are an important part of our culture.

We also recognise that we have an important part to play in addressing environmental challenges and continue to reduce our impact from waste and carbon emissions. And this commitment to all our stakeholders helps to support our common purpose which is fundamental to our long term success and to delivering strong returns for our shareholders.

Our consistent strategy at Close Brothers focuses on the long term and has delivered strong performance over many years. The specialism and diversity of our businesses continue to support our resilience and performance, both now and for the future. In the last year Asset Management and Winterflood have been impacted by the challenging equity market environment, while the Banking division continued to move forward, delivering solid profitability and returns.

We have a particular focus on the future resilience of our business and on our readiness for any change in the macroeconomic outlook. Equally important is our model discipline, building capital and retaining flexibility within our funding base, while leveraging the significant experience and expertise across the Group.

This year we've conducted extensive contingency planning for a downturn in the UK economy across our various businesses, ensuring that we're ready and able to lean in when the opportunity presents itself. Investing in operational resilience, core technology and regulatory compliance to protect our model and keep our business safe is a constant commitment.

We're also committed to investing through the cycle to improve and extend our model, and have a number of compelling programmes currently in progress, some of which are already delivering substantial benefits.

The diversity and specialism of our businesses continue to support our resilience and good performance. This slide illustrates the broad range and number of businesses that contribute to our success. We have three separate divisions in Banking, Asset Management and Securities, each with a distinct product offering and customer base.

And within Banking we have five primary business lines, each of which contains multiple specialist lending businesses in distinct and unique markets. This year all five grew, reflecting both resilience in our core businesses and the increasing contribution of a number of new products and initiatives.

We achieved particularly good growth in Commercial, with Asset Finance benefiting from good growth in our transport businesses, along with increased uptake in personal contract hire. Within Invoice and Speciality Finance we continue to see good demand for our asset based lending proposition and saw ongoing strong growth in Novitas.

Elsewhere we were pleased to see a return to growth in Motor Finance, benefiting from recent improvements in our sales capability. And Premium Finance achieved good growth driven by several significant new broker relationships in the year.

In Property we continue to see good regional growth opportunities, to offset any slowdown in London and the South East. And this year launched a new bridging finance service in Manchester and expanded our offering in Northern Ireland.

In Asset Management we continue to attract business through all three of our distribution channels, offering a range of advice and investment management services.

And in Winterflood we maintained our leading position in market making, and continue to extend our offering to institutional clients and through Winterflood business services.

This familiar slide illustrates how our lending model has performed through the cycle in previous years and over the long term. We do this by maintaining our lending standards, protecting our margins and continuing to invest for the future. Consequently, we do not chase growth and consider it an output, with faster growth in periods of low credit supply and slower growth in more competitive market conditions.

In the current environment our growth has been moderating over recent years, reflecting the high supply of credit at this stage in the cycle. The credit environment continues to remain relatively benign with active competition present across our range of businesses.

We're also conscious of the current period of heightened market and economic uncertainty but, while we cannot predict the outcome of the impact on our clients and customers, we do know that we can rely on our tried and tested model. And, as demonstrated over a number of cycles, we do not change our approach. Our long track record shows that we have consistently delivered strong returns and have continued supporting our customers and we've maintained our long term dividend over a wide range of market conditions.

Our diversity also supports the relative resilience of our net interest margin. Each of our numerous businesses is consistent with our high net interest margin strategy, but with differing supply and demand characteristics and income streams. Our net interest margin is therefore the sum of a number of distinct moving parts, yet overall has remained relatively stable. It also reflects that our customers value us for service, our expertise, and our strong long term relationships, and that we do not compete on price.

This year our net interest margin has remained broadly stable on the prior year, and the slight decline of 10 basis points overall was driven by lower levels of transactional fee income, combined with the higher cost of funds reflecting the increase in the Bank of England base rate in August 2018.

The benefits of the Close Brothers' model have been evidenced over a long track record of performance and through several economic cycles. Our resilient and prudent approach, always maintaining our discipline and sticking to our lending criteria, means we've been able to perform consistently and reliably over many years. Our lending is predominantly secured with typically short tenures and small average loan sizes. And our people have significant specialist expertise in underwriting, in collections and in credit risk management. Many of them have been with us for many years, with long term experience through previous turns in the cycle.

In the past year we've undertaken extensive scenario planning, leveraging that internal expertise and experience to prepare and ensure our readiness for any change in our trading environment. Our lending model, security and experience gives us a resilient platform from which we can ensure that we're ready to protect our business, continue to lend and indeed lean in to maximise any opportunities presented in the event of an economic downturn.

As you know, investing through the cycle is a key part of our strategy, and we have a number of initiatives underway. I'd now like to take the opportunity to share with you an example of where investment we've already made in one of our core businesses has delivered significant benefits.

Back in 2016 we began a transformation project in our Premium Finance business where we wanted to enhance our proposition to customers and brokers by upgrading our processes and technology and improve the growth prospects of this business. Now substantially through this programme we've successfully delivered a new, resilient and scalable customer contact centre built on technology that forms the foundation for our customer-facing enhancements. We now have improved digital service capabilities, with slicker and faster customer journeys, and a business intelligence proposition backed by data analytics that's proven key to supporting recent large new broker wins. And we continue to transform and enhance our system resilience and risk mitigation capabilities for our customers and intermediaries.

This investment has delivered substantial benefits well in excess of the original investment case, including new business with a 34% growth in loan book since 2016, and an increase of 20% in the volume of cases that we write. And we've also achieved substantial cost savings through improved operational efficiencies.

We have a number of other compelling investment programmes currently in progress. This year we launched our new customer deposit platform which will further increase the diversity and flexibility of our funding, and expand our distribution and extend our range of retail savings products for customers, giving us access to cheaper sources of funding. We successfully implemented our new systems at the end of the last calendar year, and have since begun launching a series of new deposit products, with more to come over the course of our 2020 financial year.

Our Motor Finance transformation project is now well underway and is aimed at enhancing our service for dealers and customers while bringing improved cost efficiencies. Early benefits have already been recognised with increased sales volumes in the core UK market, with improvements to our underwriting and customer onboarding processes still to come.

And we also continue to make good progress on IRB, with increasing confidence as we move through the process. IRB will enable us to optimise our capital efficiency and provide long term strategic flexibility, with risk weightings that better reflect the risk profile of our lending. We continue to have ongoing constructive engagement with the PRA and currently expect to submit our formal application around the end of the 2020 financial year.

In last year's Asset Management seminar we outlined the strategic benefits of our decision to invest in and develop this division, which continued to be proven out in recent performance. Despite the challenging conditions experienced for much of our financial year the Asset Management division continued to deliver strong net inflows at 9% of opening managed assets, benefiting from contributions across all our distribution channels and from recent hires.

You can see that over the last six years we've consistently delivered good net inflow rates between 6% and 12%. This allows us to steadily grow our managed assets over time, regardless of short-term volatility, and build the profit contribution of the division.

Ongoing investment in people, technology and research capabilities are enhancing our operating efficiency and improving our client experiences, maintaining our strong reputation in the wealth management market and attracting new portfolio managers, advisors and clients. This year we also expanded into a new client office in the West End of London.

The Asset Management division continues to show significant long-term growth potential. Our integrated offering remains attractive and we continue to focus on growing organically, extending our distribution via a multichannel approach and improving our operating leverage with robust and scalable technology.

And, finally, Winterflood, which continued to deliver solid profitability despite difficult trading conditions. Retail and investor activity and trading volumes remain significantly down on the prior year, reflected in the reduction in adjusted operating profit. However, Winterflood remained focused on maximising the daily trading opportunities available throughout and maintained its well-established position as a leading market maker.

We've made good progress on expanding our relationships with institutional clients, benefiting from opportunities presented by MiFID 2, and establishing a presence in the USA. We also continue to focus on enhancing our proposition via Winterflood Business Services, which provides dealing, custody, and execution services, and now has over 50 clients and £3.7bn of assets under administration.

Winterflood has a long established position as a market leader in providing market making services, but as a daily trading business it remains sensitive to financial market conditions. Through close risk management of daily exposures, and the expertise of our traders, the business incurred only two loss days in the year, a notable achievement amid volatile equity markets, and the long-term returns at Winterflood remain very strong.

In Banking, our diverse portfolio of businesses and strong credit quality position us well to continue lending and supporting our clients and customers throughout the economic cycle. The Asset Management division is focused on continued growth in client assets through organic new business, and selective hiring of advisers and portfolio managers.

Winterflood maintains a strong position in its markets, and while as a daily trading business it remains sensitive to market conditions, it continues to focus on maximising daily trading opportunities. The specialism and diversity of the Group supports our resilience and profitable long-term performance, and we continue to monitor external economic conditions while preparing and contingency planning for any market downturn. We remain committed to investing in our key strategic initiatives while maintaining our cost discipline. Overall the Group remains well positioned to continue supporting our clients and customers in a wide range of market conditions.

Thank you, and we'll now be happy to take any questions. As usual, please may I ask that you give your name and company before asking your question.

Q&A session

Question 1

Gary Greenwood, Shore Capital

I've got two questions. First on the Banking division, there's I think been a change in mix in the business for a while, the property proportion's been increasing, and that's probably partly contributing to the lower NIM and lower impairment ratio. If I look at historical peaks in impairment ratio, I think you peaked around 2.6% in 1993 and 2009. I'm just wondering given

the change in mix, whether that would no longer be a sort of sensible peak for the business if we were to go through a cycle again, and therefore what would be?

Then, secondly, on the Asset Management business, can you just remind us when you bill with regards to fees, whether that's quarterly or monthly?

Preben Prebensen

Let me just take the second one first. Martin is here. We bill some quarterly and some monthly. Is that correct?

Martin Andrew, Chief Executive Asset Management

Yes. The majority of our discretionary investment fees would be quarterly, although our fund fees accrue daily like most unit trusts or advisory.

Preben Prebensen

So, a mix of the two. Did everybody hear that answer?

Martin Andrew

Then initial fees obviously at the outset of the initial piece of advice.

Preben Prebensen

I think everyone heard the answer. On the first question, which is the change in mix and will the change in mix cause a change in peak bad debts in the next cycle. Mike, you can step in on this. I think you're right that we've done more property, but in property specifically we've also tightened the terms of our lending since the last cycle. So, if you look at the overall book, and we do lots of scenario analyses on this through the ICAP process, but also our own work, we can address the IFRS 9 additional question in a minute. But if you just looked on like-for-like, we don't expect any significant change in the peak performance. If anything, before we get into IFRS 9, because of the change in the terms in property, we might expect the peak to be a little bit lower in the next cycle. Now on IFRS 9, obviously that causes us to bring forward things. Ultimately the losses are the cash losses by the way, we need to all remember that. But IFRS 9 does have a slight difference.

Mike Morgan

Yeah, exactly. If you look at the book last time you saw the peaks under IAS39 coming at different times, so obviously that would pull that forward. As Preben said, the book is probably slightly better in some areas, so on an IAS39 basis we'd expect it to be lower. But having said that, you've got the IFRS 9 angle, so probably a little bit higher than the 2.6, but not materially higher, no.

<u>Question 2</u>

Raul Sinha, JP Morgan Cazenove

Maybe on the margin, when you showed the slide compared to any other peer it looks very stable but gradually declining. But obviously you have a big shift in your deposit franchise as you start to take more retail deposits. I was wondering whether you think that that might impact the margin next year? Also, I was wondering if you could give us any colour on how much retail deposits you have already collected through the platform that you've launched this year?

Preben Prebensen

Through the new products?

Raul Sinha

Yeah.

Preben Prebensen

Mike, maybe you can take that one. But let me address the retail deposit platform and whether as you say that would be a drag on NIM. Actually the case for the spend on that platform was quite positive. And that's because we think that as loan volumes increase, and as we ultimately encounter a positive yield curve again – those do exist, we just haven't seen one for a while – being able to offer a whole series of deposit products as opposed to fixed term two year/three year/one year deposits, will allow us to actually spread the maturities from the shorter end of the curve, notice accounts and things like that, and spread out. So that actually is a positive for us. We think actually the deposit platform itself will provide a positive impact on our cost of funds overall, because we're moving from very rigid longer-term fixed deposits, which in a positive yield curve you would see as a kind of add around, towards a much more spread proliferation of products.

If you think about how other banks look at their liquidity tests and things like that, they behaviouralise their deposits, their current accounts and things like that. We can't do that with our fixed term. We can start doing that as we introduce shorter term notice accounts and see the stickiness of those. So we think it's a positive actually rather than a negative. And how much have we collected so far?

Mike Morgan

It's relatively small so far in terms of products. We've got an SME notice account. We've got a 95 day notice account that's gone out. We've got a SIP account there. Also, it gives us the opportunity going forward to look at things like cash ISAs and instant access. We've got the online capability coming in over the final part of this year. What we have seen so far very much support the benefits that we had in the original business case, and we'll see that build. So, we're very much in line with what we thought.

Preben Prebensen

We actually think it's a positive.

Raul Sinha

How big do you think this retail franchise will become as a part of your deposit base going forward?

Preben Prebensen

What is now? Bear in mind that unusually for a bank of our size we have very high credit ratings, so we can tap the institutional SME charity kind of local authority market for term deposits at preferred terms actually. And so that is a part of our funding model which is specific to us. But the retail side is about a third.

Mike Morgan

I think we've got nearly £2bn of retail deposits there, around five plus in total, so more corporates. And so the opportunity to move that balance a little bit back onto the retail side I think is what we're doing. But we're very happy with where that is at the moment. Being able to spread into these other accounts we'll get more competitive rates there as well. In a sense the size of it will depend on the lending opportunities, because clearly we've got a lot of opportunities to raise funding across the organisation. But clearly we will do that in tandem.

Preben Prebensen

You also have to look at it the other way, which is that we want to preserve our funding model. We also want to access the flexibility of all of these other products within the retail market, so that we as I say can kind of spread that maturity from shorter than we go right now, right out. But behaviourally come to the same conclusion if you like, that our funding model is as it should be. It will be a cost benefit analysis across the maturity spectrum: public markets; securitisation markets; institutional deposits; retail deposits. We don't have a target in terms of those things, it's really a cost benefit analysis.

Raul Sinha

Just maybe a question on the Motor Finance business which has been a little bit volatile, and obviously other banks are seeing very contrasting trends. What sort of changes have you made, and why are they working? If you can talk us through that, that would be useful, thank you.

Preben Prebensen

We have a relatively new management team in there which is overseeing our investment programme, which we talked about. That investment programme is enhancing our sales capabilities, and that is both the way that we lead, as well as the tools that we provide them with and provide our dealers with. That kind of increase in those tools is growing, and so we're becoming more effective in servicing the dealers. Therefore, we have seen actually the first growth in our core UK Motor Finance book for really some time now. That's quite interesting, because it's against a backdrop of quite a weak market in motor. But you have to remember the part of the market that we really serve, so slightly older used vehicles, much more local. We serve just under 6,000 motor dealers right now. We've often talked about the pyramid of motor dealers, we're definitely in the lower echelons of that pyramid. But we're serving them better and better.

At the other end of the market we don't do new cars anyway, and that's actually much softer than the used car market. And then the used car market overall finance penetration is growing even if the market is reasonably anaemic. So that's kind of helping us and other people.

Then I would say that for the first time we have started to see two or three of the big banks slightly pulling their horns in motor, for the first time in this whole cycle. We're not calling a change in the overall competitive environment, please don't take that away, but it is interesting that we are seeing that happen.

So, I think it's a confluence of those things that's causing us to just see a slight uptick. If you remember, the peak of our market share in used car finance tends to be around 12% when everybody else runs away, and it tends to go down to about 5%. We have hit 5%. So over a long period it wouldn't be surprising if we start seeing that edge up a little bit, and that's what's happening.

<u>Question 3</u>

Jason Napier, UBS

The first one on expenses, please. It looks like some of the past investment's paying off, as you say the return to volume growth in Motor and so on. I just wondered if revenues were to print flat this coming year, what the expense base might look like given the plans that you have which are longer duration if you like?

Then, secondly, on the outlook for credit, the credit indicators and so on, you obviously have a much more diverse business set than we can see. But I'm just wondering given the sort of shorter duration books and things like invoice finance factoring, discounting and so on, what it is you are seeing going on in the economy? We're all poised for a break event, but what does business as usual look like from the indicators that you can see, and how far ahead do those indicators allow you to look?

Preben Prebensen

Why don't I have a go at that second one, and Mike I think the first question on what do we do if revenue is flat now in terms of BAU, what can we do there, and in terms of the investment programmes, what would we do there. I think we re-prioritise is kind of the short answer to the question, but there are things that we really will hang on to because they create really significant value, IRB for example. I've stolen Mike's thunder on the second question, so I'll move on to the other one.

On the credit outlook, you're right that we're quite protected both in terms of kind of the resilience of NIM and overall growth, even though it's an output for us, by having over 20 different lending businesses. Are we seeing any kind of early warning signals? Basically no. The bad debts don't tend to be joined up. They're isolated, they're individual events, rather than trend events starting.

Invoice is a good question, because it's where you might see a bit more fraud, with more desperate smaller businesses you might see them failing. So I think David Thomson, if he were here, would say it's a little warmer. But there is no kind of trend, the candle hasn't gone out.

So while we’re simulating, and kind of we have a lot of playbooks for each of the lending businesses, and we’re doing that because it’s a good thing to do, it’s not because we see this thing imminently. Mike, do you want to just address the expense thing?

Mike Morgan

I mean, we look at the business over the long term, so investment is a fundamental part of that, and our margins and returns allow us to do that, but we have a very rigorous prioritisation process, and so we make sure that when we invest we know we’re going to get good returns from that. And the investment that we talk about is in the areas that Preben’s talked about here, which you’ve seen, but also in protecting the business; we think we have something of real value here. We operate in a very heavily regulated environment and we have operational resilience and cyber challenges to meet as everyone else does. So we’ve invested heavily in those areas as well, so it’s about protecting, improving and extending.

In order to do that though we need to keep on top of the business as usual costs, and that’s a big area of focus for us, and as you’ll have heard me say up there, you know, we have kept staff costs flat year-on-year and we really squeezed the discretionary spend as well. So going forward we would continue doing that. If we were really under a lot of pressure on the income line we would take more aggressive action around those freezes and we would take more aggressive action around some of the discretionary spend, some of the consultancy spend. Ultimately though we would have to have another look at our investment spend. We don’t think it makes an awful lot of sense to sort of stop and start investment, it’s inefficient and ineffective,

but we would have to take that into account, and if that was the case then we would go through our investment plans and look to scale that back, but that would be very much a last resort.

Preben Prebensen

And I think we need to kind of reiterate that we think that being agnostic to the cycle in our long term strategic investment in the business has really driven value in this business over a period of time and the programmes that we cited will really deliver value, whether it's the Treasury Deposit platform or Motor 2020 as we call it, we've seen it in premium with the IRB programme. Those are our biggest programmes by the way, that's why we cited them, that we're not kind of just selecting a bunch for interest, those are the real money programmes, but it would be with real reluctance for us to start slowing those down. It's the wrong thing to do, frankly, and we think we are distinguished by not doing that generally as other people do stop start.

Question 4

Charmsol Yoon, UBS

Just to follow up on Jason's question on cost. So given your comment on your discipline on BAU cost is it right to think that the cost delta year-on-year, I think it's £17m, the majority of them came from the investments?

Mike Morgan

Yes, two thirds of that roughly was investment growth and a third of it was BAU cost growth, but obviously within the BAU cost growth staff costs were flat, and really it was around investing and the running of the technology and operational resilience that caused that BAU cost part to grow.

Charmsol Yoon

And also is it possible to share the broad split of investment spend versus BAU?

Mike Morgan

That wouldn't be something that we would normally share.

Charmsol Yoon

And last question, on the Asset Management, so obviously that's a 7% increase in cost and as you heavily invested in people and technology my question is whether we're likely to see a similar trend next year as you continue to invest in people and technology or should we think that you will probably deliver higher income growth, starting from next year, benefiting from what you invested this year?

Mike Morgan

Well, it's probably worth me starting off and then I can hand over to Martin on that, but the growth in the Asset Management business is really down into parts, one bringing in some new private client high net worth individuals who have joined over the course of the year. Naturally as they come in there is a small J curve so we have to absorb that, but you will see from the inflows that we've had that that's been very strong. And Martin has also been investing heavily in their platform to put that infrastructure in place.

In terms of looking forward it would certainly be the intention to bring more high net worth individuals in, that's been very successful, as Preben says we've set up a base in the West End for them, and we will continue to invest in that platform as well.

Preben Prebensen

The specific revenue line is obviously affected by markets as well, so there's that. Do you want to just grab a microphone?

Martin Andrew

The only thing I would add to what Mike said is that on the cost line we've seen an element in the increase in our costs coming from taking research costs onto our P&L and paying for fund administration costs out of our P&L, and we had half a year effect of that last year and a full year effect of it this year; so that amount of increase we wouldn't expect to continue in the future because the year-on-year comparison will be the same each year now.

Question 5

Nicholas Herman, Citibank

Most of my questions have been asked, just a couple of small questions please. On Asset Management you reference the increase in cost use of new hires, would you just talk about the average business plan of those hires in terms of AUM to be brought in, average time to pay back? That would be helpful.

And then in Securities, I think it was a 14% decline in income year-on-year versus a 9% decline in cost, off the top of my head. I think you referenced that was due to variable cost. So that variable cost decline, is that commensurate or was the variable cost decline commensurate with the income decline I guess is my question? More or less.

Preben Prebensen

So I think in Winterflood that model clearly does show a decline in costs with income decline. That's the structure of the model, including the compensation side of that model. So those things tracked exactly as they should. We're spending money elsewhere though, which is why I think that the relationship isn't linear. We're investing in Winterflood Business Services, we're investing elsewhere in the business, so that's why it wouldn't be a kind of linear thing, but the absolute decline in costs is an illustration of that relationship.

In terms of the hires and the payback of the hires in CBAM which was your other question, I think, Martin, we might go back to you if we can if we can get a microphone to you.

Martin Andrew

It obviously varies quite a lot from individual to individual, but broadly speaking we would want the sort of average book size of our high net worth private client fund managers to be £100m or larger. They're not all at that level, but that's where we'd want the average to be. And as Mike has already suggested, when we hire somebody obviously the costs start day one and the revenues build over time. If we look back at our experience over several years we normally find that we deliver against our business plans pretty much very accurately and we normally find these people and these situations begin to contribute profits within a sort of two to three year timeframe.

Question 6

Raul Sinha, JP Morgan

I'm just wondering if you've got any further thoughts on how the business is going to change in terms of risk management as you move to IRB? Obviously you've progressed in your application. From the outside we don't seem to get a lot of sense of what the risk weightings can be, but I guess the property book is one thing that you've talked about in the past. Do you actually think there's going to be a lot of capital release from IRB, or is this just more about getting to the right way of managing the business as you rescale?

Preben Prebensen

So I think it's very important that we share that one of our primary drivers for doing this is that we will be evaluated on the assets that we have, as opposed to European averages of those assets. So we think it's important that our capital is lined up against our activities as opposed to whatever those European averages might be. And that is an overarching risk management benefit to us.

The IRB process requires that you pass the use test, so you're using these models in your business, they're not just independent of what you're doing and kind of there to calculate capital. So we're doing a lot of work making sure that that is indeed the case. So in Property that's really been the case through the slotting model for some time. In Motor it's also quite straightforward to kind of show how those credit scoring models are used and line up and so forth. So it will be reflective of the way that we do things as well as giving us the answer which is how much capital should we have based on the risk of how we do things.

And then in terms of the benefit, it's time consuming, it's expensive, but the investment case is really clear as far as we're concerned. We will not be deciding what the equity release might be if you like or the new RWA levels might be, but that's up to the PRA. But we're more confident because of the progress that we've made in the last year, that's what we're signalling. We have a very good relationship with them. We have sight of what we think the answer is, and we think it's significant, but that is all that it is prudent for us to share.

Question 7

Shailesh Raikundlia, Panmure Gordon

Just a couple of questions if I may. Just a first one on the dividend policy. Obviously you talk about the progress of the dividend policy, I'm just wondering what your thoughts were, particularly in this set of results where sort of your EPS hasn't moved much but dividend has progressed. So obviously whether you go to a pay average or something like that going forward, what your thoughts are on that.

And, secondly, just back on margins, and particularly in the property NIM, you have previously mentioned there was sort of quite a lot of drag because of sort of floors being placed on certain lendings on the Property book, whether that's sort of run through or we're still likely to see…

Preben Prebensen

Sorry, can you just repeat the property side?

Shailesh Raikundlia

You had some floors put in in terms of the interest rates and whether that's run through or whether you've still got quite a book to come through.

Preben Prebensen

So let me take the one on dividend policy. We increased our dividend 5%, you're quite right, that's against a backdrop of kind of slight reduction in our earnings, so how do we think about that? Really I think you need to introduce the kind of concept of long term and short term into that thinking. So we take a very long term view of our dividend policy, and in order to kind of protect that view we take the opportunity of building cover when we can. So in the years when our earnings were marching up very significantly at that point in the cycle our dividend increases were more modest than our earnings increases, and as a result our cover built.

In this last year we had a very slight reduction in our earnings and we progressed the dividend by 5%, which kind of maintained that progression. The short term volatility if you like shouldn't detract from our long term dividend policy, and we've talked about the markets businesses, if they had simply performed the way that they had the year before our earnings would have gone up and we wouldn't have the question. So our dividend policy shouldn't move in relation to relatively short term movements in things like markets and that sensitivity.

We think the dividend is the expression of the safety and soundness and diversity and distinctiveness of this organisation, so it is bedrock in how we think about life, and that cover means that we can think about that almost independent of the short term change in our earnings. That's different from a major dislocation but even in the last major dislocation we held it. So I think I calculated that our bad debts could quadruple and we would still cover our dividend. That gives you a sense of how we view it.

So interest rate floors and property.

Mike Morgan

You're absolutely right, yes we do have interest rate floors in the Property book. Obviously the base rate is 75 basis points, the floor is set at 1%, so if interest rates go up we're unable to pass that 25 basis points on in property and obviously that would have an effect on the bank wide net interest margin. Conversely, if they go down we'll benefit from that.

Preben Prebensen

And the bank wide Mike, is about six basis points.

Mike Morgan

Yes.

Preben Prebensen

And that will be in isolation, entirely in isolation, but of course we have no further exposure once base rates have gone through that 1%, so it's just the next base rate increase basically or decrease.

Concluding comments: Preben Prebensen

If there are no other questions? Thank you very much indeed. Thank you.