Close Brothers

Close Brothers Group

Tuesday 24th September 2013

Preliminary Results

Preben Prebensen, Chief Executive

Good morning and welcome to our presentation of Close Brothers 2013 full year results. Jonathan will walk you through our financial results in detail and I'll then provide an update on our business operations and the Group's strategic position as we look ahead to the current financial year. And we'll be happy to take any questions after the formal presentation.

Before I hand over to Jonathan I'd first like to share with you the highlights of this year's performance. We've delivered a strong set of results. Group adjusted operating profit is up 24% to £167m with continued good growth in Banking supported by an improving contribution from Securities and Asset Management.

As a result adjusted earnings per share was up 23% to 83p and our return on equity improved to 16%. We continued to deliver strong returns whilst maintaining our high quality balance sheet and strong capital position with an improved Core tier 1 capital ratio of 13.3%. I'm pleased to say that we've increased the full year dividend per share for the third consecutive year up 7% to 44.5 pence. And I'd now like to hand over to Jonathan.

Jonathan Howell, Group Finance Director

Good morning everyone. I'll now take you through our performance for the year. As Preben said we've delivered a strong set of results with an improved contribution from all three divisions. For the Group as a whole adjusted operating profit is up 24 to £167m. The Banking division achieved another year of strong profit growth. The loan book grew a further 13% and bad debts continued to improve. This led to an increase in profit of some £23m to £158m.

Profit in Securities increased £1m to £26m. Within this Winterflood's profits increased slightly to £17m despite challenging market conditions for most of the year. And as expected Asset Management returned to profit with a contribution of £4m. This is an increase of £8m on last year.

And finally central group expenses were unchanged at £21m.

Turning now to the income statement. Overall, income for the year increased 10% to £583m. This was driven by continued growth in Banking as well as higher revenues in both Asset Management and, to a lesser degree, Securities.

Operating expenses increased 8%. This principally reflects costs to support growth in Banking whilst costs in Securities and Asset Management remain broadly stable. As a result the overall expense income ratio improved to 63%. Despite growth in the loan book bad debt charges in the Banking division reduced to £51m. And this resulted in strong growth in operating profit of 24% for the year.

In the year we recorded some £2m of exceptional income. This relates to the continued reduction in the Group's holding of Mako from 27% at the last year end to 16% today. The tax charge for the year was £43m corresponding to an effective tax rate of 26%. After tax adjusted EPS increased 23% to 83.1 pence and basic EPS, after exceptional items, increased 19% to 81.6 pence.

And finally we have increased the full year dividend by 3 pence or 7% to 44.5 pence. The strong earnings in the year have allowed us to continue growing the dividend whilst at the same time improving our dividend cover which now stands at 1.9.

The Group has a simple and straightforward balance sheet which is principally made up of assets and liabilities related to the lending activities in our Banking division. The customer loan book and treasury assets now account for over 80% of the Group's total assets. Overall, total assets increased 8% in the year to £6.8bn and this was entirely driven by the loan book which grew 13% to £4.6bn. The loan book continues to be principally short term secured on a diverse range of assets and with prudent loan to value ratios.

Our treasury assets were stable at £1bn and now almost entirely comprise high quality liquid assets to meet the requirements of our banking activities. This remains a prudent liquidity position which is ahead of regulatory requirements. Our balance sheet also includes securities assets related to the market making activities of Winterflood and Seydler. These are principally short term settlement balances and trading positions and were stable in the year at £600m. These assets are largely offset by trading balances on the liabilities side and the net position was unchanged year-on-year at around £100m.

The Group has a strong funding position maintaining the diversity and prudent maturity profile of our funding. In the last year total funding increased 7% to £6.3bn covering 135% of the loan book at the balance sheet date. This increase reflects good growth in deposits of some £600m to just over £4bn with good demand for both our retail and corporate deposit products.

We also renewed over £1bn of facilities including extending the maturity of our two securitisations. At the balance sheet date term funding of a residual maturity over one year had increased to £3.3bn. This is a prudent position covering more than 70% of the loan book. And the average maturity of this term funding at 26 months remains substantially longer than the loan book at just 13 months.

Our capital position remains strong with a Core tier 1 ratio of 13.3% and a leverage ratio of 9.8%. This is an increase on the prior year which reflects an 11% increase in Core tier 1 capital to £692m driven by strong profit growth. And more modest growth of 7% in risk weighted assets principally reflecting loan book growth. The reduction in the Group's holding of Mako also benefitted the Core tier 1 ratio in the year.

The Group remains well positioned for the implementation of the Basel III capital regime under CRD IV and we expect to comfortably meet the new capital requirements. We now estimate that applying CRD IV in full on a pro forma basis at 31 July would increase our Core tier 1 ratio by around 0.8%. This is driven by the new discount for SME lending under CRD IV which accounts for a significant proportion of our risk weighted assets. CRD IV will apply to us for the first time at the next half year results to 31 January 2014.

Now looking at each of our divisions more closely starting with the Banking division. Income increased 10% to £396m. This was driven by continued good loan book growth during the year. Costs were £188m this is an increase of 11% as we continue to invest to support growth. Around two thirds of this increase is volume related growth including around 70 new hires in the year and performance related compensation reflecting the increase in profits. Our investment spend including amortisation of prior year investment also increased as we continue to develop our infrastructure to support the growing business. Overall the expense income ratio remains stable at 47%.

Despite loan book growth bad debt charges reduced as the credit quality of the loan book continued to improve. As a result the division's overall profit increased 17% to £158m. This resulted in a further improvement in the ROE to 24% and in the operating margin to 40% as our specialist lending model continues to deliver both good growth and strong returns.

The loan book increased 13% to £4.6bn with good growth across Retail, Commercial and Property. The Retail loan book increased 12% to £1.9bn due to strong growth in motor finance from both smaller existing dealers and new larger dealerships. Commercial increased 13% to £1.8bn with good growth in both Asset and Invoice finance. This reflects increased sales capacity in the last few years.

Property continued to benefit from strong demand and low competition. The Property loan book increased 14% to £900m and continues to account for around 20% of our loan book. The division has consistently delivered strong returns during a period of significant growth reflecting the consistent discipline we apply to our lending.

In the year the net interest margin was 8.8%, lower than the prior year. This principally reflects growth in lower margin, lower risk products over the last two years. The bad debt ratio improved further to 1.2% with reduced bad debt charges across Retail, Commercial and Property. This demonstrates our discipline in sticking to our prudent lending principles. Overall we have maintained our strong return on the loan book at 3.6%.

Now looking at the Securities division where performance improved slightly despite continued low investor risk appetite in the year. Overall, adjusted operating profit increased £1m to £26m. Profit from Winterflood, the largest business in securities, increased slightly to £17m reflecting improved trading conditions in the second half.

Seydler increased its profits substantially to £8m as it benefited from increased capital markets activity in Germany. And this offset a reduced contribution from Mako of £1m. Since the start of the year our shareholding in Mako has reduced from 27% to 16% today as we continue the phased sale of our investment. As a result Mako's been reclassified as an equity investment and no longer generates associate income in the Securities division.

Winterflood's performance continued to be affected by low investor risk appetite although market volumes increased in the second half of the year. As a result average bargains per day remained at 47,000 despite a slower first half. Income per bargain was also broadly stable at £6.30 as trading remained concentrated in large cap stocks with low demand for AIM and small cap stocks which generate higher margins for Winterflood. Overall, income was slightly up on last year at £75m.

Winterflood has a variable cost structure and its expenses are therefore closely linked to revenue. Given the small increase in income, expenses were also broadly stable at £58m; and overall profit increased slightly to £17m.

Now turning to Asset Management which has returned to profit this year. We have developed a scalable model and the focus is now on driving revenue growth whilst controlling costs to maximise profitability. And in the last year we achieved good income growth of 12% to £78m with an increase in both advice and investment management revenue. At the same time we held costs flat at £74m. As a result we achieved a significant improvement in performance with an overall profit of £4m and ROE of 10%.

In the last year AUM increased 9% driven by market movements with a continued improvement in mix through strong inflows in our core distribution channels. Total inflows were £1.2bn up over 20% on last year coming from our own advisers and investment managers as well as third party IFAs. However, net flows were negative due to outflows of £1.4bn. These include client drawdowns in the normal course of business as well as redemptions of three low margin mandates and the maturity of our legacy structured funds which together accounted for around £470m. This was more than offset by £1bn of positive market movements due to the strong equity market performance in the year with the FTSE up over 17%. And as a result overall AUM increased to £9.1bn.

Now looking at the drivers of income in more detail: the revenue margin on total assets expanded to 88 basis points; this reflects our improving mix of assets with an increasing proportion of higher margin private client assets. Total advised assets increased 9% to £5.1bn, and the revenue margin increased to 73 basis points, up from 68 last year. Total managed assets increased 16% to £6.2bn reflecting good sales of our investment products as well as positive market movements. The revenue margin on managed assets increased to 71 basis points due to the reduction in lower margin institutional assets over the last two years.

Within this assets which are both advised and managed increased 32% to £2.2bn. The strong growth reflects good sales of our integrated investment management and advice proposition. These assets generate both advice and investment management income and therefore have a higher revenue margin at well over 100 basis points.

So all in all as you can see this has been a good year for the Group. Thank you very much, and I'll hand back to Preben.

Preben Prebensen

Thank you, Jonathan. The Group has performed strongly despite continued economic uncertainty which demonstrates the strength of our business model. We focused on developing our core businesses and all of our divisions are now in a position to generate strong sustainable earnings. We stood by our prudent and conservative approach which has served our clients and businesses well. Our strategy is clear – we only operate in chosen niche markets where we can differentiate ourselves and build strong relationships and where we have significant expertise.

While each business has distinctive characteristics the whole group shares these common attributes. Importantly, our strategy has remained consistent and continues to be based on our core principles of simplicity and prudence in all market conditions. We are doing what we've always done. We've consistently maintained a simple, high quality balance sheet and strong funding position which has enabled us to deliver sustainable growth.

2013 was a breakout year for our performance. We delivered adjusted operating profit growth of 24% and increased our return on equity to 16% while at the same time as growing our loan book, improving our capital ratio and increasing the dividend. We recognise that loyal and long term client relationships are critical to our success and we've developed our business model to continue to provide our clients with the highest level of service. At a time when public trust in banks is low we've provided our clients with stability and continuity and while we recognise the importance of digital development, we also remain intentionally personal. We connect our clients with real people and our decisions are made by real people.

What differentiates us is the individual expertise of our people across the Group. Our lenders, traders, advisers, fund managers and portfolio managers are highly specialised in their fields. They use this expertise to find out exactly what their clients need and then apply expert skills and knowledge to deliver the best solutions for each client.

In the Banking division we have 500 front line sales staff working from over 40 local regional offices. We spend time getting to know our customers' businesses and will only lend in areas that we fully understand. Due to this specialist knowledge we develop we're able to provide a consistent level of service and pride ourselves on the speed of our decision making which allows our customers to get on with the day to day running of their businesses.

Similarly, Winterflood serves its markets with dedicated staff that are amongst the most experienced in the industry. Our success as the leading UK market maker lies in both the skill of these traders as well as our robust proprietary technology. Indeed around 20% of our employees are focused on IT and in-house development which enables us to implement competitive and fast trading solutions to meet a range of client requirements.

Seydler's emphasis on personal service and long-standing client support has enabled the business to maintain its position as the market leading designated sponsor in the German small and mid cap market. It has over 200 clients in its designated sponsoring business, and through leveraging these relationships it's built a strong capital markets franchise.

In Asset Management we strengthened our national presence and we now have around 130 advisers in ten UK locations and 50 investment professionals providing a range of services to our clients. Our personalised and long-term approach has earned us a strong reputation and a loyal client base.

Turning now to our Banking division. We gave a detailed update on the Banking business at our investor seminar in May, but I would just like to begin by reminding you of our differentiated lending model which has supported our strong key ratios and consistent returns through the economic cycle. Our lending model has remained unchanged as we continue to grow, with all of our lending sharing a similar risk and return profile across the different asset classes of our loan book.

We offer specialist, predominantly secured lending with small ticket sizes, conservative loan to value ratios and short term loan maturities. At 31st July around 90% of our loan book was secured, with the majority of our loans less than £50,000 in value and more than 60% of the loans maturing within 12 months. Our high touch, high service model differentiates us within the sector, and one of the reasons our customers remain loyal comes from the reassurance and comfort of knowing that we will be there through the good times and the bad times.

We've also continued to benefit from our consistent underwriting discipline and as a result we've maintained consistently strong returns throughout the cycle, with a ten year return on equity averaging 19% and a ten year average return on the net loan book of 3.5%.

So as you can see we remain very committed to our lending model which has supported our track record of strong returns in a range of market conditions, and during a period of significant growth. We also have a strong market position underpinned by long-term customer relationships and an extensive local distribution network which has helped sustain our ten year average growth rate in the loan book of 11%. While we maintain tight control over our lending criteria the rate at which we can grow at any point in time is determined by conditions in the lending market and changes in credit, supply and demand. We have seen some signs of competition returning, but the market is still fragmented. Many of the banks we used to compete with have a reduced presence in our markets which has created opportunity for us and the scale of new entrants is still far smaller than the lenders that have exited the market in recent years.

We're still seeing good demand for specialist and tailored finance. For example, our commercial business worked with over 23,000 SMEs during the year, which we're well placed to reach given our strong distribution network. This still represents a very small part of the overall SME market in the UK which remains underserved by the high street lenders.

So overall our lending environment continues to be favourable and during the year we had strong levels of new business, grew our customer numbers and maintained high levels of repeat lending, in excess of 65% across all our lending businesses. This was reflected in the 13% loan book growth in the year which remains broadly consistent with our long-term growth rate.

Looking ahead to 2014 we remain committed to helping our clients access funding in all market conditions. We talked you through our outlook in detail at our Banking division seminar in May, and the presentation is still available on our website. However, just to remind you quickly we continue to see good opportunities for growth across our lending businesses.

Firstly, we remain a relatively small player and believe there is good growth potential in our existing markets. We're well positioned to benefit from both an increase in demand and through growing our market share across all three of our lending businesses.

Secondly, we're always exploring opportunities for growth in adjacent markets which share common attributes and returns with our core businesses. Some examples of areas we have explored and developed over the last few years include a specialist sales team in asset finance who have a strong reputation for arranging bespoke leasing solutions. And in Property we offer loans to housing associations to assist with their private for sale developments. Overall we believe that our specialist knowledge and local distribution network places us in a strong position going forward.

Moving on to Winterflood, where despite difficult trading conditions continuing in 2013 the business remains solidly profitable. This demonstrates both the resilience of our business model and the skill of our traders. Winterflood has a highly variable cost base which is tied to trading revenue through settlement costs and performance related compensation. Our primary focus is on market making and we do not carry the additional fixed costs associated with primary activity. As a result in difficult markets Winterflood is able to manage its costs and maximise profitability while at the same time maintaining its trading capacity and headcount for when markets improve.

Winterflood is a cyclical business and its performance is sensitive to market conditions and retail investor risk appetite in particular. During the year despite continued investor uncertainty and periods of volatility our traders delivered a profit on 245 out of 253 trading days in the year. As a result of this model we have been able to maintain a leading market position throughout the cycle. Together with the diversity of our product and market coverage we're well positioned to benefit from any increase in retail trading activity, regardless of what part of the market it occurs in.

As Winterflood marks its 25th anniversary we continue to focus on what we do best: our core market making activities. Our commitment to providing clients with continuous liquidity and our willingness to make prices in any size for UK, European and US securities, even during the most volatile market conditions has helped us maintain our position as the leading market maker in the UK.

At the same time we constantly explore new ways to build on our core capabilities in order to maximise revenue and profit opportunities. We continue to develop the execution, custody and settlement capabilities of Winterflood Business Services to provide additional services to our clients. And during 2013 Winterflood became a market maker for the pan European regulated exchange Equiduct which has broadened our client base outside of the UK while increasing our profile within Europe. And we also strengthened our fixed income offering, joining the London Stock Exchange's order book for Retail Bonds which builds on our strong track record in gilts and corporate bonds.

Market conditions in 2013 remain difficult for Winterflood. Retail investor risk appetite remained low and although retail market volume's recovered very slightly they were close to cyclical lows. An active secondary market is to an extent dependent on an active primary market but as the chart shows the number of IPOs continued to reduce. In particular new money raised on AIM which generates the highest margin trades for Winterflood remained at historical lows. However, when we did see days of stronger sentiment Winterflood did benefit and trading activity increased. We believe there are a number of catalysts including increased primary market activity which could trigger a sustained recovery in risk appetite and thus benefit Winterflood.

Recent tax changes such as the abolition of stamp duty on AIM shares, as well as their inclusion within ISAs may also present opportunities for Winterflood to grow or enhance revenues. In the 2014 financial year so far we have seen some pick up in retail activity and in AIM trading and as a result Winterflood's performance has improved. It remains difficult to predict future market behaviour, but overall we're confident Winterflood remains well positioned for any sustained market recovery.

The Asset Management division made significant progress during the year. We've now completed the restructuring process to refocus the division on wealth management for the UK private client market and several achievements in 2013 demonstrate the strength of our scalable business model. The division returned to profitability as we said it would and the fixed cost base has now stabilised, enabling us to benefit from increasing operating leverage as the business grows and develops scale. We've built our propositions to take advantage of market opportunities including changes in investor preferences, technology, regulation and demographics. Clients have responded well to our propositions and we receive strong gross inflows in the year attracting new clients through our own advisers and portfolio managers as well as third party IFAs.

The inflows in the year have been supported by our investment performance track record. Our Discretionary Portfolio Funds have just reached their three year anniversary and all five strategies have outperformed their respective IMA sectors since inception, and earlier this year they were awarded the 5-Diamond rating by Defaqto. Similarly, the majority of our bespoke portfolios have consistently outperformed their ARC peer groups over a five year period.

During the year we've received increasing external recognition and endorsement, receiving a number of additional awards recognising our proven expertise and providing financial advice and managing multi-asset portfolios.

In 2012 we set out our medium-term targets to 2015 to demonstrate our path to profitability and expected margin expansion. During 2013 we made good progress towards these targets. Firstly, the revenue margin increased to 88 basis points this year. This is due to a greater proportion of higher margin assets demonstrating one of the benefits of restructuring to focus on the private client market. We also increased the proportion of assets from which we generate both advice and investment management income. As Jonathan said, we now have £2.2bn of assets, both managed and advised where we own a revenue margin of over 100 basis points.

Going forward we expect the revenue margin to continue to grow as we increase sales of this integrated proposition to both new clients as well as existing advised clients.

Secondly, the division returned to profitability this year with an operating margin of 5%. Now that our major investment spend has been completed we have a more stable and scalable costs base and we’re starting to see the benefits of our investment in improving front and back office productivity. We’re confident that we’re on track to meet our target operating margin of at least 15% by 2015 through organic net inflows and increased operating leverage as we build scale.

To summarise, the division is now operating as a single integrated business. While the wider impact of RDR on the broader wealth management community is not yet clear, we believe we’re well positioned in the new environment. Given our propositions and distribution we see opportunity to grow further share in the market. Going forward we expect to continue to grow revenue organically through increased growth in AuM and through revenue margin improvement. We also expect improving efficiency and operational gearing to help drive strong profit growth in the business.

So to conclude, we see good opportunities in our chosen markets and the Group is well positioned for 2014. In Banking we continue to see good opportunities for growth. Securities remains well placed to benefit from any sustained improvement in trading conditions. And in Asset Management we expect continued progress towards our medium-term targets. Overall we’re confident in our outlook for the current financial year.

Thank you very much for listening and we now look forward to answering any questions that you may have. As well as Jonathan, the heads of our businesses, Stephen Hodges, Julian Palfreyman and Martin Andrew are all here in the front row and are happy to take any questions. Can I just remind you to state your name and company before asking a question.

<u>Question and Answer Session</u>

<u>Question 1</u>

Gary Greenwood – Shore Capital

Hi, it’s Gary Greenwood at Shore Capital. I just had two questions. The first one’s just on dividend policy. Obviously you’re seeing improving earnings growth at the moment and also the capital position is now improving. So if you could just update us on your thoughts around dividend policy.

And then the second point was just on clarification on tax rate guidance, I think from what I’m reading in your results there, the tax rate was a bit higher than you would have expected this year because of deferred tax asset write down, so should we expect that to normalise back to the UK Corporation Tax rate next year?

Answer: Preben Prebensen

Okay, I'll start on dividend policy, and then Jonathan, you can fill in any blanks as well as covering the tax rate. Our dividend policy is really one of a sustained increase in the dividend over time, that's what we seek to achieve and this is the third year of dividend growth. But at the same time there's a balance, we also want to increase dividend cover, and so while we increased the dividend by 7% this year we also increased the dividend cover from 1.6 to 1.9. And that is really where we stand with respect to that policy.

Further question

Just to follow up on that, what do you think is the right level of dividend cover?

Preben Prebensen

We don't have a target, I think it's not something which is set in stone. From our perspective we think it needed to go up a bit from the 1.6 level and it is now, and then we can look at external benchmarks, general financials I think are 2.5 times if you look at the UK right now, and some of the other banks in the sector are somewhere between two and two and a half, but we don't have a set target, we have an objective to both increase the dividend in a sustained way over time as well as seeing that cover get a bit better.

Answer: Jonathan Howell

Yes, just on dividend, just one thing to say is we've delivered over the last three years exactly what we said we would deliver which would be a progressive dividend increase that was sustainable, importantly sustainable, whilst at the same time increasing cover and that's what we've done, and as Preben said, we've moved from 1.6 to 1.9 whilst three successive years of dividend growth.

On tax, it's a good question, the underlying Corporation Tax rate applying to us this year is 23.7%, our effective tax rate was 26%, and that difference was the write down in the deferred tax assets that we're holding in our balance sheet as a result of passing into law during the course of this financial year the reduction in Corporation Tax from 23% to 20%. So that reduction in Corporation Tax in future years, not during this year, has caused us to take an immediate write down in those deferred tax assets which has opened up that sort of one and a half to 2% gap between our effective tax rate and the Corporation Tax rate. Going forward, our guidance is exactly as it has been in the past to expect our effective tax rate to be just marginally higher than the underlying Corporation Tax rate just to take account of a few disallowable items that you'd expect in a business of our size.

Question 2

Robin Savage – Cannacord

It's nice to hear that you want to retain earnings in order to grow the business and if I can turn to the Banking business I do understand from your comments that you haven't changed the way you operate, but you do say the reduction in the interest margin is a growth in lower margin, lower risk products. I wonder whether you could just talk about the business that you didn't take on, so the sort of maybe higher margin, higher risk products that you decided not to grow?

Answer: Stephen Hodges

I think the point is that the headline NIM has always represented a mix, a range of businesses, we have a wide range of products through all the three principle divisions, Commercial, Retail and Property and each of those, there is a range of risk and reward on those. Our key indicator of course is the net return on the loan book which has been very consistent at 3.6% and as we saw on the graph, has been very consistent over ten years and we wouldn't expect to see that materially change.

Preben Prebensen

So just to give you some other reference points, the first half NIM was 8.9, I think the full year was 8.8, so it's actually not changing very much right now.

Stephen Hodges

And the long-term range is I think eight and a half to ten.

Preben Prebensen

Exactly, and that's a very long-term range of eight and a half to ten. So I think that's kind of more context for you. We don't consciously kind of manage that number, we consciously look at the opportunities to create the net value that Stephen referred to and that's been very consistent.

Question 3

James Hamilton – Numis

If I could carry on the net interest margin point. Given the impact that Funding for Lending and a variety of other government schemes have had on the cost on the liability side of the balance sheet, and the duration mismatch between your assets and liabilities, obviously with the liability side being longer duration, if we were to mark to market all of it, would your net interest margin go up?

Answer: Preben Prebensen

So is your question that funding costs are declining?

James Hamilton

Yes. And you have a longer duration of funding costs than the duration on the asset side of the balance sheet? So if you replaced them all today with exactly the same assets, exactly the same customers at the market clearing price, would your net interest margin go up?

Answer: Jonathan Howell

Yes.

Further question

By how much, is the next question?

Answer: Jonathan Howell

We won't disclose that. The important point that you're raising is, yes we do have this maturity mismatch which is in our favour in terms of the funding and liability management against the loan book. Of the £6.3bn of funding that we've got, £3.3bn is of term, in other words greater than 12 months, and that average term is 26 months compared to the average term on the loan book of 13 months, and so any immediate marginal reduction in funding costs at the moment that have really occurred in the last six months or so, it is going to take a good number of months, 12 months plus, for that to start feeding materially into the loan book and our overall weighted cost of funding that we apply to the loan book.

Answer: Preben Prebensen

But your point is a good one and is correct, if you have a reverse maturity profile as we do and you borrow longer than you lend, funding cost reductions will take a longer time to feed through. That's entirely true. But we won't change the maturity transformation of what we do. And of course as those funding costs come through and reduce, it will depend upon the dynamic at the time of the amount of supply of credit, the amount of demand for credit, in terms of whether those things are being used to increase competition by our competitors, which is already happening today.

Further question

Thank you. I don't want to labour the point and I promise this is the last one. Would it be fair to say that if you were to mark to market both, there would be a compression in the yield on the asset side of the balance sheet, but the compression on the yield on the liability side of the balance sheet would be greater therefore unaffected net benefit. Is that correct?

Answer: Stephen Hodges

No, I don't think there would be a material change on the asset side. There would be a material change, if we absolutely replicated the liabilities' side of current cost of funds, I think you're right, there would be a reduction in that. But of course there's no guarantee that we will do that going forward. We have diverse sources of funding and from time-to-time we choose to raise longer-term funding in the wholesale markets or whatever it may be, that may at that moment in time be more expensive. If we think that's the right thing to do we will do that. So I think it's difficult to anticipate exactly what the benefit would be.

Answer: Preben Prebensen

Yeah, I think that's important. So let's underscore that we won't change the way we fund and the way we lend, we will always borrow longer than we lend. At a time of declining funding costs that means it will take longer for those to feed through to us than they would to our competitors. The other point is, yes if you did mark the observable decrease in funding costs it would have a net benefit. But we're not going to, so it's an artificial kind of assessment.

And the second point is, we will not change the way we lend or whom we lend to or at what terms, as a result of that we will do what we do and the two things are kind of independent in that respect.

<u>Question 4</u>

Arnaud Giblat – UBS

I've got three questions please. With regards to the prospective growth in the Banking book, could you maybe indicate how an improvement in the economy, in the macro, could affect demand from your existing customers, what are you hearing there specifically on the existing customers? And maybe if you could also split out what proportion of the growth in the loan book this year came from existing customers rather than new customers?

Secondly, in the Securities' division, I was wondering clearly the revenues have declined at Winterflood because of a decline in revenue per bargain, and that's been mostly attributable to a lower proportion of AIM stocks. Are you as well seeing a general reduction in fees on a like-for-like basis assuming equivalent mix in AIM versus FTSE stocks?

And finally, on the Asset Management division, with your current set-up your current employee base, IT platform, what level of assets under management can you manage off that platform today without incurring material incremental costs?

Answer: Preben Prebensen

I hope I got all these! The first is, in terms of what we're seeing broadly in demand, I would say that right now we're seeing a few places of kind of strong demand strong conditions. Two examples would be: the Motor business, which is actually seeing strong demand both in new and used; and the Property residential construction business, which I think we all know about, 85% of what we do is in London and the South East, and we are overwhelmingly a residential developer in terms of what we finance. So those both kind of lend themselves to indicating that the consumer or the property owner is showing real signs of life.

I would say conversely in the SME area it's patchier, and we haven't yet seen a broadly based increase in demand for credit. And that may be a lag effect, you know we've obviously all seen the kind of green shoots and early indications of economic recovery. It may be a lag effect, it may be because they do have cash resources, it may be because a very large proportion of very small companies use trade credit and other things before turning to banks. But it is observably true that we haven't seen a broadly based increase in demand among SMEs. Do you want to add anything to that Stephen?

Answer: Stephen Hodges

I would agree with that, I think it's definitely the case that small businesses like large business are still focusing on repaying debt and have still got a lot of liquidity on their balance sheet, and it's clear that levels of corporate activity and levels of investment are below the long-term average. Would we expect to benefit when those two things start to pick up? Yes, I think we would. Of course there's always the other side of the coin which is the level of competition at that moment in time, and as we've said at the moment we would characterise the competition as patchy, and the new entrants who are coming into the market as being individually relatively small. So to answer the question, I think as and when the demand picks up we would expect to benefit.

Answer: Preben Prebensen

The other question on the Bank was the extent to which we are seeing new customers as opposed to repeat customers. So the two things there 65% of our business was repeat business. That varies. It's as a high as I think 85% in some places, so we get a lot of repeat customers. It's a very service focused business model, it's a very high touch very personalised business model, so all of that goes with those repeat business levels. And I think in terms of numbers of customers, we've seen an increase in numbers of customers consistently since 2010.

Answer: Stephen Hodges

Total number of borrowers is up 27% since 2010.

Answer: Preben Prebensen

So that gives you an idea of footprint. Obviously we have more people at the frontline, we have more branches, we've built a bigger footprint to be able to do that.

The next question you had was I think around the income per bargain which was relatively stable in the last year compared to the year before that. Both relatively low years cyclically for Winterflood, I think if you look at a 10 year period those were two of the lowest years. And you're right, it's a question of mix, a lot more activity in large cap stocks than in small cap and AIM stocks in the year that's just gone by. As that proportion changes we would see the revenue per bargain for wins as a whole change. We haven't talked very much about the first part of this year, August and September, but we have seen increased levels of AIM trading – for reasons that we can go into – and with that we have seen increases in revenue per bargain. So those things do naturally follow.

Was there any follow-up question on Winterflood or revenue per bargain?

Further question:

If you were to look just at the AIM income per bargain and exclude all the rest, would that be the same as it was two years ago, just on AIM stocks?

Answer: Preben Prebensen

That's a good question. So when AIM comes back, when it bounces back, does it come back to the same kinds of revenue per bargain levels as we saw two years ago. Julian, without disclosing numbers that we don't disclose, is that generally the experience?

Answer: Julian Palfreyman, CEO Winterflood Securities

Yes, we would hope that it would increase back to previous levels, but we can't actually forecast or guarantee that that will happen.

Answer: Jonathan Howell

Yeah, I think the important point is that we've just had seven weeks since this year end, and as you can see August has been a good month for AIM trading activity, and if you just look at the LSE statistics total volumes for AIM are up 20%. Winterflood's have participated in that as you would expect. We've seen a pickup in margin on the AIM stocks and therefore proportionately across the whole trading book in wins. But absolute, as Julian said, word of caution, it's only seven weeks, it's not a medium-term trend that any of us can define yet, and as you know Arnaud as well as we do, volumes can move up or down quite quickly.

Answer: Preben Prebensen

I think the sample size is a little small for us to really answer your question. We've actually seen August and September bounce, but it's a little hard to say do the kinds of revenue per bargain numbers for AIM trading for that period compare to two years before? They're not discernibly lower, just to put that point, we wouldn't want to make that statement, but nor is it a very large sample size, we're seven weeks into the year.

Your next question was I think around Asset Management, and I think just to interpret your question, in terms of the business that we've built, how scalable is it to take on additional amounts of AuM at these kinds of fixed cost levels? I think that was your question. Martin, do you want to take this?

Answer: Martin Andrews, Managing Director Asset Management

Well it's hard to put a specific number on it, but generally a significant proportion of our cost base is fixed and we wouldn't see particularly correlated to AuM per se, and we'd expect to see that therefore generating increased leverage as we go forwards. A proportion of our cost base is variable and linked to the number of clients rather than the AuM per se, so as we grow the number of clients we do expect the frontend of our business to have to grow to cope with that, although we would expect – as I think Preben and Jonathan have alluded to in the presentation – to see some increased productivity from the frontend of the business now we've got to the stage in our journey that we have. I think that's how I would answer the question.

Answer: Preben Prebensen

And in fact we're happy to tell you that 80% of the cost base is fixed and 20% variable.

<u>Question 5</u>

Nitin Arora – HSBC

Couple of questions. Firstly on the Banking side, the capital generation and the tier 1 ratio. I think as you show in Slide 10, the capital generation in the business is running ahead of risk weight assets, growth in the risk weighted assets and tier 1 is 13.3%, come Basel III it will be around 14%. What is the level where you're comfortable carrying the business with, and given that capital generation is running ahead of risk weighted assets, how do you see deployment of that, whether in growth or some M&A or return?

Then second question on Securities. I think we have seen some of the businesses, some of the private client managers changing their trading business, i.e., they have been moving from localised trading to central trading desks, from local places to single place. Is it having any impact on the Securities' business given that I would think it's more relationship driven with some of the traders?

Answer: Preben Prebensen

Just on a capital point, I think there's one part of that question which is around the extent to which the Group right now is kind of self-sustaining in a capital sense, and I think Jonathan should handle that. Then there's another, which is do we have a target for our capital levels and how are we going to use it, which I'm happy to take. So Jonathan, do you want to do the first part of that?

Answer: Jonathan Howell

I think the important thing to understand is that we've seen an increase in the Core tier 1 ratio from 12.8% to 13.3% during the course of this 12 month period, and there are two components that it's worth breaking out to really understand. First of all is the underlying performance of the business and what that is doing in terms of capital usage or capital generation, and with a loan book growth at 13% over the last 12 months and an improved level of profitability across the whole group, for this last 12 months in operational terms the group has been capital neutral. We've stopped consuming capital as we were when we were growing the loan book at 20% per annum, and we're just at this inflection point when potentially we can start improving the level of capital and the capital ratio going forward on an operational basis.

The other effects that we benefited from during the last 12 months, was the reclassification of Mako. It's a one-off. Mako was previously an associate, that has moved to a trade investment, and therefore as a result of that we have lower risk weighted assets on our balance sheet and we have fewer capital deductions in terms of the goodwill that we were holding in relation to Mako. That plus some other small adjustments is what gave us the half a percent uplift, not so much that the underlying business was capital generative during the period.

However, we are at that inflection point, and just to reiterate that we have always maintained a strong, prudent and appropriate capital ratio. That capital ratio has given us flexibility. It's given us flexibility to grow for three years plus at 20% per annum growth in the loan book, whilst other banks have been rebuilding their balance sheets. And it also gives us the strength and the flexibility to deal with the uncertain regulatory environment that we're all in. We've had Basel III, that's been implemented through CRD IV, there's always discussion about bank capital requirements, and having a strong ratio means that we feel very comfortable if capital requirements or capital needs evolve over time.

So that's where we are. We have probably reached that inflection point, we are moving into a slightly different environment, but this strong and prudent capital position that we have will continue to be a priority. Clearly though, if our capital position improves materially over subsequent years, then of course we'll look at it and see what level of capital the organisation, the company needs and what amount of capital is appropriate to be returned to shareholders. But as you can see, where we are now we're clearly not in that position this year end. It's something though that we're very conscious of and it's something that we will be looking at in future years.

Answer: Preben Prebensen

Your next question was around centralised trading, whether our clients are actually centralising their trading activities, whether that would have an effect, or consolidating their trading activities and whether that would have an effect on us. It's really not the nature of what we do. We have relationships, direct dealing lines with 360-380 retail brokers, 80% of what we do is retail, so that's the heart and soul of what Winterflood does. We see it slightly on the Winterflood Business Services side, which is a small activity for us right now but we may see it a little bit more on that side of the business. Do you want to add anything Julian?

Answer: Julian Palfreyman

Yes. I'd just like to say that our focus is heavily on Retail and servicing Retail. Since we started the business 25 years ago it very much was relationship driven. Certainly in the last 5 or 7 years it's become focused on best execution from a regulatory perspective and also from the client's perspective. And what we've done over the years is to invest in our technology that allows us to give retail investors best execution across a number of venues, trading platforms and other markets. So as much as it's very important to maintain the relationships with our clients, the thing that they demand first and foremost is best execution and the delivery of that in a good manner.

Concluding comments: Preben Prebensen

Any other questions? If not, thank you very much indeed. Thank you.