Close Brothers Group

Tuesday 13th March 2012

Interim Results

Preben Prebensen, Group Chief Executive

Good morning and welcome to today's presentation of our 2012 interim results. Over the last six months we've delivered a resilient performance overall. Conditions for the Banking division have remained favourable, although the market environment for Securities has been difficult. Overall adjusted operating profit was unchanged at £63 million. This reflects another strong performance from the Banking division, with profit up 27% on the prior year. In Securities performance has been affected by difficult trading conditions, with increased volatility and lower volumes in the markets. Asset Management has continued to make good progress on growing the Private Client business, and is in the final stages of restructuring and investment.

Given significant progress in the last financial year in exiting non-core businesses the results we're presenting today are clearly focused on core continuing operations. We've maintained a strong funding position with continued good access to a diverse range of funding sources and a strong capital position with the core tier 1 ratio of 12.3%.

I'm pleased to announce an increase in the interim dividend of 0.5p on the prior year to 14.0p.

I'll now hand over to Jonathan who will take you through the results in more detail; and afterwards I'll talk about our businesses, before we open up to Q&A.

Jonathan Howell, Finance Director

Thank you, Preben, and good morning. In the first half our financial year we achieved a resilient performance. Overall income reduced 5% on H1 last year to £262 million. The Banking division achieved good income growth, but this was more than offset by lower income in Securities. However we also reduced operating expenses, and bad debts were lower than last year. So overall adjusted operating profit was unchanged year on year at £63 million. Adjusted earnings per share reduced by 3% to 31.9p; however the board has declared an interim dividend of 14.0p per share, up 4% on last year. This follows a 1p increase in the final dividend last year.

The group reports adjusted operating profit before any exceptional items, goodwill impairment and amortisation of intangible assets. In the first half we recorded £6 million of exceptional income; this particularly reflects foreign exchange gains realised on the partial sale of our investment in Mako. The prior year period included £5 million exceptional charge related to the restructuring of Asset Management. Including exceptional items we reported profit before tax of £67 million.

While profit was unchanged overall there was significant movement between divisions. The Banking division achieved another strong performance, and its operating profit increased 27% year on year to £62 million. The loan book continued to grow strongly, increasing a further 9% in H1. The net interest margin remained strong and bad debts improved. However Securities was affected by difficult market conditions for both Winterflood and Seydler, and profit reduced from £31 to £13 million. Asset Management is now in the final stages of its restructuring and recorded a small loss of £3 million, as expected.

Turning now to the balance sheet. The group has maintained a strong and stable financial position, while continuing to increase the efficiency of its balance sheet. In the six months to 31 January total assets were broadly unchanged at £6.2 billion; even though the loan book increased 9% to 3.8 billion. This reflects a £200 million reduction in treasury assets to £1.2 billion as the group continued to reduce excess short-term funding and liquidity. Securities trading assets and liabilities also reduced, reflecting lower settlement balances at the balance sheet date. On the liabilities side customer deposits were stable at £3.2 billion; and borrowings increased £100 million to fund loan book growth; and equity was broadly unchanged.

The group has maintained a strong capital position. At 31 January we had a core tier 1 ratio of 12.3% and a total capital ratio of 14%. The strength of our capital base has allowed us to employ capital to take advantage of growth opportunities. And the reduction in the last six months reflects continued strong loan book growth, leading to a 6% increase in risk weighted assets.

We've also reported for the first time our leverage ratio. This broadly reflects the Group's core tier 1 capital as a percentage of total assets. We have a strong leverage ratio of 9.4%; this is well above the Basel III minimum of 3% and well ahead of most peers, and it reflects the relatively low gearing of our balance sheet. Although the regulatory environment remains uncertain we don't currently expect Basel III or the ICB proposals to materially affect our capital position.

Finally our capital supports a high quality loan book with a consistent track record of limited bad debts through the economic cycle. Overall this gives us the flexibility to support our strategy.

We've maintained a strong and stable funding position with diverse funding sources and a prudent maturity profile. Overall total funding reduced slightly to £5.3 billion, around 140% of the loan book. This reflects a £300 million reduction of excess short-term funding as the group continues to improve balance sheet efficiency. However term funding, with a maturity over one year, increased to £2.7 billion and covered 73% of the loan book at the balance sheet date. This is a very prudent maturity profile because our term funding had an average maturity of 29 months compared to 13 months for the loan book. Over the past two years we have diversified our sources of funding, which now include corporate and retail deposits, a group bond, securitisation and wholesale facilities. And we continue to have good access to new funding. In the first half we raised a £250 million two-year securitisation on the motor finance loan book. We also raised over £200 million of new term retail deposits and since the balance sheet date we have agreed the renewal of our existing £350 million securitisation on the premium finance loan book. Overall we have maintained a strong position with significant flexibility, and remain well positioned to fund future loan book growth.

Turning now to treasury assets where our focus is on maintaining a prudent liquidity position while considering balance sheet efficiency. Overall treasury assets reduced by about £200 million to £1.2 billion, as lower short-term funding reduced our liquidity needs. High quality liquid assets, which include deposits with the Bank of England and gilts reduced slightly to

£700 million, reflecting lower short-term cashflow requirements; and our holding of CDs reduced slightly to some £200 million. Our portfolio of floating rate notes was broadly stable at £300 million. However since the period end around £70 million have matured and we will continue to reduce this portfolio over time. Overall we have a prudent liquidity position relative to short and long-term cashflow needs and consistent with the maturity profile of our funding.

Turning now to the Banking division. Here we had another strong performance with significant growth in income and profits. Total income increased 11% to £177 million. This was driven by net interest and fees on the loan book, which increased 14% to £173 million. This reflects strong growth in the loan book, which is up 18% year on year, with a continued strong net interest margin of 9.6%. As a result of continued strong loan book growth expenses also increased £12 million or 16% to £85 million. Over half of this increase is due to an increase in staff and other costs related to loan book growth, particularly in asset and motor finance. In addition we invested around £5 million in the division's infrastructure and information systems, particularly in credit, finance and IT. This investment ensures we properly manage our larger business and that the growth remain safe. Despite year on year growth in the loan book of 18% bad debt charges reduced £7 million to £30 million; and as a result we achieved a 27% increase in operating profit to £62 million, with a good return on equity of 20%.

Turning now to the loan book. We continue to see good demand for our lending services, and we're now into our third year of strong growth. In the six months since 31 July the loan book increased a further 9% to £3.8 billion. This growth was broadly spread and continues to come mainly from our core businesses. The Retail loan book increased 9% in the first half to £1.6 billion; this reflects continued strong growth in Motor finance, benefiting from good demand and increased geographic coverage over the last few years. Premium finance also increased modestly. The Commercial loan book increased 6% to £1.5 billion. This was driven by continued strong growth in Asset finance of 11% coming from both new and existing customers. However the smaller Invoice finance loan book reduced as we continue to lend selectively in a competitive market. In Property we achieved growth of 19% reflecting increasing demand and limited competition. This has allowed us to grow while lending selectively and improving the quality of the loan book.

As we grow our priority is to maintain our established lending model and the key ratios remain consistent with their historical ranges. Firstly, the group has remained a strong net interest margin at 9.6% this is broadly in line with H2 last year, but down from a long-term high of 10% in the prior year period. Secondly, in H1 the bad debt ratio was 1.7%, unchanged from the second half, but a substantial improvement from 2.4% in H1 last year. Commercial's continue to improve, and we continue to see low levels of bad debt in Retail. Property also reduced year on year, albeit from a higher level. Overall we continue to lend at consistent criteria, and remain focused on the credit quality of our loan book. Thirdly, through the strength and consistency of our lending model we continue to achieve a good return on our loan book of 3.4%.

Results for the Securities division were affected by difficult market conditions for the industry. Income reduced 40% year on year to £52 million, driven by substantially lower income at both Winterflood and Seydler. However we have also reduced our expenses by over 30%, reflecting the variable cost structure of our businesses. But overall operating profit reduced substantially to £13 million.

Looking now at operating profit by business. In the first half Winterflood's performance was affected by volatile markets and low retail risk appetite and operating profit reduced by two-thirds to £8 million. However it has maintained its leading market position and remains well

positioned for when trading conditions improve. Seydler's performance was also affected by conditions in the wider markets, in particular it experienced both low capital markets activity and difficult trading conditions. Overall it recorded a small loss of £1 million. Associate income from Mako increased to £6 million, as expected, in periods of extreme volatility.

Looking now in more detail at Winterflood's performance. Income reduced 46% year-on-year to £38 million. This reflects firstly the impact of increased volatility in the first quarter on trading performance; and secondly a shift in mix towards more liquid, lower margin stocks as a result of lower risk appetite from retail investors. This resulted in substantially reduced income per bargain of just over £6, down from £11 in H1 last year. However, bargains per day were in line overall at 48,000, benefiting from particularly strong volumes in August. In these difficult trading conditions Winterflood has continued to demonstrate resilience in its trading model, with only six loss days in the period. Winterflood also demonstrated its ability to reduce costs in a period of weaker performance, while maintaining its capacity and its market position. Expenses were 34% lower in the period, primarily reflecting lower performance related pay.

And finally turning to Asset Management, which is now in the final stages of its restructuring. Income increased 14% year on year to £34 million. This was driven by an 18% increase in management fees on AuM, following the acquisition of three Private Client businesses last year. Expenses were broadly unchanged at £37 million as the effect of acquisitions was offset by lower investment spend. Expenses included £2 million of non-recurring investment related to the development of the customer proposition and platform. The division has now substantially completed its £18 to £20 million investment programme, with a total spend of £19 million to date. Overall Asset Management recorded a small loss of £3 million. The division's strategic focus is to grow the Private Client business, and Private Client AuM increased 6% in the period to £6.9 billion. This is up more than 50% over the last year and now accounts for 80% of total AuM. The £400 million increase in the first half principally reflects the acquisition of a small Private Client business. Net new funds were £180 million although new business levels were affected by difficult markets and lower investor risk appetites. And these net new funds were partly offset by negative market movements. The revenue margin on Private Client assets was 81 basis points, affected by lower dealing income and initial fees in a difficult market environment. Institutional AuM reduced to £1.7 billion, largely reflecting the previously announced redemption of a £1 billion mandate. Across the division the revenue margin was broadly stable at 70 basis points.

And finally the outlook. In the Banking division we continue to see good growth opportunities and expect a further strong performance in the second half. The Securities division remains well positioned and we've seen early signs of improvement in trading conditions since the period end. The restructuring in Asset Management is now in its final stages, and we expect a further small loss in the second half. Overall our businesses are well positioned and we are confident of a solid performance for the year. Thank you.

Preben Prebensen

Thank you, Jonathan. In the first half our 2012 financial year the financial markets have been difficult, with low investor risk appetite and volatile equity markets. Clearly this has impacted our Securities division but the market environment for Banking has continued to be favourable, presenting us with good opportunities. In these markets our businesses have again demonstrated the strength of their established and resilient business models, and going forward our priority remains to maintain these models.

The Banking and Securities divisions both have a long and successful track record of delivery throughout the cycle, and in Asset Management we're building a high quality,

scalable, leading wealth and asset management business in the UK. We also have sufficient resources, including funding, liquidity and capital to support our businesses and will continue to manage these resources carefully.

Together this leaves us well positioned to continue making the most of market opportunities in each of our divisions and that is to capture growth in Banking, while importantly maintaining our disciplined lending criteria and distinctive business model, maintaining our market position in Securities and maximising profits in all market conditions and transforming Asset Management to capture the opportunity in the UK Private Client market.

Turning to look at the Banking division first. The environment remains favourable for us, and we continue to see substantial growth opportunities in our core markets. 2012 is the third consecutive financial year of strong growth. Since July 2008 the loan book has increased around 16% compound per annum to £3.8 billion today, and growth remains well ahead of the ten year average of 11% per annum.

Where we stand today credit supply remains limited, competition remains low and there are so far no signs of this growth slowing. As we capture this growth our primary focus is to ensure that it is safe and the credit quality of the loan book is maintained or improved. We monitor key metrics of the loan book very closely, for example, the level of security, of loan size and maturity to ensure that this is the case. In addition, we're investing in infrastructure and in management information, particularly in the areas of credit, finance and IT. And this investment is essential to allow us to grow safely while maintaining the high touch local integrated model which is fundamental to our client proposition and to our strong margins and returns. Most importantly, we will maintain our strong and distinctive business model. Our lending is, and will remain specialised, short-term and predominantly secured.

As we focused on maintaining the model all key ratios have remained consistent. The net interest margin has remained strong with a ten year average of 9.2% during a period of consistently good loan book growth. The first half of 2012 margin is slightly above this at 9.6%. We also have a very good track record of limited loan losses, and the bad debt ratio has remained consistent between 1% and 2.6% over the last ten years which covers a range of market conditions. The first half 2012 bad debt ratio of 1.7% is well within this range and is approaching the ten year average of 1.6%.

In addition, despite 11% compound annual growth in the loan book over the last ten years and significantly higher growth in the last three years the overall shape has remained unchanged. As you can see since 2008 the overwhelming majority of the loan book continues to be secured, over 60% has a maturity of less than one year, and almost three quarters of the loan book is small ticket loans under half a million pounds each.

We've always done some larger, longer term loans but the discipline we apply to our lending criteria has ensured that the profile of the loan book overall remains very stable. Additionally we have not increased our concentration in any one area and the split between Retail, Commercial and Property has also remained unchanged at around 40%, 40% and 20% respectively.

The growth we've achieved is within our existing parameters and history, and has also shown that this is sustainable growth. We've increased our share in our markets through expanding our franchises. By way of an example, in Motor Finance over the last 12 months we've increased the number of dealers we intermediate through by 40% to 8,400. In Asset Finance we've increased the number of direct SME clients by 11% to 18,500, and in Property we have relationships with over 750 property developers up 28% in the last year. And in addition to winning new clients we've maintained high repeat business levels, ranging

from 50% to 80% across Retail, Commercial and Property. While we stick to our model this gives us the confidence that as we grow we can continue to deliver the consistently strong returns you've seen, including a return on equity averaging 19% over the last ten years.

Looking now at the Securities division which has been operating in difficult trading conditions over the last six months, last August was characterised by sharply increased market volatility driven by uncertainty in the macroeconomic outlook. Following this from September to December there were lower retail volumes in the market reflecting reduced risk appetite. Clearly these conditions have impacted our trading businesses in the first half. However, our businesses have retained their leading market positions and responded well to the market challenges. Winterflood, the leading market maker to UK retail stockbrokers was primarily affected by the lack of risk appetite. For example, retail trading volumes in AIM stocks were down over 60% between September to December, compared to the last financial year. As a result Winterflood's volumes in these higher margin, less liquid smaller stocks were also substantially lower, particularly during September and October. Over the past month or so AIM and small cap market volumes have recovered but remain below last year.

Seydler, our Frankfurt based business, has also been impacted by difficult conditions in its markets, however Seydler has a strong position in German small and mid cap markets and is well placed for any market recovery.

As you know in September we agreed to sell our associate investment in Mako to the management team. Mako tends to outperform in periods of extreme market volatility and as such its profit increased in H1.

Looking now at Winterflood, while its profit was substantially lower in H1 it's demonstrated resilience through its size, expertise and operating model. At the end of January it continued to be ranked number one in market making to UK brokers across each of the main UK indices, and the same is true looking back 12 months or indeed over the last five calendar years. And this has held true in all kinds of market conditions. Importantly we're committed to maintaining the capacity in this business which allows it to retain its leading market position and differentiation. Winterflood remains the largest in its markets with approximately 100 skilled and experienced traders and sales force, providing continuous liquidity to over 300 UK stockbrokers and over 150 institutions. The core of what it does is pure market making with virtually no primary business, and it's been doing this for over 20 years. As a result Winterflood has a flexible, highly variable cost base and can manage costs through the cycle without compromising its market position.

And finally, Winterflood has maintained a consistent and conservative risk appetite with no proprietary driven trading. Its consistent trading performance is borne by the number of loss days which over the last five years has averaged only five. So while its performance has clearly been impacted by recent market conditions we're confident that through its leading market position and robust operating model it remains very well positioned to benefit once market conditions improve.

And now turning to look at Asset Management where our restructuring is in the final stages. As we set out in the investor presentation in May last year our priorities in our financial year 2012 were to focus on our core businesses, building scale and assets in clients, to complete the non-recurring investment spend and to roll out the propositions before moving into the delivery phase from 2013. If we compare this to what we've done we're very pleased with the progress.

In 2011 as you know we exited our non-core businesses, including UK offshore and the Cayman Islands. This allowed us to significantly de-risk the business and increase the clarity

on our core business. Over the last three years we've been building scale through acquisitions, having bought four private client businesses with a total of £2.9 billion of client assets, including a Scottish IFA in the last six months. This has significantly extended our capacity by adding a further 88 advisers, taking our total to around 120 and extending our geographic presence. These acquisitions have also increased our management depth and skill. And as planned we've substantially completed the £18 million to £20 million non-recurring investment in the propositions and platform with a total of £19 million to date.

In the last six months we've made substantial progress on the development of our client propositions. We launched the common advisory proposition and technology platform in November of 2011, on schedule and on budget and this is now being sold by our advisors to new clients. For the rest of this financial year we'll continue to train our advisers on selling this to new and existing clients. Our proposition will include a self directed offering which is also connected to the platform. This application is in the final stages of live user testing and will be available to new clients later this spring.

In addition, over the last few months we've completed our offering of investment funds by launching a third party multimanager as well as a passive range of funds. These are in addition to our existing in-house discretionary funds which were launched in 2010 and these are now fully integrated with our common advice proposition. We're building a good performance track record with all five of our in-house discretionary funds in the top quartile in the 2011 calendar year, the first full year of investment. Our fully bespoke high net worth portfolios have also outperformed their benchmarks over the same period.

When we embarked on this transformation three years ago we saw significant opportunity in the market. We estimated then that there were 1.6 million people in the UK with between £100,000 and £5 million to invest, representing £650 billion of investible assets. We noted the changes in demographics, regulation and technology were opening up new opportunities. Today we continue to believe in this market opportunity and now have the business model, technology and people largely in place to take advantage of it.

Although in its early stages, we now have an integrated proposition incorporating advice, investment management and the platform, which utilises our multichannel distribution network. Early feedback indicates that the proposition is attractive and in particular that the degree of choice in the investment proposition is highly differentiated.

Going into the next financial year and beyond our focus will be on driving revenue growth and maximising profitability from the propositions and distribution capabilities assembled over the last two years. These have been developed to capture multiple revenue streams from advice, investment management and the platform. And in the short term our greatest opportunity for capturing these revenue streams is by selling our new propositions to our existing private clients.

Clearly at the same time we're also selling the proposition to new clients and will continue to build scale. As we've previously said we'll also look for further acquisitions, however our criteria are strict and we'll only pursue those that fit well with our strategy, fill existing gaps in our geographic presence and can achieve high quality earnings. In summary, we're very pleased with the progress we've made in transforming this business and are excited to move into the next phase of delivery with this strong model.

To conclude and summarise, our resilient performance in the first half is testament to our strong and specialist business models and the experience of our people. We remain committed to executing our strategy in all our divisions, principally to continue to focus on

capturing growth in Banking while maintaining the discipline of our model, maintaining our strong market position in Securities and completing the restructuring in Asset Management.

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

Question and Answer Session

Question 1

Robin Savage – Collins Stewart

At the Asset Management presentation there was a comment that there was going to be a compelling price proposition. Given that this product is now being sold to clients, although it may not be provided to self directed clients at the moment, can you give details of the pricing please?

Answer: Preben Prebensen

Yes. I think that the pricing proposition is different depending upon whether you're talking about the advice channel, the high net worth channel or the self directed channel. And in the advice channel it depends on how much we're talking about, the size of the client, but the upfront fees are between 1% and 3%. The annual advice fees are between a half and 1% and then we would look to add to that through capturing the investment margin and the platform fees. The investment margin cost to the client would be between three quarter and one and a half percent, our share of that would be around half actually. And the platform fees that we would retain would be targeted around 25 basis points. So that would be the advice channel.

High net worth is more classically upwards of let's say 80 to 100 basis points, and the self directed channel would be more like 40 basis points. And our margin overall that we're targeting, as we said in May, was 100 basis points for the overall private client proposition, that will clearly depend on the mix that we achieve from those channels.

What I would add is that it's still very early days since we launched the advice proposition in late November, but the early indications are that our advisers think it's an attractive proposition, the clients that we're selling it to think it's an attractive proposition and we have not seen any resistance to our pricing model. Martin, would you like to add something to that?

Martin Andrew, Chief Executive Asset Management

Yes, I would just add, Preben, a couple of points that the revenue margins that we're expecting to capture are within what clients are already paying, so we're not anticipating increasing overall expenses for clients. And the other thing I would point out is we talked about value, the value proposition last year in May, and being able to capture the asset management revenue share and an advice revenue share and a platform share doesn't happen automatically, it depends on the quality of the platform, the quality of the investment management, that's where we've been putting a lot of the investment, the £18 million to £20 million that Preben's referred to, and the breadth of quality and choice on the investment

side is an important driver of value which underpins the price we're charging to clients and helps us capture that extra opportunity.

Preben Prebensen

And as I mentioned actually I think the initial indications are that that breadth of investment proposition is considered highly differentiated by the advisers and the clients that they're going out to. Again, early but encouraging.

Question 2

Arnaud Giblat - UBS

I've got three questions on the Banking division please. Clearly you've strongly grown the loan book, yet the cost to income has increased, and you've indicated that you've invested in infrastructure, so I'm just wondering looking forward shall we expect further investments in the infrastructure base? And if not, over what period of time do we have the cost to income ratio coming back down as you get some more operating leverage coming though?

The second question is on the bad debt ratio coming down and the outlook being positive there, I'm just wondering how much of that could be coming from the shift in mix? Perhaps could you indicate what the return on net loan book per bucket is, if you could give us a bit of colour there that would be quite useful between Retail, Commercial and Property?

And finally on the total assets for the bank you're utilising more effectively your balance sheet, as you indicated, what impact has that had on profitability for the Banking division?

Answer: Preben Prebensen

Let me take the last one first. In terms of the efficiency of our balance sheet what we've been doing over the last couple of years is actually emphasising the opportunity to grow the loan book as opposed to hold a lot of assets on the treasury side. And that's clearly the right thing to do given that the return on the loan book is what it is, the opportunity is there while returns on the treasury asset side have actually been declining and are de minimis right now. So our strategy is absolutely to focus on the loan book that's what we do.

Our treasury assets are really simply held to provide us with the necessary liquidity bit we need as a matter of prudence. And that liquidity is really being put into very high quality assets. And so you'll see that we hold most of that in deposits at the Bank of England and in gilts and less and less in FRNs or indeed even in bank CDs. And that's very much our strategy. So we hold what we should hold as a matter of prudence in liquid assets, treasury is really a cost centre, it's there to fund the Bank and it's there to maintain liquidity of the highest quality. And so that emphasis is very obvious and that is clearly also driving our returns; the returns on the loan book are excellent, the returns on treasury assets are de minimis we're shifting that very consciously. So that is really I think the answer to that question.

In terms of the cost structure, do you want to take that Jonathan?

Answer: Jonathan Howell

And also just following on from what Preben had to say on that clearly we're still at a very prudent level of funding in terms of our total funding available of £5.3 billion, that covers the

loan book by 140% as we set out today. And, similarly, when you look at the term funding that we have, i.e. over 12 months, that's increased over the last six months from £2.5 to £2.7 billion, and is still covering over 70% of the loan book with this very strong maturity mismatch which is always running in our favour. So notwithstanding we'd be more efficient on the treasury assets and the liquidity side in terms of the total funding we're very strong and in terms of maturity profile.

In terms of costs the key thing to understand is that yes we've seen costs go up by £12 million in the first half, and that really represents very much our model and at least half of that cost increase is driven by volume related costs. And don't forget, to put it in context, this Bank over the last three years the loan book's grown by 60% and profits have grown by 90%. And we have a decentralised local model running significant parts of the Bank which means that there are very strongly related volume related costs, and to put that into context, if you look at Motor finance and Asset finance over the last 12 months they've increased their headcount by 130 to 150 people. And that local model is important to us because not only is it distribution it's underwriting capability that is there out in the regions close to the customers and if necessary it's repossession capability. So part of that cost increase you're definitely going to continue to see as an integral part of the model. £5 million of that cost increase related to spending in infrastructure, IT, finance, credit, credit risk capability, and what we want to do is to make sure that we are strengthening and improving our capability to manage this Bank that's grown considerably and as we look at it now it is continuing to grow.

So our cost income ratio for the six month period was 48% if you put that in the context of the cost income ratio average for the last ten years of 49% we're performing there or thereabouts in terms of the way we performed over the last ten years. Notwithstanding that we do believe that over time and certainly not in the short period of next 12 months, 18 months, two years but over time we believe that we can get to a stage where that cost income ratio could improve, but not yet we have further investment to do.

In terms of bad debts - I think was the other one you raised - we did 2.4% bad debts in the first half last year; 1.7% in the second half last year; 1.7% in the first half again this year. And that's against a backdrop of what we believe and continue to see is improving quality in our loan book, we're still lending at about 90% of our loan book is secured and still at very strong and industry leading LTVs. If you look at the history of our bad debt ratio over the last ten years that's gone from about 1% to 2.5% and the ten year average is about 1.6%. We don't give formal forward targets for the bad debt ratio but there's nothing, as we sit here today, that we see that leads us to believe that we can't move down towards that 1.6% long-term average and potentially move through it. But that is completely dependent upon the economic situation, the state of the economy, the state of our borrowers. So we'll make sure that we update you quarter by quarter on the bad debt ratio.

Preben Prebensen

Do you want to comment at all on the question about the bad debts as between Retail, Commercial and Property?

Answer: Jonathan Howell

Yes in terms of Retail has been at an all time low now for about two years and is still staying there. It's got nowhere further southwards to go and that is consistent with what we've seen over the last 18 months. And again there is nothing, as we sit here today, in any of our lead indicators that leads us to believe that that could be changing.

In terms of Commercial we are beginning to see that come down, it's continuing to come down over the last 12 months. And that reflects partly lending to the SME sector but also reflects there's a longer term tail on this book of say two to three years in much of that lending and so therefore improved bad debts takes a little bit longer to feed through.

And then lastly in Property that is where, as you recall, we had a legacy part of the book which predated Jan 2009 that had previously been a little bit sticky and affected our bad debt ratio in H1 of the last year. And we are now seeing that sort of property part of the book to be sorted out, fully provided for as we've always provided, and that situation is improving in property as well.

So if you look at the pieces where is the improvement coming? Partly in Commercial which we've seen happening now for about 12 months to 18 months. And certainly in Property we're beginning to see that improve for the first time since the start of the recession and the credit crunch.

Question 3

Nitin Arora - HSBC

Just following up on the question of balance sheet efficiency if I look at slide nine that clearly shows that loans have grown by £300 million out of which £100 million is funded through borrowings and £200 million is coming out of treasury assets. And as you say that treasury assets were earning nothing, next to nothing, so shouldn't we able to see an increase in net interest margins because you're moving certain part of the loan book or certain part of assets which was not earning nothing to whatever 13/14% gross interest margin without any additional costs there. So I was expecting to see given the more efficiency in the balance sheet I was expecting to see an increase in net interest margins there.

Answer: Preben Prebensen

Well first of all I don't think you'll see a lot more happening there because we need to maintain a core amount of liquidity as a matter or prudence in terms of the Bank. And that liquidity will be invested in things like gilts and deposits at the Bank of England. But in terms of the impact on the net interest margin Jonathan do you want to take that?

Answer: Jonathan Howell

Well as you appreciate the net interest margin is a final output of a considerable number of variables. The cost and supply of funding, the demand for credit, the supply of credit from our competitors and the mix of the book so there are a considerable number of variables that funnel into that one metric. I think there are three things we should highlight; one is that when we were up at 10% that was an all-time high for the last ten years, and we flagged that up at the time. We've operated in the last ten years in this corridor between 8.5% and 10% and H1 last year was literally the high water mark of that. So our expectations, given that our loan book has not changed in characteristic, our borrowers have not really changed that will eventually start to come down.

The second point about it is that we have seen a slight change in mix and that those parts of the book that are growing slightly more faster at the moment have slightly lower net interest margins than the average; and you can see that in Property and Motor. And then I think also it's worth just factoring in that in H1 last year we had slightly higher fees inside that net interest margin than we had in previous periods. Now these fees cover a whole range of things; variations on terms, extension of terms, new facility sign-on, they moderate and

increase and decrease over time it just so happened in H1 last year that was a particular highpoint for those fees.

So those are the three factors that I'd identify. But to say the law of averages if it's 8.5% to 10% over ten years the long term average has been about 9.3% something like that, you'd expect it to come back at some stage. And we test all the time with Stephen and the lending divisions to see whether we can keep increasing and keep pushing and you do hit a level when actually yes our bespoke, our niche, our secured, our local form of lending, that is valued and people will pay a premium for that, but at some stage people say well no actually we'll find an alternative source of funding. And historically interestingly every time we've tested it we get to about the mark that we were at H1 last year.

Further question

Okay. As you say there are I guess two more variables to that; one is the gross interest margin within various products. So has that changed in the last six months? And secondly the cost of funding has that changed?

Answer: Preben Prebensen

The cost of funding that's been stable actually. No real change there. Different sources of funding but the blended rate has been quite stable.

Answer: Jonathan Howell

And swap back that swaps back at about LIBOR plus 260 something like that and that's been pretty stable across the whole book, but that's blended. There are obviously differential costs depending upon different forms of funding.

Further question

And gross interest margins?

Answer: Jonathan Howell

No material change there.

<u>Question 4</u>

David Appleton - Alder Investment Management

Two questions please. The first is on competitive dynamics in Banking you mentioned that you've reduced your lending and invoice finance due to competitive pressures it seems that that's really the only area where perhaps there's been an escalation of competition, perhaps you could give us some colour on that?

And then secondly on the Private Client business I'm just trying to I guess get a little bit more colour on how you see the M&A marketplace, if you like, because as we push up towards RDR there's clearly a lot of panicked IFAs looking to sell their businesses. And I just wanted to get a bit of colour from where you might be focusing, what your disciplines are on the quality and the price of which you would be willing to pay for acquisitions? Thank you.

Answer: Preben Prebensen

Let me take that one first if I may on acquisitions. We've done most of what we need to do. So we may make one or two additional small infill acquisitions of IFAs if they represent interesting geographic locations, a hub, or bring leadership or the kind of quality of advisers that we would like to see. And we signalled that back in May

We made a small one in Edinburgh, Scott-Moncrieff, which we're very happy with; very high quality business less than £300 million of assets under management. And if we could find that kind of acquisition in one or two other places then we would do that. So our view is that we are very substantially along the way in what we need to do there. And that's the kind of thing that you'll see happening.

In terms of Invoice Finance actually it is right that we see acute competition there from the clearing banks. That's about the only place where we really see them right up against us. And our share of the independent part of that market has remained reasonably stable but the clearing banks are very aggressive, they're looking to move from being an unsecured overdraft provider to also being a secured lender against receivables or providing factoring facilities and they push that aggressively. So that's the kind of environment that we do see it's the only place where we really see them directly and in that form. And we will not do business at any price and so we do walk away. It's a high quality business. It's a very high repeat business and the returns at our prices and the repeat numbers make it an attractive business but we'll clearly be selective.

Further question

To get a sense, a bit more colour, are you starting to lose brokers because you're being outbid I guess on business by the clearing banks because they're so desperate to get their SME numbers up?

Preben Prebensen

Do you want to comment on that Stephen?

Answer: Stephen Hodges, Managing Director and Banking Chief Executive

I would say overall the competitive environment across the face of the Bank continues to be benign. It is the case that in invoice discounting we have consistently seen more competition, for the reasons Preben has explained, the clearing banks see invoice discounting as an area where they're happy to continue lending to the SME sector, it's short-term, they can get security and at a time when they're reducing their involvement in other sectors of the balance sheet property and asset finance invoice discounting remains attractive to them. So that's the one where we continue to see, I wouldn't say it's particularly worse, but we're continuing to see a high level of competition.

Elsewhere across the majority of our Commercial and Retail businesses the position continues to be benign. I wouldn't say we're seeing any particular increase in competition there. Interestingly, in Property which in a whole variety of ways continues to be late into the cycle we're actually still seeing a reduction in competition, we're seeing only in the last few months we've seen one or two competitive banks withdraw from our particular area of the property sector.

Question 5

Carl Hazeley - Goldman Sachs

Just on the early signs of improvement in Securities, is that driven by income per bargain or number of bargains?

Answer: Preben Prebensen

No it's actually not so much the number of bargains. That actually didn't really change that much over the first half actually, and hasn't really changed very much in February and March, it might be up a little bit, Julian, but it's really income per bargain which is improving because the mix is shifting back towards a slightly more normal mix with more participation by UK retail in small cap and AIM stocks.

Concluding comments: Preben Prebensen

I think if that's all we will thank you very much for coming. Thank you.