OSB GROUP PLC

2023 Interim results presentation transcript

10 August 2023

Andy Golding, Group CEO
Good morning, everybody, and thank you for attending the OSB Group's 2023 half-year results. It's good to get back to an in-person meeting, and good to see a number of familiar faces in the room.

Firstly, I am truly sorry that this reporting period is impacted by the recent announcement we made regarding the impact of changing customer behaviour in our Precise Mortgage book on the EIR accounting, and consequently the adverse adjustment we had to book in the first six months.

This has of course reduced our financial KPIs in the period. And whilst we are here to provide any further colour the analysts and shareholders may require; I cannot emphasise enough that the business remains in a fundamentally strong position. And I hope that sharing some of our key operational successes with you through this presentation would only serve to remind you of the number of positives that make the Group a strong and long-term proposition for both customers and owners alike.

I'm going to start by giving a brief summary of the key highlights in terms of performance for the first half. April will then take you through in some more detail in terms of the numbers. You'll then hear a little bit more from me, on how our lending and savings franchises have performed, followed by the outlook, before we open up to Q&A.

Gross organic lending increased by 2% in half one to £2.3bn, despite a clear softening of the wider market driven by the increased living and borrowing costs denting purchaser confidence.

The net loan book grew in the first half by 4%, 5% before the impact of the adverse EIR adjustment, demonstrating the strength of our lending franchise.

We are now the fourth largest Buy-to-Let lender in the UK, according to the UK finance data, and we've continued to increase our market share of new business flow during H1, without compromising our underwriting standards. We have focused Precise Mortgages on growth in the residential sector, and Kent Reliance on really serving the professional landlords who still are making purchasing decisions, as well, of course, as having more complex refinancing needs, which plays well for the Kent Reliance strengths.

Our InterBay brand has seen more than a twofold increase in lending during the period, and retention performance across the board has been strong, with now 75% of borrowers in Kent taking a new product with the Group within three months of their deal maturing, and an already very encouraging 59% in Precise Mortgage, as our Choices programme there gains traction, enabling us to lock in long-term income generation for the future.

We remain committed to doing the right thing for our customers. I'm pleased to confirm that we're embedding the new Consumer Duty rules into our business and have signed up to the Government's Mortgage Charter.

So, turning to our strong credit and risk management, ECL provisions have increased during the first half, driven by moderation in house prices, a continued worsening of the macroeconomic outlook, modelled IFRS 9 staging migration, and a handful of specific provisions. However, importantly, three-month-plus arrears have remained broadly stable at 1.2%.

The Group remains well capitalised and highly liquid, a position that we feel is very important when facing into macro headwinds. We've enjoyed strong growth in retail savings at attractive post-swap costs, and customer net promoter scores remain excellent.

Our capital position is strong, with CET1 at 15.7%, and in April the Group issued £250m of MREL-qualifying Tier 2, making further progress on optimising our capital stack.

We have declared an interim dividend of 10.2p per share, in line with our stated policy, and we continue to target a medium-term CET1 ratio of 14% once the capital stack has been fully optimised. The Board remain committed to returning excess capital to shareholders, however, this of course is contingent on us being able to issue senior HoldCo debt to meet our interim and end-state MREL requirements.

I'll cover more about the outlook in our guidance later on, but we remain excited by the opportunities in our core markets, and I hope that my introduction has provided a useful reminder of the simple fundamentals that provide the backdrop for us to continue to deliver attractive and sustainable returns across the cycle.

These two slides show our statutory and our underlying financial highlights. On the underlying slide, we've shown our KPIs, excluding the EIR adjustment. I think it's important to understand the underlying strong shape of the business.

For example, excluding the EIR adjustment, the ROE would have been 22%. April will cover each of these for you in her review, but I hope this snapshot reiterates my points regarding the fundamentals of the Group under normalised trading.

I'll now hand you over to April, to talk you through the numbers in more depth.

April Talintyre, Group CFO
Thank you, Andy, and good morning, everybody. Before I start, I would like to add my own apology for the EIR adjustment we announced in our trading update on 6th July, and the impact it's clearly had on our financial performance in the first half.

Today we are confirming a total underlying EIR adjustment for the Group of £180.7m, which is £208.5m on a statutory basis, based on behavioural assumptions consistent with those outlined in the trading update, and also consistent with an additional month of behavioural observation since then. I'll talk more about the EIR adjustment later, and I'm sure we'll cover it in Q&A as well.

So, turning to the slide, we've presented the performance in the first half on an underlying basis, before and after the EIR adjustment. This slide explains the key drives of the first-half ROE of 8%, or, as Andy mentioned, 22% excluding the impact of the adjustment.

The Group delivers an underlying pre-tax profit of £117m for the first six months of the year, down 60% from £294m in the prior period, with the benefit of net loan book growth and improved margins more than offset by the adverse EIR adjustment and a higher impairment charge. Excluding the EIR adjustment, underlying PBT would have been £297m.

Again, excluding this adjustment, underlying net interest income grew by 25% to £461m, due primarily to growth in the net loan book and a strengthened net interest margin, which was up 31 basis points to 333 basis points on an underlying basis, marginally exceeding expectation and reflecting the beneficial impact of rising base rates. More on that later.

We continue to maintain our strong focus on cost discipline and efficiency, with administrative expenses coming in slightly below our expectation in the first half. The underlying management expense ratio of 78 basis points was 6 basis points higher than the prior period, reflecting the anticipated impact of inflation and planned investment in people and operations.

The underlying cost-to-income ratio increased to 40% in the first half, due to the lower income following the EIR adjustment. Excluding this adjustment, it increased marginally by 1 percentage point to 24%.

Looking ahead, we expect an underlying cost-to-income ratio of around 29% in the second half, due to planned further investment in the business as we make further progress on the next phase of our technology investment, focusing on improving efficiency in our business operations. Taking that second half guidance would result in a full-year ratio of circa 33%.

We recognised an underlying loan loss equivalent to a ratio of 37 basis points in the first half of the year, due primarily to moderation in house prices and a worsening of the economic outlook, as well as modelled IFRS 9 stage migration. I'll provide more detail on the key drivers a bit later.

So, turning to the income statement, you'll see that we recognised a net underlying fair value loss on financial instruments of £12.1m, compared to a gain of £11.1m in the previous period. The key driver behind this change was the loss in respect of the ineffective portion of hedges that arose from recent swap volatility and will unwind over the remaining lives of the hedged fixed-rate retail saving bonds and mortgages. And this was partially offset by further gains on pipeline mortgage swaps, which will also reverse over the life of the swaps.

Underlying earnings per share of 19.5p in the first half reduced by 60% versus the prior period, commensurate with the reduction in profit. Underlying EPS would have increased to 51.3p, excluding the EIR adjustment.

Turning to the next slide, which summarises our strong, secure balance sheet. Our net loan book increased by 4%, or 5% excluding the EIR adjustment in the first half, to £24.6bn, supported by £2.3bn of gross new lending, which was up 2% versus the first half of 2022. Retail deposits grew by 5% to £20.7bn, as at the 30th of June, as the Group continued to attract new savers.

We remain predominantly retail-funded, with a diversification provided by Bank of England funding schemes and securitisations. We repaid £301m of funding onto the Indexed Long-term Repo scheme during the first half, and drawings under the TFSME scheme remained unchanged at £4.2bn.

As Andy mentioned, in June, we completed a £330m STS securitisation of owner-occupied prime mortgages originated by Precise Mortgages under the CMF programme, which really demonstrated investor demand for Group issuance.

The credit quality of our loan book remains strong, with three-month-plus arrears broadly stable for the Group at 1.2%, and that includes OSB at 1.3% and CCFS at 1%. Andy will talk to the interest coverage ratios for Buy-to-Let originations a bit later.

Our loan book is secured as sensible loan to values. The weighted average book LTV for the Group increased marginally to 63% in the first half, from 60% at 2022 year-end, reflecting a moderation in house prices in the period. The new lending LTV improved marginally to 68%, from 71% in the first half of last year, demonstrating our continued focus on the risk assessment of new lending.

Turning to the next slide, more about the EIR adjustment, as promised. The EIR adjustment, of it, £178m related to the Precise Mortgage book, and the estimated time that borrowers would spend on the reversion rate at the end of their fixed-rate term. The Precise Mortgages products were designed to move to a revert rate, which was similar to both the initial fixed rate and open market rates, and you can see that on the red line of the graph.

In contrast, our Kent Reliance has historically had a high step up in reversion, providing a clear incentive to refinance. In light of this, Kent Reliance has a long and well established broker-led Choices programme, to encourage borrowers to switch to a new product with us quickly, and we assume that on average they spend circa one month in reversion.

The graph on this slide demonstrates this difference in how each band stepped up or down in reversion, using five-year fixed Buy-to-Let through time. And you can see that sharp acceleration and step-up, especially from late 2022 and through the first half of this year, due to the unexpected rapid rise in base rate.

These rate rises and the volatile rates outlook led to customer behavioural changes for Precise borrowers, and over the course of the first half, we observed a step-change in how long customers were spending on the reversion rate before selecting a new product with us or refinancing, in particular, the attrition rate of borrowers who stay on the reversion rate for several months.

This moved our expectation of the number of months spent on reversion rate down by 12 months to five months as at the end of June, giving rise to the EIR adjustment. Following this adjustment, the potential impact of any future behavioural changes is much reduced. The impact on net interest income of plus or minus three months spent on reversion is plus or minus £70m.

We've also disclosed the impact on the Group's net interest margin for new origination, assuming 12 months less spent on reversion for the Precise customers. Keeping all other assumptions unchanged, including pricing, swap spreads, cost of funds, and product mix, would lead to a reduction of just 11 basis points, based on Group applications in June. This will obviously take time to come through in the overall Group net interest margin due to the size of the back book.

The next slide shows our NIM waterfall, where you can see the high-level drivers behind the NIM in the period. Underlying NIM reduced to 203 basis points, from 303 basis points in the second half of last year, with the benefit of base rate rises more than offset by the adverse EIR adjustment, which accounted for 130 basis points.

But, moving from left to right on this waterfall, the retail funding spread benefited from delays in the market passing base rate rises on to savers in full. The cost of new retail funding also benefited from widening swap spreads, particularly at the one- and two-year points, where we raised retail funds.

There were also delays, though, in mortgage pricing reflecting the rate rises in full and volatile swap spreads. A slightly lower impact, you can see in the amber bar. Other funding primarily relates to the benefit of increased average funding from Bank of England and equity, as well as favourable swap margin calls.

The underlying net interest margin for the second half of 2023 is expected to be broadly flat to 2022, after the expected impact of further planned MREL-qualifying debt issuance, subject to market conditions, resulting in a full-year NIM of circa 2.6%.

The next slide provides a waterfall of the movement in the statutory impairment provision in the first half. As you can see from the chart, and again, moving left to right, we adopted more adverse forward-looking macroeconomic scenarios in our IFRS 9 models, which, together with house price moderation in the period, accounted for a £12.6m increase in provisions. Enhancements to models and updates to post-model adjustments, to reflect the potential impact of the rising cost of borrowing on customer affordability, led to an increase of £8.4m.

A £4.5m increase in provisions related to accounts with arrears of three months or more, and a further £15.8m related to changes in the credit profile of borrowers as they transitioned through modelled IFRS 9 impairment stages. This transition was primarily movements from stage 1 to stage 2. Individually assessed provision increases, net of write-offs and other items totalled £0.8m.

You can see that our total coverage ratio has increased by 15 basis points in the first six months and remains more than twice the level it was pre-pandemic at the end of 2019, as geopolitical, inflationary, and cost of living concerns have replaced pandemic-related concerns. We will continue to proactively review our forward-looking economic scenarios and coverage ratios as the outlook evolves.

Let's take a look at capital. You can see that the Group's CET1 ratio remains strong, at 15.7%, at the end of June. Again, going from left to right in the waterfall, which explains the movement in the CET1 ratio in the period, you can see our very strong capital generation from profitability of 2% prior to the EIR adjustment.

We utilised 0.8% to support the 4% growth in net loan book during the period. The impact of the declared interim ordinary dividend was 0.4%, and the full effect of the £150m share repurchase programme announced in March was immediately deducted from capital, with an impact of 1.4%.

We also had non-cash transitional and other items of 0.8%. Finally, the impact of the statutory EIR adjustment on capital and RWAs was 1.2%.

The next slide provides an overview of the components of the Group's minimum capital requirements, its capital resources at the end of June, and our interim MREL requirement from July next year. Total capital resources as at the end of June of 19.2% include the benefit of our successful £250m MREL-qualifying tier 2 issuance in April. As Andy said, this marks further progress on our journey to optimising our capital stack.

The Group continues to target a CET1 ratio of 14%, once the capital structure has been optimised fully, and we intend to come to the market with a programme of further MREL-qualifying debt issuance ahead of our July 2024 interim MREL requirements, likely in two separate benchmark-sized issues. We expect to operate above the 14% target in the meanwhile, and as we wait for clarity on the implementation of Basel 3.1 later this year, and its timing versus the Group's IRB accreditation.

The group continues to actively engage with the PRA on the timing of our IRB application, relating to rating systems covering our core Buy-to-Let and residential first charge mortgages. The Group is ready to submit module 1 when regulatory consent is provided.

In line with our stated dividend policy, we have announced an interim dividend of 10.2p per share. As with previous years, the Board will make its full-year dividend recommendation with the full-year results taking in account of, amongst other factors, the economic outlook at that time and continuing progress against the group's MREL-eligible debt issuance programme.

The Board is confident that the Group's strategy and proven capital generation capability can support both strong net loan book growth and further capital returns to shareholders, supported by further planned issuance of MREL-qualifying debt, in advance of the Group's interim MREL requirement in July, subject to market conditions.

I now pass back to Andy, who'll give an update on our lending and funding franchises.

Andy Golding, Group CEO

Thank you, April. Our award-winning lending franchises continue to drive retention and deliver growth, whilst maintaining our position at the forefront of the market.

Originations in both Buy-to-Let and residential have been encouraging, despite the more subdued overall market, both in terms of volume and quality. Our carefully selected commercial lending has performed well too, reporting a near-doubling of originations following our renewed focus in the subsegment, through our InterBay brand.

Average interest coverage ratios for new originations have reduced as expected, given the significant increase in underlying mortgage rates, but clearly demonstrate that landlords have been able to balance raising rents with their costs. In H1, they were healthy at 178% and 154%, for OSB and CCFS respectively, and despite house price moderation, our LTVs remain sensible across the Group.

Professional landlords accounted for 91% of OSB's Buy-to-Let completions in the period, and limited company mortgages represented 86% of Kent Reliance and 65% of Precise completions, an increasing trajectory that continues to play to our strengths.

Our funding platform continues to deliver to our savings strategy of attract, retain, and satisfy. We opened circa 86,000 new savings accounts in the period, despite increasing competition for deposits, and we retained, through reinvestment into new fixed-rate products, 90% and 87% of maturing deposits in OSB and CCFS respectively.

Net promoter scores stayed high, at over 60+ in Charter Savings Bank and 71+ in Kent Reliance. We've been working hard on our technology development during the first half and expect to be able to launch a new customer-facing savings platform in H1 '24, which will enhance the journey for our savers whilst delivering operational efficiency within the business.

Our Bank of England funding through TFSME remained unchanged at £4.2bn, and in June we completed that £330m securitisation transaction of prime residential mortgages.

So, in summary, a strong operational performance and the fundamentals still good. Clearly, I'm still disappointed that the period has been impacted by the adverse EIR adjustment. We remain cognisant of uncertain macroeconomic outlook and the impact of the higher cost of living and borrowing on the mortgage market, and specifically customer affordability. However, we have a healthy pipeline of new business, and have a proven track record of retaining and attracting new customers and working with high-quality borrowers. Based on current pipeline and application volumes, we continue to target underlying net loan book growth at circa 7% for 2023, supported by that widely reported demand mismatch in rental property supply.

As we look at current pricing and funding costs, we expected underlying NIM for H2 '23 to be broadly flat to the full year '22, resulting in a full underlying net interest margin of circa 2.6%, after the expected impact of further planned MREL-qualifying debt issuance, subject to market conditions.

We expect the underlying cost-to-income ratio to be circa 29% for H2, and therefore 33% for the full year, as we continue to invest in improving customer experience and operating some of our core systems.

The Group does have a track record of delivering strong results, and whilst the adverse EIR adjustment has had a disappointing impact on H1, I hope that you will agree that the underlying strengths of our business model are not in doubt and that despite some macroeconomic uncertainty and headwinds, we look forward to the future with cautious optimism.

Thank you for listening, and we will now open up to Q&A.

Q&A

Gary Greenwood, Shore Capital

I just wanted to ask about the impairment charge, which I think came in the first half that was higher than was my understanding for the full year. I'm just wondering, to what extent are you just taking a prudent view that it looks like it's mainly provision build, rather than actual underlying losses? Obviously the EIR assumption changes were surprise to most, is this just management trying to be very cautious? And then how should we think about impairment charges coming through in the second half of the year? Should they be lower?

April Talintyre, Group CFO

Good morning, Gary. A lot of this was a worsening in the economic outlook, and obviously the knock-on impact that has on our post-model adjustments from an affordability assessment perspective. And really, it's because of the worsening outlook through to June when it came to both inflation and interest rates.

You're right, the underlying performance of the book remains very strong. I suppose, as we sit here today, I think everything looks a little bit better. But it clearly has been quite a volatile ride, hasn't it, from a macroeconomic outlook over the last year or so.

So I think we're suitably positioned. We've always been a little bit more conservative, perhaps, than the pack when it comes to our assumptions for HPI. I think the main change in our scenarios, other than a higher peak for base rates, was that HPI would be just a little bit steeper, peak to trough, but also more prolonged trough. And that's really what's been driving it. And clearly the expectation of higher sort of end peak rate for base rate has had an impact on our post-model adjustments as well, for affordability.

But, as I said, whether it's credit performance, economic outlook, the SONIA curve, you know, everything's looking a little bit better now. So if that continued, then one would expect a more benign second half.

Gary Greenwood, Shore Capital
Thank you.

Perlie Mong, KBW
Hello. Can I ask you about margins? First of all, I think the second-half guidance is effectively 303 flat to full year 22, so it's quite a large step down, 30 basis points. Obviously, some of that would be MREL issuance costs, but I guess the cost of funds and passing on on the lending side will probably balance each other out a bit, so is it all because of the MREL? Because that sounds quite a lot. So what else is in there, in that assumption?

So yes, that's number one, and the second question is, what are your assumptions with regards to the unwind, of the forward-looking part, of the EIR adjustment that you've taken, and whether that 303 H2 guidance includes that? And more broadly, how does that unwind interact with the 11 basis point impact on the front end, that impact that you're seeing on the front end?

April Talintyre, Group CFO
You've hit me with a technical EIR accounting question. I'll try and be succinct. I think those are both for me, aren't they? So, what drives the second half NIM? Well, clearly, you're absolutely right, part of the impact, but only part, is due to the coupons on both the Tier 2 issued in April but also a few months of coupons on our planned further issuance programme of senior HoldCo debt.

But the other item is, what we've got, mortgages which are maturing onto their prevailing rates. As we honoured our application pipeline, I think we've spoken about this in the past, we honoured the application pipeline and our offered retention pricing, through a period of swap spread volatility, and periods of time when those swap spreads widened.

And I suppose that was a very deliberate stance. It's stood us in very good stead when it comes to our broker Net Promoter Score, and also our ability to grow our market share during the first half. But it has had some impact on margins in the second half. And we're also assuming that the cost of retail funds settles at closer to SONIA through the bulk of the year. Over the last 18 months, we've had opportunities to raise retail funds at significantly below SONIA.

And also, if you think about the longer-term view for NIM, clearly, as the 18 months' worth of funds that's significantly sub-SONIA comes to refinance, and if I'm right, they will sort of settle closer to the SONIA mark. Clearly that's going to provide a drag, unfortunately, on margins going forward. I think you've probably heard much the same from other banks through the reporting season as well.

Technical EIR, let me try and be succinct. Because of the mechanisms of EIR, the impact of the unwind of the liability we've created is really balance sheet, and it's a balance sheet reversal because the cash we'll receive over the life of the mortgages will be less than the interest accrual we continue to make, because you don't change your EIR percentage and your interest accrual for behavioural changes.

Benjamin Toms, RBC
Good morning.

Andy Golding, Group CEO
Ask one about the market, Ben, not about EIR.

April Talintyre, Group CFO
Or dividends.

Benjamin Toms, RBC
There's a one in there about EIR. You mentioned about your new savings platform coming online next year. You obviously don't have a current account offering currently. I was wondering whether you can give any colour on whether you intend to fill that gap, either organically or inorganically.

And secondly, on slide 17, you talk about the Precise EIR asset, reflecting time spent on reversion and early repayment charges (ERC). I'm just interested in any assumptions you're making around early repayment charges. We've recently seen mortgage holders making overpayments in the resi market, and I was wondering if there's any upside there, if you've modelled repayments for EIR in a similar way to the reversionary duration, i.e. using actual experience rather than future expectations?

And if I can squeeze in a third one, just in relation to your reversionary assumption of five months, and using the actual experience, you'll be aware that other UK banks take a slightly different approach. I know you won't want to comment on peers. My question is a bit more specific. Have you had conversations with your accountant around OSB's accounting in this area and why it's different to peers, and if yes, what was the outcome of those conversations? Thank you.

Andy Golding, Group CEO

Thanks, Ben. I'll talk about the savings development work and current accounts. We're not building a platform to launch a new current account. We're currently building a much slicker, much more self-service orientated, app-based, etc., savings platform. So it makes it very easy for savers to pick a new product, switch from one product to another, or renew when their product comes to maturity. Just a much smoother customer journey, and we think that's really important as a fairly big provider now into that retail savings market.

But no, we're not planning to build a current account franchise. You kind of always toy with would the benefit of effectively zero rate funding, be it assistance? You've got a lot of infrastructure costs that go with running a current account franchise. Are there offerings out there which are for sale and potentially achievable? I don't know. We always do market evaluations. Kleinman's printed his article about Shawbrook and one current account provider. We will continue to look at the market and see opportunities, and if something presents which we think adds long-term value for shareholders, we'll come back and talk about it. But nothing that we can talk about further at this point.

April Talintyre, Group CFO

I think you're right, Andy, and I can't comment on what other competitors may be saying about their EIR accounting. We certainly do take a forward view as well, but based on the data we have available to us. So it's not rigidly sticking to a run rate of behaviour, but we have to pin it on something.

Yes, we've had conversations with the accountants. They continue to support our accounting methodology as being appropriate for our circumstances. Circumstances are different across the different banks, both from a product design perspective and from, perhaps, their availability of data through the cycle. But there's no question in their mind that our accounting was appropriate.

You asked about ERC assumptions. We do make some assumptions, but it's just not material for any of our books. We're very conscious that we've seen quite a bit of volatility in behaviour. We saw, for example, when there was a fear of rapidly rising rates post the mini budget, we saw a real acceleration of people paying the 1% early redemption charge in the last year of their mortgage in order to fix again. We're not expecting that's going to happen again. But if it was in any way material, we would have disclosed sensitivities in the accounts. And that's valid across our books, Kent Reliance and InterBay and the Precise books. I think that was it, wasn't it? Yes, thank you.

Andy Golding, Group CEO

Just adding on some of that customer behaviour on mortgages, interestingly, two-year fixed-rate mortgages haven't the been the flavour for a really long time, and actually we're seeing some savvy borrowers that are saying, we're going to shorten the product term because rates are high, because they're taking a forward-look view. And even some that are just saying, we're going to stick on variable for a bit, because we think the long-term or medium-term prognosis is a better direction of travel on swap rates, and therefore fixed pricing.

So, in part, that's the beauty of dealing with some professional landlords, because they are taking a portfolio-based financial decision, rather than Mr and Mrs Smith worrying about whether their mortgage is going to go up a couple of hundred quid. That's interesting behaviour that we haven't seen for a long time in the low-risk rate environment.

Grace Dargan, Barclays

Just coming back on impairments, I appreciate a good chunk of the impairment was model-driving, I guess another good chunk was stage 1 to 2 increase. So, what in particular were the increase in credit risk indicators that you saw change as a result of that, and how are you expecting those to evolve from here, i.e., are you expecting a similar run rate? I guess noting you're saying actually underlying is quite strong, so it will be interesting to hear your thoughts on that.

And then maybe I will ask one on capital. Appreciate it's difficult to talk about full year '23, but maybe looking more medium-term, you've got, I would say, s bit more visibility now on your thinking around optimising the capital stack. It would be really good to get your latest thoughts on balancing distributions and loan growth, and also how you're thinking over the next two or three around timing of distributions, or, put another way, how much above 14%, if you're fully optimised, are you comfortable operating at, given the changes that are coming through with Basel? Thank you.

April Talintyre, Group CFO
Gosh, all good questions. You're absolutely right, there was an impact, £15.8m, from staging, that was predominantly stage 1 to stage 2. I suppose it's the only part of the IFRS 9 framework where you don't use perfect foresight, because if it's stage 1, then you take a 12-month view of your potential losses, and when it goes into stage 2 it's lifetime. And some of it was arrears-based, but a lot of it wasn't, and I suppose it's the usual factors of a worsening credit score, perhaps higher personal indebtedness, and other factors we look at which give us those sort of early warning indicators.

Of course, once you've entered into a stage, it takes a time before you can cure out of it, particularly stage 3 to stage 1, but also stage 2 to stage 1 as well. So you could find yourself broadly flat when it comes to portfolio arrears, but still see a growth because of that difference between people going in and people coming out, if that makes sense. Does that answer your question?

Grace Dargan, Barclays
I guess into H2 in particular, are you concerned that you'll see a similar charge?

April Talintyre, Group CFO
Oh, I see. Well, we've obviously got the benefit of a month and a half or so since then. As I mentioned earlier, the way you look at it, things look a little bit better. Really, it's the expectation of where rates will go in particular, and it's the HPI performance, which really makes a difference. And we don't wait to see arrears before we put people through the stages based on those early warning indicators. But we've got a little ways to go this year, but what we see today is looking mildly positive.

Capital, I guess you're asking more medium-term rather than the dividend for this year. I don't think there's really any change to our policy. As we optimise our stack, we can free up more CET1 to distribute to shareholders, and so it's quite linked to the timing of that and optimisation of the stack and the debt issuance. And I personally, and the Board, think of the capital we generate every period through profitability as kind of fuelling growth and a progressive dividend. And the size of the back book the capital generation capability of it, can do both.

And then I think about the excess of CET1 above our minimum requirement and our target of 14%, once you've optimised the stack as being available for distribution back to shareholders through share repurchases.

Of course, we've got that uncertainty to some extent on what will happen with Basel 3.1, but we should know by the end of the year and be able to give a lot more clarity, and I would say there's been a lot of lobbying from industry, industry bodies, Government, against some of the platinum plating. Also, the lack of transitional relief for standardised firms, despite Basel bending over backward to give relief to IRB firms.

And I think it's broadly helpful, perhaps, as to how the US have come out in the last few weeks with their consultation paper. It's a slightly later implementation date. It's a much higher threshold, 100bn, before you have to adopt it. But more importantly, they have stated quite clearly that they don't necessarily feel that the risk weights were always appropriate for their market. And I think hopefully that just gives the PRA a little bit more wiggle room to listen to the feedback. But I'm, of course, just speculating. We'll find out as we go to the end of the year.

Really, no change from anything we've said in the past when it comes to our philosophy on capital, and this is a business that generates considerable capital through profit. We do have a strong position, we've got a good excess, which means we are in a good position whichever way you look at it, and over the medium term that should allow us to return further capital to our shareholders.

John Cronin, Goodbody
Hi, guys. Thanks for the presentation. Just a few from me, please. Following up on some of the previous questions on net interest margins, and I appreciate you've outlined, April, the trends where you should expect to see, in the second

half, contributing to a downdraft half on half in underlying NIM. Just trying to think beyond 23. How should we think about NIM evolution, given the kind of profile of mortgages rolling off, and further issuance plans, and maybe broad-based pressures on asset yields and deposit costs perhaps? Just trying to get a sense of where you think we should be, with our NIM forecasts to beyond 2023.

And secondly, just to follow up as well on costs, I've got two questions on costs. One is, you've obviously got costs growing at a pretty strong run rate as guided, and the planned investment in the business we'll continue to see that come through. Are you concerned in any way around potential further investment beyond what you were initially expecting, perhaps, as a result of this EIR adjustment and the kind of influence that that might have in terms of required cost spend for the IRB programme, without trying to overdraw the links between the two. And then secondly, in terms of percentage uplift, how should we think about cost growth trajectory beyond 2023?

And finally, one on product fees. Thanks for the update in H1 ICR disclosures, and if you were to adjust for those to account for the up-tick there has been in product fees in average terms, what kind of an impact would that roughly have, how much would that reduce interest coverage ratio by if you were to overlay that differential between where product fees were say 18 months ago, and where they are today?

Andy Golding, Group CEO
Thanks, John. Let's do them in reverse order, and I'll take the ICR point and touch on costs, and then April can add on costs and talk about the NIM bridging and journey.

The ICR piece, we do our ICRs at a stress rate, and if that's a five-year fixed, it's the pay rate. And of course, you do in the higher interest rates environments, and you'll see it not just in our product availability but our competitors', we will offer customers an opportunity to pay a higher fee and therefore a lower fixed. But we are talking about a five-year fixed, casting forward over a significant amount of time, when rents will undoubtedly rise during that period. And actually, the prognosis is that the exit onto another five-year fixed rate in five years' time will be lower, so that's just kind of engineering products, really, to suit market taste. No different from what we were doing back in 2013, when we were writing Buy-to-Let mortgages in the mid-fives, and then we started to push them down to the fours, but upped the fees so that landlords that had the capability wanted to do that.

We've disclosed that the flow of ICRs, in terms of the half year, I think they're still very strong, particularly given that interest rates versus what we were looking at 12 months ago for an underlying mortgage cost a lot higher, many of our Buy-to-Let loans are in the sixes, particularly in the OSB and the InterBay brands, and yet we're still delivering 178% ICR coverage, which I think is very strong. As spot rates come down, and we hope the overarching price mortgages come down, and rents continue to go up, because of that demand-supply mismatch, I think that position will only improve. And of course, book ICRs on existing loans are higher, because typically we've been originating around that sort of 198-202% ICR mark.

So, I can't answer the question exactly the way you asked it, but if it isn't a five-year fixed, it's at a stress rate, and that's a fairly significant stress rate over and above, and that's how we calculate the ICRs. So there's no funny business, I guess, is the words, in the way that we calculate and disclose them.

April Talintyre, Group CFO
I suppose the one point is actually, if you think about the first half, a lot of it, we still thought base rate was going to peak around 4%, and therefore we weren't loading fees on. I think it's only at the point where you suddenly see a real widening of the swap spread, and things have come back a bit since then, that we might have put a bit more fee on the product.

Andy Golding, Group CEO
Yes, I think that's right. In terms of cost, John, and you know we're always a cost control animal, we try to make sure that the management-expenses ratio is in line with the growth in the balance sheet. Clearly, we've had to absorb, like every other business, a fair chunk of inflation both in terms of our on-costs for energy and other bits and pieces, but also trying to do the right thing by our staff, which I think is pretty important in a high-inflationary environment.

I think the cost base is in good shape. We have invested a fair chunk during the course of the first half of this year, in terms of development, that new savings platform that I talked about. We try and balance carefully the difference between capital expenditure and revenue expenditure. And if my IT CIO or my COO want spend money on enhancing a system, they need to show me the benefits case that says, when am I going to get it back, in terms of operational efficiency. So we're quite balanced in the way that we look at that.

I mean, I don't think that the EIR adjustment has a bearing on cost. I don't think it changes. IRB is about credit risk modelling, and the way in which we manage credit and operational risk in the business is not about accounting. So I don't think it has any bearing on that.

Clearly, April will touch on NIM, some of the costs that we face are around coupons on elements that come through the net interest margin. But we will continue to grow the cost base in line with the balance sheet if we need to. We'll try and continue to keep that management-expenses ratio right. And our cost-to-income ratio, as you know, John, is always wildly moved by either income upward or, in this case on the EIR adjustment, downward, which has an impact. But costs are generally pretty well controlled.

April Talintyre, Group CFO
If we get to a stage where we want to invest a bit more beyond the growth in the balance sheet, of course that's the point where we'll come back and we'll talk to the market about it, with a good business case for synergies, just like our colleagues have to come to us if they want to spend some money.

So, going back to NIM, you're asking me a great question, as always, more of the medium-term drivers. You're absolutely right, Andy, we do have further issuance requirements. You only have to look at the capital stacks for our MREL requirements to know and have a good estimate of the amount that we're looking to raise. I mentioned a couple of benchmark-size trades on top of that Tier 2 trade, before we get to July, and some more after that. So that clearly is a drag.

I think I mentioned earlier that, over the last 18 months, we've been raising retail deposits at significantly sub-SONIA, SONIA minus 40, SONIA minus 50. That's more weighted towards one year than two year, because that's been what investors have been looking for, retail depositors have been looking for, through this period of rate volatility. And that will start to mature from next year, really, onto whatever the prevailing rate is, and I'm calling that closer to SONIA. And that is going to be a drag. I think you'll see that across the industry.

We have an awful lot of borrowings across the industry from Bank of England under the TFSME scheme. As long as wholesale markets are liquid, I would expect a lot of that to be refinanced through covered bonds, securitisation, that is more expensive than retail savings at the moment. We will probably do some of that through securitisation ourselves. And it could, of course, have a knock-on impact to the savings market, if the wholesale markets are not liquid.

So certainly, that amount of funding having to be refinanced, I'm calling that that's going to have an impact on everybody's cost of funds. When it was given to us, we all were told we had to drop mortgage pricing. We'll have to wait and see what the competitive dynamic is on mortgage pricing to see whether that increased cost gets passed on to borrowers, and that is also obviously impacted by the affordability constraints of higher rates.

And I guess I mentioned earlier, in the short term, and it is obviously a factor for the medium term as well, on the lending side, where perhaps business the industry wrote five years ago, was on higher yields to what we're facing today, and that's because the mortgage market hasn't passed on all of that widening of swap spreads and rate rises on to borrowers either.

And I mentioned earlier, the short-term impact is just the way we honoured our application pipeline. We hedged some of our application pipeline, but not all of it, and therefore we have had some ups and downs when it comes to what the actual NIM is of that front book, between the application points and when we actually completed. But of course there are ups as well as downs there.

I should finish with some upside, which is that we've obviously been very cautious in our lending appetite, really, since the pandemic, and we're not doing so much of the high-yielding business that we're very good at. As soon as that outlook stabilises, you should expect us to start doing more of those high-yielding businesses, development finance, bridging, commercial, asset finance, etc., and I hope that is a real potential upside to our net interest margin as well.

John Cronin, Goodbody
That's very helpful, thanks. Can I just come back on one on the cost point, I'm modelling cost up by 14% in '24, 9% in '25, I mean not looking for specific guidance on this, obviously, but we hear from the other banks around it in terms of cost and the IRB programmes, and directionally would you be guiding to double-digit growth over the next while?

April Talintyre, Group CFO
We're not going to give guidance for 2024. There's clearly some inflationary impacts and wage inflation. We did the right thing by our staff in this challenging environment. But it's all about how much investment we want to do in the

business, and whether we can do that within the economies of scale we naturally generate plus any further inflationary pressures. But I think inflation, thankfully, is starting to come down.

Andy Golding, Group CEO
I think, demonstrably, we've done a pretty good job in the first half of this year of absorbing what was fairly chunky inflation on staff costs, and other bits and pieces, because of growth in the balance sheet, and therefore management of the management-expenses ratio. That's the denominator, John, we always come back to, is, if you're going to grow your cost base, you've got to grow your balance sheet to pay for it. And you won't always do that in exact harmony, but if you're doing cost more than growth, you need to have a pretty good business case to make it so.

April Talintyre, Group CFO
And we're not shy about coming back to the market and saying, we want to invest a bit more money but we're going to generate the following synergies. We've just not had to do that so far, given the growth in our business, and we've been able to fund things we want to do through economies of scale, as we continue to really modernise our technology stack, which I think is like every other bank, we've just been, I think, quite lucky with our ability to do it within the economies of scale we've generated.

Andy Golding, Group CEO
Thanks, John.

Portia Patel, Canaccord
Thank you very much. I'm afraid my question's on EIR again. Just two, please. The sensitivity provided to the reversion period is very useful, so thank you for that. But I was wondering if we should expect a one-off impact, like we've seen in this period in the future, if reversion period moves either way, or should we expect it to be reassessed on a more frequent basis going forward, such that the impact can be smoothed? Perhaps this is a function of the accounting treatment. If you could just explain, that would be really helpful.

And secondly, I just wondered if there had been any changes, or if you are intending to make any changes, to the design of the Precise Mortgages product, to encourage behavioural trends more akin to what we have seen in the Kent books. Or do you believe that the Precise products are fit as is? Thank you.

April Talintyre, Group CFO
Will we expect any more? It really depends on what happens to interest rates and the interest rate outlook, because that's really what's driven this. And perhaps after this adjustment, there's more chance of people spending a bit longer if rates start to fall.

Portfolio landlords, as Andy mentioned, there are reasons why they might stick on the revert rate despite it looking like a very high step-up, as they assess their overall cost of funds across the portfolio, and they'll have their own view about what's going to happen to rates, and whether it's worth a little bit of short-term pain in order to lock in a rate as it starts to fall. And we have a lot of anecdotal evidence that residential customers are actually thinking the same way as well.

So it's very much driven by the absolute level of rates, but also by the outlook. And so I suppose there's always chance of people spending longer, or less. We look at this frequently, anyway. The very formal process, involving our auditors, from a challenge perspective, is six monthly. But this is something where we're collecting data every month and will continue to do so.

The size of this adjustment, really, was the result of such a rapid increase in rates over such a short period of time, which meant that the entire back book was suddenly facing a material step-up and an incentive to refinance, whereas previously it had reverted to a rate slightly above or very slightly below the fixed rate. So it was the speed of the rate changes which really caused this.

So, clearly, heightened sense, I'm sure, across the organisation and the Board, on looking at this even more frequently than we did previously. But it wasn't that we were asleep at the wheel. We were looking at this. It was just a sudden change.

And I don't think there's anything wrong with the design of that product, in fact designing a product that has a relatively modest step up, in reversion, there's nothing wrong with it. It's just vulnerable to 12 consecutive base rate rises in a very short period, I suppose.

Andy Golding, Group CEO
Yes. Portia, I would say, products that we're writing today have a different step up that those that were written five years ago, as in, it's not quite so high a margin of a base, so that has a sort of forward impact in terms of behaviour.

But I think, going forward for us, it is important that we continue to build the Choices programme in Precise Mortgages, which does over time mean, you will try and get more people onto a new product when their product matures. And of course that locks them in for a further period in terms of a new fixed rate, a new product fee, etc., etc.

But a couple of City people have said to me, "why would anyone stay on a revert rate for anything at all I wouldn't". But the average borrower, particularly residential through Precise Mortgages, is not that kind of individual. And by the time they realise that their payment's gone up, then there's a three-month window to get a refinance done, and that takes a while, and we all know solicitors are a bit slow, and whatever. So there's always some time, and that's why, for us, it's important that we keep pushing the Choices programme message. But it amazes me.

Some people, you're right, you say, look, here's another deal and it's a good deal, and they still think about it for quite some time. But, over the years, we will work hard to change that behaviour.

But you talked about it being one-offs. We'll monitor the thing. We've taken EIR adjustments all the way through in the past. They are typically normal course adjustments that are absorbed within our ability to grow the bank and make profit, and that's the way I think we're trying to think about it going forward.

April Talintyre, Group CFO
We have applied for same assumption to parts of the back book that were originated more recently than are likely to reach reversion in what we expect to be a falling rate environment. So perhaps there's some element of prudency there. But we've been wrong on what's going to happen with the rate outlook over the last 18 months, so I'm not going to call it. We're certainly just looking at what the SONIA curve is implying at the moment.

Andy Golding, Group CEO
Thank you very much, everybody, for attending, and have a good day and a good weekend, as we're nearing that point. Cheers.