Virgin Money

2015 Q3 Interim Management Statement

Thursday, 15th October 2015

Jayne-Anne Gadhia, Chief Executive Officer

Good morning everyone. Thanks very much for dialling in. I'm here this morning with Dave Dyer our CFO and Richard Hemsley our Chief Banking Officer. I'm going to give you a short update on our latest performance and then we all look forward to answering your questions.

So I'm really pleased that our great Q3 results show us growing strongly in all areas and becoming increasingly profitable. Our cards performance so soon after migration is especially encouraging.

Our net interest margin has also been strong in the quarter and it's remained broadly flat with the first half of 2015 and that's despite the competitive mortgage market.

Now as you know we've got four main drivers of our NIM: mortgage asset spreads; cards volumes; deposit pricing and balance sheet efficiency. And we've done well in each of these areas in the quarter and NIM's benefitted as a result. So I'll just take a moment to explain how.

First of all we're really pleased that we've continued to grow mortgages strongly at the same time as managing spreads well. So in the first nine months of this year we wrote £5.5bn of new mortgages, that's about 3.5% of the market, and of course I'm delighted with that because it keeps us at the top end of our market share guidance. And redemptions have been in line with our expectations which gives us strong net lending growth of £2.6bn.

And we've continued to manage spreads carefully by diversifying the mix of our business within our existing product range and within our approved risk appetite. And we've actually pulled back a little on our buy-to-let business in the quarter and we remain entirely in line with the market with about 17% of our portfolio being in the buy-to-let space.

But given market competition front book mortgage spreads have fallen, as you'd expect but we're still within 20 basis points of our initial target of 200 basis points that we discussed last time.

And we've continued to compensate for mortgage spread compression through the growth of our credit card business and through deposit repricing.

Credit cards ended the quarter with balances of almost £1.4bn, we were delighted with that. And yields, and indeed our effective interest rates on credit cards are entirely in line with plan.

The Sex Pistols marketing campaign worked as well as we'd hoped and our 20 day headline product which was 0% for 40 months, worked as expected to announce to the cards market that we're back as a serious competitor.

We also grew our retail deposits strongly despite the fact that we further tightened the price on the book. In fact we've just completed a second back book reprice on about £8bn worth of deposits. We reduced rates by 20 basis points and were pleased once again that retention experience has exceeded our expectations. To be clear this reprice was finished towards the end of the quarter and so it hasn't yet contributed towards NIM.

We also continued to improve our balance sheet and funding efficiency. We increased our loan to deposit ratio somewhat although we remain happy with a top end of 110% and we continue to manage our conservative liquidity portfolio tightly.

All in all then we made very good progress in protecting NIM in the quarter and although the impact of mortgage spreads still assumes a reduction in Q4 that will bring down the average NIM for us for 2015 as a whole, our credit card performance and deposit repricing experience give us continuing confidence of reaching our target of 170 basis points by the end of 2017 as we've always planned.

And we've also made further progress in developing our non-interest income.

Our current account base remains small but we've seen real growth here during the quarter and there's certainly a continued appetite from customers to switch to Virgin Money. So we're looking to the imminent CMA report as a possible benefit here.

Our investment and pensions portfolio has performed bang in line with expectations, and we've benefited from our hedging policy around this business in the face of recent equity market volatility. And of course I hope you'll have seen that our insurance business has been augmented only this week by the introduction of our new Home and Motor products.

As you'll have seen we've also announced the appointment of George Ashworth today to lead our SME developments. George has many years of experience in the SME market and we look forward to developing the Virgin Money business in this direction, cautiously and gradually in the years ahead.

Despite our investment in new products and our significant asset growth I'm really pleased to report that costs remain on plan. That means that they're broadly flat quarter-on-quarter although with such significant income growth there's a gradual uptick in the run rate as you'd expect.

Meanwhile asset quality across both mortgages and cards has remained as good as ever and our capital position is equally strong. Indeed with new capital rules on ring-fenced banks due out just as we speak we believe that our prudent capital position and simple business model protects us well for the future. We remain confident that our current capital plans enable us to deliver against all known regulatory requirements and that's without compromising our planned returns.

So looking ahead we remain happy with the targets we set out when we listed almost 12 months ago, despite a macro environment and mortgage competition that differs materially in reality from what we expected then.

Covering those movements as well as covering the new bank tax, which we think is here to stay, shows I think that the Virgin Money business has the flexibility to succeed and deliver and that's due to our scale, our brand, our lack of legacy and our uncomplicated business model.

So that means that our outlook remains confident. We expect to deliver mortgage market share around the top end of our guidance of 3% to 3.5% this year and beyond.

Cards growth is slightly ahead of plan but it’s actually too early to say that we’re going to exceed our targets, rather, we remain happy with our goal of building balances to £3bn in 2018.

And despite market pressures we’ve done well I think to manage net interest margin this year and we still plan to achieve 170 basis points by the end of 2017 although I am sure that there'll be some ups and downs along the way as base rates move and as the mortgage market develops against the backdrop of new taxes and new capital requirements which we expect will in the end push up mortgage spreads. And we remain on target to meet our cost/income ratio of 50% by the end of 2017.

So I hope you'll agree that there's not really any new news in our Q3 update, what we’re doing is continuing to deliver on our promises and we continue to look forward to our future with confidence.

So now Dave, Richard and I would be delighted to take any questions you may have. Thank you.

Q&A session

Question 1

Ian Gordon, Investec

Good morning. I agree with your comment that you've done exactly what you promised, I guess what I really wanted to explore is how much flexibility you have to expand your horizons. On the mortgage volume, as you say, you were broadly stable versus the first half, notwithstanding a stronger, wider market in Q3, so the market share came down in the quarter. I know that you work to your 254 mortgages per day, how much could you step that up in 2016 if mortgage volumes in the wider market are stronger, especially if they’re supported materially by remortgage activity?

And then if I could just tack on a quick second: other income you've said is growing in line with expectations, if I'm honest I wasn’t actually expecting very much growth in other income at this stage so could you give me a little bit more colour on that please?

Jayne-Anne Gadhia

Okay thank you very much, Ian. I’ll start and maybe Richard you'll want to add a little bit. But I think that as far as our flexibility for further growth is concerned as a business that has been floated for less than 12 months we’ve always felt that 2015 meant that we had some pretty ambitious targets and we're just really pleased to be delivering on those. So we don't intend or expect to increase our guidance at this point but to continue to develop what we think continues to be quite exciting growth for the business.

We continue to target the top end of the range of our planned market share of mortgages, Ian, and equally we continue to be confident of delivering £3bn worth of credit cards.

And part of the reason why we think it's important to stay within those tramlines is obviously that enables us to manage our capital efficiently as well and be confident of our return profile. So I would be in a position of confirming our guidance at the top end of expectations rather than saying that we feel that we can make a step up at this point. Hopefully in the years to come that will be possible but it feels like a sensible place to be at the moment.

And as far as other operating income's concerned, I mean you pick up on the right point really, it continues to grow, but of course as net interest income grows too as a percentage of net interest income it's remaining relatively flat really, I think it was getting on towards 13% or to be specific I think it was 13.4% at the half year, and for this quarter it's roughly flat on that but of course growing in line with net interest income.

Was there anything you wanted to add, Richard?

Richard Hemsley

No, I think just in terms of mortgage volumes as we look forward, I mean clearly we're on a daily basis keeping a very close watch on where the spreads are and making sure that we manage that mix of volumes and spreads, and I think we've demonstrated through this year, you know, we do have the operational capability and operational leverage that says that if that opportunity is there to do more we will do but we'll constantly look to manage the profitability and the spread around that.

Ian Gordon, Investec

That's great, thanks very much.

<u>Question 2</u>

Ivan Jevremovic, UBS

Good morning and thanks for taking my question. I just wanted to ask two please, one of them just on margin, perhaps to clarify, also following on from some comments I think you made at the first half so if I remember correctly you were talking about effectively sort of asset pressure continuing a bit into the second half and then the deposit repricing coming through a little bit later so as it were sort of by the time we get to the exit of this year the deposit repricing has made up for the asset spread pressure. Is that still the case or do you think that by the sounds of things sort of asset spreads are maybe stabilising more than you expected and the deposit repricing should help?

And just as a kind of second part on the asset spread outlook that you set, about it being stable at the end of this year and going into next year, would you see that more as a function of what's happening in the market or specific actions you're taking on mix and pricing? I'm just asking because you're the first of the UK banks to go, so I think people might look at you as a bit of a bellwether. Thanks very much.

Jayne-Anne Gadhia

Sure, thanks Ivan. Well why don't I answer your second question first and then ask Dave to talk about the margin outlook. So I mean I think that we're looking, in terms of our asset spreads expectations, looking forwards, we think that we are managing that both because of our management of the Virgin Money portfolio and because the market is starting to level off if you like. So it seems to us as if, I think we said before, the race to the bottom has certainly levelled out. We do see some organisations continuing to reduce their prices in certain products and in fact we do the same, but it's definitely not across all products now and you can see that all mortgage providers I think are managing mix and spread to maximise profitability and volume. So the market seems more sensibly competitive than it was in the first half of the year when there was a genuine rush – we thought – to grow volume at the expense of profitability. So that feels to be a little bit more normalised, I wouldn't say it's completely normal but it's certainly normalising.

And from our perspective, as I say like others we've been managing spread by managing mix, as I think we've said before we have the ability to nimbly price our mortgage portfolio so we can move price quite frequently. And so if we're finding that there's a particular area that's particularly competitive we can change the price in that quickly and respond quickly to market movements, and you'll probably see that in some of our pricing announcements that I know the market's seeing.

We have pulled back a little bit on buy-to-let as I said because we don't want to get overheated there. We increased a little bit our higher loan to value business but between 75% and 80% as opposed to much higher than that and as I think you know, any business that we write in the 90% to 95% area is covered entirely by the government's guarantee scheme. So we're doing that entirely within our risk appetite but it's the ability to be nimble that enables us to be competitive in that market and has helped us to come up so far with a good spread position.

But let me hand you over to Dave and perhaps you'll just talk a little bit about margin, Dave?

Dave Dyer

Yes, I mean on the outlook you're right, the two main components in the last part of the year are going to be the flow-through from the pipeline of the asset pricing compression, offset by the flow-through from the deposit side of the repricing, so those two counterbalance over the last quarter to give us a very slight headwind against the current NIM position. We are currently working to the assumption that that pretty much stabilises into 2016 and that the front book pricing won't get worse. We've not yet assumed it will get better, absent a BBR change and our planning assumption for next year is for one change in July. However, there may be some impetus for it to get better because of the tax surcharge, and who knows what the capital implications of today's announcements may be, but there's certainly not likely to be any easing of pressure on capital so they may come through into repricing in the market in the early part of next year.

Ivan Jevremovic

Understood, thank you very much, that's really helpful.

Question 3

Guy Stebbings, Exane BNP Paribas

Good morning. A couple of questions, firstly on credit cards. The £1.4bn for the third quarter certainly sounds very good and ahead of expectations. I just wondered whether you were able to give any more colour on how that's kind of faired over the course of the quarter because I know you talked about the half year that's starting the half very well, so I just wondered if it was broadly consistent throughout the quarter. Should I…?

Jayne-Anne Gadhia

Why don't you go for your second question as well, Guy?

Guy Stebbings

Okay, thanks. And the second question was just briefly on SME banking now that you've talked about bringing George on board and you said sort of enter the market cautiously and gradually and presumably you're waiting for the CMA findings, but I just wondered if you could provide any additional colour around that?

Jayne-Anne Gadhia

Sure. I'll perhaps answer both of those if I may. So first of all on credit cards, we are as you say slightly ahead of expectations as I said in my sort of opening comments really, that's because we've focused very hard on making enough noise in the market for the market to notice that we're properly back. So in partnership with MBNA over a number of years clearly we were one of the main credit card providers, but as we acquired their book and agreed with MBNA that we would reduce volume in the market, and then last October as we prepared for migration we actually closed to new business, quite clearly the market impetus was going away from us and so we knew that we wanted to really come back with a punch and that's why we did the Sex Pistols campaign, that's why we had in the market very briefly the 40 month zero percent card.

Both of those things have had a very significant impact and people have noticed that we're here. Martin Lewis has been emailing his followers to say that we're back and all of that has really helped us. And so we see all of that very successful marketing campaign as part of the reason why we're slightly ahead of volumes as things stand. And we expect that now to normalise with normal marketing, normal exposure, normal experience, if you like, and as a consequence, because of the good experience we've had we're even more confident of being able to get to our £3bn in 2018, we just think it's too early yet to say that we're going to be ahead of that. So we just encourage everyone to think we've done well so far from a standing start, but not to over-egg where we might get to, because as I say we're just turning into a more normal position now.

And then as far as George is concerned we're delighted to welcome him to the team. I think I've said off and on over the last 12 months, that over 20 years of being with Virgin in financial services the owners of small and medium sized businesses through a variety of our guises over 20 years have spoken with us and contacted us off their own back to say that they're inspired by Richard Branson and they see Virgin as a natural home for them to do their banking. And so we've always taken that seriously and realised that it's a real opportunity for the brand. But of course that said we also know from our experience that the only way to develop a business successfully and profitably is to bring in subject matter experts to do it. And initially we've been a team of retail bankers, we then brought in a team of credit card experts and with Richard joining us with his own experience of running Lombard and being able to bring George in and hopefully others will follow, we're starting to develop the subject matter expert capability to enable us cautiously to enter the SME market.

But again, what we're really saying to the market is this is a strategic investigation for us, and it's something that we'll do in the same way that we think we've done other things. We will plan to grow initially organically of course, we do that slowly and sensibly based on a sensible plan, and only when we've got the right people in to manage that business really effectively. So you should see this as very much the indication of intention rather than an economic driver for the immediate future, but we hope it'll be a very big economic driver for the years ahead.

Question 4

Rohith Chandra-Rajan, Barclays

Could I just follow up on the NIM question actually and to clarify some of the guidance which perhaps I'm taking too literally. I think what you said was that the NIM was broadly stable in the third quarter and you expect some compression in the fourth quarter, and you're reiterating guidance for the full year to be a little bit above 160. So first half was 165, which if the three quarters are stable on around 165 would imply something like low 150s for Q4, and I think the deposit re-pricing probably adds something like 5 or 6 basis points to the NIM. So I suspect I'm either taking something too literally or missing something in terms of what Q4 might look like, so I wonder if you could elaborate on that a little bit please.

Jayne-Anne Gadhia

We understand that in our caution to guide the market and not to get ahead of itself we may have confused slightly. When I look at some of the analysts' reports that say that there's a view now, I think it's a consensus for NIM, Rohith, for the year based on everything that I've said is that we might come out at around 163 basis points. I feel relatively comfortable with that consensus but not above it. If that helps? So in other words, I think it's the fact that we continue to stick to just above 160 that may be slightly confusing, if you see what I mean. We will outperform the 160 in the way I've just described.

Rohith Chandra-Rajan

That would imply something of a step down in the fourth quarter, and I thought that what you were saying previously was that the third quarter might be weak but because of deposit pricing fourth quarter would be better, and that seems to have flipped around a little bit.

Jayne-Anne Gadhia

Well, that hasn't been our intention to say that. I think to be absolutely honest, we've been very pleased with how we've able to manage the NIM in the third quarter is the fact of the matter. As far as Q4's concerned we will be seeing the planned or expected impacts of asset spread compression coming through in Q4, but as we say, we've got to a place where we see that turning round now for the year ahead. So I still think that we'll be doing extremely well to come out in 2015 with a net interest margin ahead of the 160 basis point guidance that we gave at the beginning of the year. And as I say, with some swings and roundabouts along the way we can see our way from there to the 170 by the end of 2017. We're pleased with the performance that we're achieving, to be honest.

Rohith Chandra-Rajan

Okay, thank you. Could I just ask very briefly then just on the mortgage mix, I think buy-to-let was 28% of the flow in the first half, you said you've eased back a little bit on that. I was wondering what proportion buy-to-let is now? And similarly just on the higher LTV stuff, how much of a mix is that now and going forward?

Richard Hemsley

You're absolutely right, Rohith, we were a flow of about 28% in the early part of the year. We've pulled that down to around 20-23%. As Jayne-Anne says, that literally can vary week-by-week dependent on where we see the opportunity from a pricing perspective, and that's facilitating us to grow towards the stock reflecting the market levels from that perspective.

In terms of higher LTV, again as Jayne-Anne says, we have stepped that up a little bit, so again we will move in and out of that particular area, but it represents something that's less than a third of the flow business that we've got coming in. Of course from our perspective high LTV means anything that's 75% and above, again reflecting the comment that says anything between 90% and 95% is government backed.

<u>Question 5</u>

Nick Baker, Goldman Sachs

One quick one from me on loan-to-deposit. As I calculate it a loan-to-deposit somewhere about 109%, and I'm just wondering how hard a ceiling is that 110% you've guided to? I mean could you drift up slightly above it for a temporary period of time, or is that an absolute sort of hard stop?

And then I guess going forward probably it puts more of an onus and more of a perspective on where front book deposit pricing is. You've commented on your outlook for mortgage asset spreads, and I was wondering what your outlook would be for liability pricing given that particularly a lot of the cash and one year fixed ISA deals seem to be really quite competitive at the moment.

Jayne-Anne Gadhia

For us at the moment our Board approved risk appetite for our loan-to-deposit ratio is 110%, so if you like it's a hard stop to that extent. But it's within our own gift, and if we felt that we could take that further then we would discuss taking that further. To be really clear, that would not be my immediate preference, and we do believe that we can run the business very successfully within 110% loan-to-deposit ratio, but as I say, it's a hard stop within our own gift as opposed to anything else.

Part of the reason that I'm very focused on it – and I should say that we talk about it quite a lot – is the fact that we're running a business that years ago was Northern Rock and we can imagine similar questions being had there, and we all know where that ended. Now I'm certainly not suggesting that a loan-to-deposit ratio slightly ahead of 110% is going to get anywhere close to it, but you understand why our focus is in that place. And the business overall, as you know we run very prudently in terms of risk appetite and we think this is a prudent place to be. Richard, would you like to answer the pricing point please?

Richard Hemsley

New business spreads over quarter three were broadly speaking in line with what we've seen for the full year. I think I would acknowledge that over the course of the last few weeks in certain aspects the market has tightened, but we're still seeing competitors move in both directions from that perspective. Overall, we still look at the book and as we go into 2016 may have still some more wiggle room from that perspective. So I think in the short-term it has tightened a little bit, but over the course of the year and in terms of the outlook I think we're still comfortable with the plan that we've got.

Concluding comments: Jayne-Anne Gadhia

It just remains for me to thank you all very much indeed for your time and look forward to speaking with you all again at the full year. Thank you.