Virgin Money UK PLC Full Year Financial Result 2022 - Fixed Income Call Transcript

Hosted by Justin Fox (Treasurer) and Richard Smith (Head of Investor Relations)

Justin Fox, Virgin Money UK PLC

Hello and good morning, everyone. Thank you for taking the time to join us today. I hope you're all well and having a good start to the week. As Jordan just said, I'm Justin Fox, Group Treasurer and today as usual, I'm joined by Richard Smith, our Head of Investor Relations; Matthew Harrison, our Head of Treasury Debt Capital Markets; and Gareth McCrorie, our Debt Investor Relations and ESG Manager. Yesterday we presented our Full Year 2022 results, in person, at the London Stock Exchange, and I hope some of you managed to make it along. For those who didn't, and if you haven't already done so, please take a look at the Financial Results section of the website where you will find a webcast of yesterday's presentation, and today's Fixed Income slides, which Richard and I will go through. Yesterday's presentation contains some additional appendices which contain an awful lot of useful information. As always, we hope these sessions cover the right topics, in the right level of detail, and we remain grateful for any feedback you have.

Today's slides will provide an overview of our full year financial performance, walk you through the key elements of our capital funding and liquidity position, update you on our issuance plans for the coming year, and discuss a few of the key themes of interest that we feel are worth sharing. At the end, we'll open up for Q&A. I'll now hand over to Richard to talk you through our full year results.

[Inaudible line]

Richard, perhaps I could intervene. Your line is really poor. So I was wondering if I could step in and just cover that back over again. So let me start again with Slide 4. In the middle column, you will see we delivered a RoTE of 10.3 percent. This is a good outcome in a difficult environment that is underpinned by a cost income ratio of 52 percent. On the left-hand side, you'll see that we've delivered on-target annualised cost savings of £69 million, a full year NIM of 1.85 percent and a broadly stable cost outcome in line with our guidance. Given the benefits of higher interest rates on NIM and the progress on our cost savings programme, we are confident we will deliver on our cost income ratio targets over the next few years. Our Unsecured and BAU Business lending have grown by an average of 7 percent, and our mortgage business has now returned to growth in H2. It's also pleasing to note that our relationship deposits have grown 13 percent year on year.

Our balance sheet is robust with a low arrears profile and strong coverage level of 62 basis points and we believe we are appropriately positioned for the next phase of the economic cycle. Our CET1 ratio of 15 percent for Full Year '22 is also in a strong position, reflecting ongoing delivery of statutory profitability. Given the strong performance and our capital surplus, the Board intends to recommend a dividend of 10p per share and a further buyback of £50 million, bringing the total buyback for 2022 to £125 million. Combined, dividends and buybacks totaled £267 million for 2022.

We're also pleased to be able to revise our guidance upwards. Our 2024 RoTE is now expected to be around 11 percent, and this increase will be underpinned by a cost income ratio of less than 50 percent. We'll move to our target CET1 range of 13 to 13.5 percent by 2024 and our shareholder distributions will reflect that. In short, we are delivering on growth, we're delivering on costs and delivering on digital initiatives. We have a robust balance sheet that will support our delivery of targeted growth going into 2023. So now let me turn to Slide 5 and touch on the broader macro environment that will influence our performance next year.

As you can see on Slide 5, the macroeconomic environment has deteriorated over the course of the year and you can see the impact of recent events on our current economic forecasts compared to earlier in the year. You can see that the revisions show a deterioration in activity levels and a significant reduction in GDP expectations. Inflation is expected to peak in 2022 and decline thereafter; rates will remain higher for longer, and therefore GDP shows a downward trend. Although unemployment is forecast to rise, it does remain low by historical standards. We've also noted recent updates from the Bank of England and the OBR last Thursday, which remain within the range of expectations set out amongst all IFRS9 scenarios, which you can see in more detail in the appendices to the equity presentation from yesterday.

Despite an unsettled economic outlook, we believe there are opportunities for growth in 2023, supported by further innovative propositions that leverage the brand and offer our customers compelling value and a strong customer experience, all of which are underpinned by a unique loyalty programme.

Moving on to Slide 6, where I will detail our lending performance for the year. We've targeted growth in Unsecured and BAU Business lending and we are pleased with our progress this year. You'll see here that we have increased overall volumes with strong growth in Unsecured, offsetting the modest reduction in Business and with Mortgages stable. In our mortgage business, we took advantage of stronger spreads in Q4 to grow, prior to the September rate volatility. You can see that we have also delivered growth in the BAU Business book in the second half of this year, broadly offsetting ongoing reductions in government backed balances. We've been particularly pleased with the growth in Unsecured, reflecting prudent growth in our high-quality cards book. Looking forward, we will continue to diversify the balance sheet and grow overall lending balances in FY23. Having grown the mortgage book in the second half of this year, we expect to deliver further modest growth in FY23. And in Business, we expect growth in the BAU book next year, while government backed balances will continue to run off. In Unsecured, we will look to take further market share, but expect growth to slow reflecting our tightened affordability criteria. At this point, I will now hand back to Richard.

Richard Smith, Virgin Money UK PLC

Thanks very much, Justin and apologies for the technical difficulties, hopefully this is better. Now moving on to asset quality on Slide 7. As detailed in this slide, we reported a modest cost of risk this year of 7 basis points. That performance reflects our solid credit quality, which has remained resilient, with low arrears and default levels throughout the financial year, with some normalisation more recently. On the left, we've set out our ECL over time. You can see that we started the year retaining significant COVID related post model adjustments. Given our experience through the year, we have now released these. At the same time, we've increased our modelled provision, reflecting a deterioration in the macro-economic outlook. We also now have in place targeted PMAs relating to potential cost of living impacts for both our retail and business customers. The net impact of all of this is that at a headline level, total provisions have reduced slightly from FY21. Nonetheless, we remain very well provisioned, with coverage above pre-pandemic levels, as you can see on the chart on the right-hand side. At this stage, our best judgement for FY23 is that our cost of risk normalises to around our through the cycle level, which we consider to be 30 to 35 basis points. So while our credit quality indicators remain benign, we are well positioned for the uncertainty that lies ahead as I will now explain on Slide 8.

We're confident in the quality of our book and you can see here why we are comfortable with our resilience. So starting with the overall portfolio, top left and cycling through. Our total portfolio is defensively positioned, with balances strongly weighted towards mortgages at around 80 percent of loans. Our mortgage book is a low-risk prime book weighted towards owner occupied, originated with strict affordability assessments, with only 3 percent above 80 percent LTV and largely on fixed rates.

In Unsecured, our underwriting criteria are prudent, and we've tightened further during the second half of '22 to reflect the affordability stresses on customers. Our Unsecured customers are generally more affluent with lower debt to income than the industry average. Their retail spend has picked up over the year and continues to be weighted to discretionary or luxury items. Their repayment rates remain stable. All of these are indicators of the credit quality of the book.

Finally, our Business portfolio remains well-diversified with strong collateral levels and skewed to lending to resilient sectors. We've provided additional detail in the appendices, demonstrating the underlying strength of each of the portfolios, which gives us confidence in the current economic climate.

Turning now to our progress on ESG on Slide 9. Our ESG agenda continues to gain momentum with significant progress made across all of our ESG goals. Alongside a 12 percent reduction in Scope one and two emissions, we delivered financed emissions calculations and net zero roadmaps and targets for 82 percent of our lending book and have committed to at least a 50 percent reduction in carbon emissions across everything we finance by 2030. You can read more about the progress and our commitments on Slide 24.

Commercially, the Sustainable Business Coach is now embedded into new borrowing greater than £2.5 million. We've launched our Agri E-fund and extended our Greener Mortgage product. We continue to focus on ensuring that no Virgin Money customer pays a poverty premium, and we're pleased to identify more than £1.1 million of support for our customers through the Turn2Us benefit calculator. We're making good progress in supporting a more sustainable future and the slide details some of our highlights in the year. There has also been a significant, often under-appreciated focus on our ESG disclosures, and it's pleasing to see the recognition of all of this work, through upgraded ratings in terms of our ESG providers, including Sustainalytics and MSCI, where we're now classified as ‘Low risk’ and ’Leader’ status respectively.

Pre-empting a question in Q&A in terms of our green funding plans, it's something that we continue to look at but for the time being, we're focused on further improving our disclosure on ESG ratings, meeting our net zero roadmaps and targets, and demonstrating lending against our new ESG products, which should allow you as investors to have a truly holistic view of our ESG credentials.

Finally, I'll conclude with our guidance on Slide 10. On this slide, we summed up our guidance for FY23 on the left and the upgraded outlook for FY24 on the right. Our guidance reflects up to date expectations for inflation and a realistic view of interest rates, which have come down more recently. In FY23 we expect NIM to remain strong on a larger balance sheet, with further improvements in the cost income ratio, alongside higher impairments, to be around the through the cycle average. We remain committed to distributing surplus capital, though we will maintain a CET1 ratio of greater than 14 percent during FY23.

Now turning to the medium term in FY24. We remain committed to our target set out in November 2021, including a RoTE target of above 10 percent for FY24 and a cost income ratio of less than 50 percent. Inflation and rates, whilst volatile, are clearly structurally higher than they were last year, but the macro-economic outlook is somewhat weaker. While we're not specifically guiding, it is fair to say that our income outlook for FY24 is stronger and we are confident that we will deliver a less than 50 percent cost income ratio in FY24, notwithstanding higher cost inflation. And finally, we expect to operate within our target capital range by FY24, enabling further buybacks. Taken together, whilst our RoTE target remains greater than 10 percent, we are pleased to confirm our statutory RoTE guidance in FY24 of around 11 percent.

Overall, it's been a strong year for Virgin Money and our outlook is positive. I'll now hand back to Justin to talk through the capital funding and liquidity positions in more detail.

Justin Fox

Thanks Richard. So turning to Slide 12, our capital generation has been robust this year, reflecting solid statutory profits and stable RWAs, resulting in 195 basis points of underlying capital generation. Excluding the software benefit from the opening capital position, we grew our CET1 by around 60 basis points; having achieved this despite 90 basis points of shareholder distributions. We announced our capital framework at our half year results and started buybacks alongside our 30 percent dividend payout. In FY22, we've announced total distributions equivalent to 57 percent of statutory profits after AT1 service costs, through a combination of dividends and buybacks, including the additional £50 million buyback announced yesterday. Altogether, we finished the year at 15 percent CET1, well above our target range, which we'll discuss further on in slide 14, but first, let's move to Slide 13.

As you can see, our capital position remains robust across all metrics. Our Total Capital ratio of 22 percent remains strong relative to a 13.6 percent requirement, and a leverage ratio of 5.1 percent remains in excess of minimum requirements. MREL end state requirements have applied since the 1st of January, requiring us to hold capital resources and eligible debt instruments equal to the greater of two times the Total Capital Requirement, that is to say two times to the Pillar 1 plus the Pillar 2A requirements on a RWA basis, or 6.5 percent of the leverage exposure measure. The year-end total MREL resources available as a percentage of RWAs were 32.1 percent, well in excess of the 24.9 percent LAC requirement. From the leverage perspective, total MREL resources available as a percentage of UK leverage exposure measure were 9.2 percent.

So now turning to our CET1 outlook on Slide 14. At the half year, we stated that our target CET1 range was between 13 and 13.5 percent. We ended the year at 15 percent as I've already said. We expect to stay above 14 percent, as Richard mentioned in FY23, reflecting current economic uncertainties and this takes into account an expected £1 to £1.5 billion of additional risk weighted assets from the implementation of hybrid mortgage models in the first half of 2023.

We expect to operate within the target range at Full Year '24. Relative to the top end of our range, we have currently around £375 million surplus CET1 before future organic capital generation. That means further sustainable buybacks alongside dividends through FY23 and FY24, starting with the £50 million buyback expansion that we announced yesterday. Future buyback announcements are most likely aligned to Q4 of next year, given the stress testing timetable that we're going through; they are also dependent on profitability, RWA growth through FY24 and, of course, regulatory approval. Turning now to the breakdown of our total capital stack on Slide 15.

We've mentioned this in prior presentations, but it's well worth emphasising, compared to others in the market, we have a very straightforward capital structure. All of the Group's regulatory capital and MREL is issued by our Holding Company, VMUK PLC. It's fully eligible, so there are no issues around grandfathering. There's also no FX exposure in the capital structure, providing stability during periods of market volatility. We have excess Total Capital of 8.5 percent over our regulatory minimum, or a buffer of circa £2 billion. While we don't have a target level of AT1 or Tier 2 per se, we're always looking to manage our buffers in an efficient manner while maintaining headroom above regulatory optimum levels to support future growth, any potential headwinds or to reflect stress test outcomes.

Over the medium term then, our AT1 and Tier 2 stack will evolve as we manage buffers within the parameters I've just mentioned, primarily through redemptions and refinancing activity. We were really pleased to issue £350 million of new AT1 this year, while at the same time purchasing £377 million of our existing AT1 securities that are callable this December. And a point to note, we have subsequently announced our intention to redeem the remaining £73 million of those AT1 securities, which will reduce the AT1 headroom detailed on the slide by around 30 basis points on a pro forma basis.

As a reminder, our call policy remains unchanged. Future capital call decisions will be assessed on a broad economic basis, i.e. balancing factors including balance sheet movements, relative funding costs, current and future regulatory capital and MREL value, rating agency treatment, wholesale funding needs, and prevailing circumstances at the relevant time. And of course, calls are subject to PRA approval, with whom we have an active dialogue.

Turning to our MREL position. As I've already mentioned, our MREL ratio of 32.1 percent comfortably exceeds the 24.9 percent requirement as a percentage for RWAs. Again, we do aim to maintain a suitable buffer over our end state requirements to help better manage maturity risk. Our view on issuance guidance remains consistent. That is, we don't see a need for incremental capital issuance in FY23 over and above refinancing, and the timing of refinancing reflects a broad spectrum of factors, not least having stable market conditions.

With respect to our Holdco Senior issuance plans, again given our comfortable MREL resources, issuance will remain broadly limited to maintaining the current surplus to regulatory requirements. On MREL call decisions given the recent market focus, to confirm, our policy is exactly the same as it is for AT1 and Tier 2 securities.

Finally, it's worth noting that our Total Capital and MREL buffers would remain comfortable, even at our target operating CET1 range and fully optimised AT1 and Tier 2 buffers. Turning now to funding on Slide 16.

Our compelling deposit propositions supported by our Brighter Money Bundles and cashback offers, have helped grow our relationship customer base further, with relationship deposits now 53 percent of total deposits. This represents a 13 percent increase year on year and a 20 percent increase since 2019. A strong performance has helped maintain our cost of funds year on year, despite much higher policy rates. On TFSME, when the scheme closed in October of last year, we had drawn our full initial allowance of £7.2 billion, whilst repaying all of our TFS drawings. As with FLS and TFS, we plan to repay TFSME about one year ahead of contractual maturity and having almost £1 billion eligible for tenor extension to 6 to 10 years, helps reduce the cliff edge risk further.

We've also successfully accessed the wholesale markets in FY22 despite challenging markets, issuing a total of £2.5 billion of secured funding across our Lanark RMBS and Covered Bond programmes. Looking ahead, we will continue to target growth in our relationship deposits however we will also participate in the market for term deposit funding where it's advantageous to do so and continue to access the wholesale market to maintain a diverse funding base. In the latter regard, we expect to issue about £1.5 to £2.5 billion of secured funding in FY23 and that's subject to deposit flows and relative cost. We've made a good start with the successful £400 million Lanark trade in October, which reopened the Sterling Financials market post recent volatility.

Quickly on liquidity, the group's LCR of 138 percent continues to comfortably exceed both regulatory requirements and the more prudent internal risk appetite metrics, ensuring a substantial buffer in the event of any outflows.

Moving to Slide 17. We've set out here our structural hedge alongside our rate sensitivities and you can see on the left that our structural hedge has driven, and will continue to drive, sustainable NIM expansion, as 1/60th of the hedge rolls per month and is reinvested at current higher rates. The yield on the hedge increased from 30 basis points at the start of the year to around 70 basis points at the end; with reinvestment rates close to 4 percent at the end of the year, we expect the total yield will continue to expand. On the right, we set out our interest rate sensitivity using our standard pass-through assumptions. Year 1 impact reflects the benefit of reinvesting structural hedge at higher rates given we assume a parallel shift in rates. But there is also some additional benefit for 'lead-lag' as managed rate assets contractually reprice before managed rate liabilities. The benefit in Years 2 and 3 relate entirely to roll over the structural hedge which builds up meaningfully over time. In practice, we have benefited more significantly from recent rate rises as deposit pass through has been lower than assumed in this sensitivity. Our rate sensitivity remains positive in Year 1, even in the 25 basis points down scenario. This reflects our assumptions on product pricing from more elevated rates that are available today.

Finally, to Slide 18. So in concluding, let me quickly recap. Many of you will hear me say that we are in a category of one, between the large O-SII banks and the challengers or larger mutuals. I think positioning us in these markets can be tricky. I reflect back on the market feedback from yesterday. I was struck by the Financial Times description of us as "Mature Allure," which for me instantly conjures up some debonair eau de cologne that might have been made available by Yardley's. Does kind of help if your formative years were back in the 80s.

So look, bear with me here. There is a current ad running right now for a French car company, which says that allure is hard to define. So why don't I have a go given the headline! We often get challenged about our size within the UK context. Are we in a sort of Goldilocks predicament of trying to find out what is just about the right size? In a much broader context, I think our size does work for us because it allows us to adapt and flex to market conditions as needed. I think our performance across 2022 has demonstrated that we are beginning to find our operating rhythm, which sets us up well for a more challenging backdrop in 2023. We have a robust balance sheet across all metrics. CET1 has improved thanks to solid, underlying capital generation, and we remain very well provisioned with coverage above pre-pandemic levels and we have a credit supportive capital framework. Funding and liquidity are robust, and the combination of our ability to grow our relationship franchise while maintaining our presence in the wholesale markets reflects that.

Now, while we remain of the view that we can deliver targeted growth across all of our products, we will maintain our prudent risk appetite, and have further tightened underwriting criteria to reflect affordability stresses on customers. We are accelerating our digital capabilities to support targeted growth and expect further NIM expansion from a combination of higher rates and mix optimisation. And at the same time, we will continue to manage our costs to deliver our cost income ratio of circa 50 percent in FY23.

We've also managed the transition to being a Tier 1 bank reasonably well. The stress test results, the resolvability assessment outcome, and our performance over the last couple of years demonstrates that. So when it comes to thinking about our debt stack, we think there's an inherent strength to a simpler, less complex bank that has enough scale to operate competitively in the markets it likes, with a risk appetite it is comfortable with. Now we're very focused on managing down the overall difference to larger peers, and we remain consistent in our views that current levels are not reflective of where the fair value point is relative to those peers. What that differential should be is something for us to work out with all of you. I think what you heard today makes a pretty compelling investment proposition and supports further spread compression to peers.

So that concludes the presentation. Thank you for your attention. Will now open the line for questions. Jordan, please go ahead. Thank you.

Operator

We have no questions on the phone lines, so I'll hand back for any closing remarks.

Justin Fox

I appreciate that, Jordan. Hopefully then, the absence of questions means that we've covered the right things. I know we're going to be coming out to meet a number of London based accounts over the next two or three days. We're really looking forward to that. As ever, we're here to help. So if you have any feedback, please do come back to us. Thank you very much, everybody, for attending this morning.

[End of transcript]