# CYBG PLC Q1 Trading Update – Analyst Call

**Hosted By:** **Ian Smith (CFO) and Andrew Downey (Head of Investor Relations)**

**Coordinator**

Hello, and welcome to the CYBG PLC Analyst Call with Ian Smith, Chief Financial Officer. My name is Lisa, and I'm your event manager. During the presentation your lines will remain on listen only. I would like to advise all parties the conference is being recorded today for replay purposes. Now I'd like to hand over to Ian. Please go ahead.

**Ian Smith, CYBG PLC**

Thank you. Welcome to everybody here in the room and also on the phone. Thank you for joining the meeting. We wouldn't ordinarily do a call or a discussion for a trading update but there's a fair bit going on in here so we thought it might be helpful to at least have the opportunity to talk about some of the stuff in the release.

We're very pleased with the solid start to the year and really getting to grips with the combined business now. Clearly a trading update and hopefully fairly clearly set out but the focus is on key themes rather than detailed numbers. I think those important bits of news have generally been picked up over the last 24 hours, what's happening with volumes, margins, and also the increase in our synergy benefits from the transaction.

Just a quick word about synergies, we really see this as confirming our original plans. We continue to look for more opportunities to drive efficiencies out of the combination, but if you recall we talked a bit about a discount being applied to our synergy plans really in relation to the takeover code process, and this is really sort of saying that we've taken that discount off if you like and confirming our original plans.

We promised to get the impact of acquisition accounting out in the first quarter, and I thought I might just spend a couple of minutes talking about that before turning over to Q&A. For those of you on the phone, we'll make sure we give you the opportunity to come in.

In terms of the acquisition accounting, you're all familiar with how this works but really a couple of streams of work there. First of all, identifying any additional assets and liabilities that weren't recognised in the GAAP accounts and then fair valuing all of the assets and liabilities on the Virgin Money balance sheet on the acquisition balance sheet. There was very little by way of additional assets and liabilities. There was a small core deposit intangible principally, and there were really three material fair value items; TFS, and then the cards and mortgage books. Essentially, again as you know what we do is replace the amortised cost carrying amounts with the respective fair values. So for example with cards, we removed the balances, the EIR asset and the impairment provision, and we replaced that with the book measured at fair value including expected credit losses.

In aggregate, we've identified in amongst those net movements in relation to those three items around about 300 million or so of fair value assets that will unwind through the P&L over the remaining life of those assets and liabilities to which the fair value assets relate. I think it's fair to say we took a fairly conservative approach to measuring fair value. A higher fair value would have boosted day one capital but of course that then comes back again so we were wanting to keep things as steady as we could.

In terms of just how we expect the unwind to manifest through the income statements, we'll continue with our management view of the world, and above the line, if you like, we'll show the results of what's going in the outside world, so the customer business. As we've seen it's, I think, broadly market practice, we'll take the fair value unwind below the line.

In the statutory view of the world, that fair value unwind will be split between net interest income and impairment, just recognising, as I say, there's some allowance for expected credit losses in there. We'll continue to talk to a single set of KPIs. We have had a couple of people go, does that mean you're going to be talking about two net interest margins and things. We think the one that is most reflective of what's going on in the business is that one that relates to the management view in terms of net interest margin, because that reflects what's happening with our lending and our deposits and wholesale funding rather than say the impact of a notional fair value of TFS for example.

We've discussed our approach, both to setting the valuation and how we think about it with the auditors and the PRA. The numbers we put out yesterday are not audited. There are still 12 months in which we can refine those estimates, but we feel pretty good about the approach and the results.

I'll stop there. I think the trading summary should speak for itself. And we'll get to some questions.

**Rohith Chandra-Rajan, BAML**

Can I start with just clarifying your guidance and expectations around lending strategy for the rest of the year? So you've indicated slowing mortgages and robust SME and consumer. Mortgages obviously had a strong quarter. What are you expecting in terms of the volume growth for the rest of the year and how are you positioning both, given what was already sustained pricing pressure? Then the guidance on SME and unsecured has that been a continuation of the trends that we saw in Q1?

**Ian Smith**

Let me start with SME. That's a real focus for us at the moment. That piece of our businesses is going well, and there's lots ahead of it. We'd expect to see continued strong growth in terms of the current book. We'll also see some benefit from the RBS incentivised switching. Mostly that's about the acquisition of liabilities; we do expect to see some assets come on board with those customers. I'd expect to see that on current form similar to what we've seen in the first quarter and then perhaps a little bit stronger with the results from the RBS incentive switching.

Retail unsecured, the cards business continues to perform well. We had a slow quarter in terms of personal loans, which is the other piece of the unsecured, so I would expect to see that continuation of that trend broadly.

Mortgages are difficult to call. The reason it's difficult to call is because I think the market is quite difficult, and we will want to be pretty tactical in terms of the places in which we play. What we said in the release is that we would expect to see that full-year growth is somewhat lower than our first quarter. I suspect that because we're looking to prioritise managing margin and protecting margin over volume growth, it will be our quietest year for some time in terms of mortgages.

**Rohith Chandra-Rajan**

Do you still expect to take market share or does it depend on the market?

**Ian Smith**

It does depend on the market. Back in November we said slower growth but we would still expect to take market share. I think that remains the case, but we're not aggressively going after it.

**Rohith Chandra-Rajan**

Just to follow up on the SME side, I guess given the timing of the RBS process, I guess that will be back-end loaded and expect it come through in the remainder of Q3, Q4, any time before we start to see that?

**Ian Smith**

Yes. Certainly second half, incentivised switching starts two weeks on Monday. And originally we had planned on the basis, sorry—going into that switching piece in a bit more detail – but I suspect it will come up later anyway. Our original planning assumption based on what we've heard from RBS and the independent body was that customers would be released in tranches or invited to take part in tranches. The final decision was to open the offer to all of the in-scope customers immediately. We would expect I think switching probably to happen a little faster than originally planned, but it's definitely a second half thing and sort of first half of FY20.

**Robert Sage, Macquarie**

I have a question, just a follow-up question on the costs, because I hear what you're saying, you basically have been looking at the discounts you applied in the prospectus, etc., but now you've sort of had three months of inside the engine, as it were. Do you sense that there is actually quite a significant opportunity to go for? I do note that you're still saying it's a minimum of 150 by the end of year three.

The second question is really in terms of the additional 50, do you think—sorry 30 million I should say—is it just going to be back-end weighted? When do you think you might actually extract those savings or should we assume fairly evenly spread over the coming three years?

**Ian Smith**

Let me answer the question in reverse. Back at the 2.7 we talked about those synergy benefits accrued relatively evenly over the three years and we still expect the same and that's consistent with how we look at this which is removing the discount rather than going and finding new cost reductions.

In terms of whether there are further opportunities available, we've been pretty focused on costs over the last three years anyway and have done it before. I think the caution here is we're three months in. We've spent a lot of time validating plans and making sure we're comfortable with the original thinking behind this. We certainly are, as I said, looking for a bit more. I'm pretty confident that we'll be able to generate some strong benefits out of this.

The important thing is the synergy estimates at the moment are, I guess, relatively one dimensional, if you like. We talked about this during the Sustain cost reduction program that we had, which is we're eliminating duplicate branches and rationalising senior management, all those kinds of things. I think that the really interesting topic is what can we do and this will come out through our strategy at Capital Markets Day in June, what can we do with really putting these businesses together and that's something that probably takes a little more time to work out rather than a simple de-duplication.

**David Da Wei Wong, Credit Suisse**

Your NIM guidance for 2019, so the 165 to 170, how much wholesale funding pressure is there or potential wholesale funding pressure is there?

**Ian Smith**

It's certainly factoring in what we see today. The live example I guess is I think you'll be aware that we're out in the market at the moment with an RMBS transaction which is expected to price over the next couple of days. Indications there are certainly first of all pricing in line with our plans, but higher than we've seen say six months ago. The NIM guidance is based on what we see as the current conditions in the wholesale funding market so we're not assuming that somehow it all gets better in the summer.

**John Cronin, Goodbody**

Just to get back to your NIM guidance for FY19, 165 to 170 bps. Can I just confirm that does not incorporate any fair value adjustments on the cards book? And then more particularly on the 300 million of fair value, the unwind over three years, is there anything you can say about the split between NII and impairments and how that will sequence over the course of the full years or even half years? If you can provide as much granularity as possible on that it would be helpful.

Secondly, on net interest margin granularity again, is there anything you can give us in terms of numbers on front-book and present back-book pricing across mortgages and the cards at this juncture and anything on marginal costs of deposits etc.? Some detail there would be helpful.

**Ian Smith**

Okay. I'm going to disappoint you on some of that, John. Given that this is a trading update. First of all, the net interest margin guidance, just to be clear with how we think about it, is not confused by any fair value or other items in there. It is about what's happening out in customer land if you like. The fair value unwind, the bulk of it is net interest income as you would imagine. So for example the impairment provisions measured under IFRS 9, given the requirement to anticipate expected losses rather than incurred losses, is going to be pretty close to a measure of fair value if you like. The bulk of it relates to net interest income.

In terms of unwind profile, we said over three to five years. It isn't sort of a straight line or set in stone because it does depend on the way the customer balances unwind through that. We're not going to guide on a particular profile at the moment but it's important to understand—it is three to five years not three.

So I think what's important, in terms of what's going on in the outside world, there's nothing unexpected or unusual on the customer side otherwise we'd have called that out in the trading statement. I think the challenges in particular around competition in the mortgage markets are well documented. The area where we have been able to widen margins over the last couple of years, particularly as we see rate increases, has been on the SME side.

I think our deposit business is holding up pretty well. If you look back over the last five quarters or so, the sort of blended average cost of origination of savings and term deposits, the more expensive stuff, is relatively steady. While there is definitely pressure in that market, we've been good at managing mix and that kind of thing.

**John Cronin**

One follow-on to that is, can you give us what rate, the differentials between the average blend of deposit cost for Virgin Money versus the average blended deposit cost for CYBG in approximate terms? Is that something you can provide?

**Ian Smith**

I don't have it in front of me, but we'll look at whether we can provide that.

**Martin Leitgeb, Goldman Sachs**

Martin Leitgeb from Goldman. I also wanted to follow up on that funding question but maybe a bit broader. I was just wondering if you could comment on your funding strategy a little bit going forward in terms of funding mix. I think one year ago, or one-and-a-half years ago you had an offering of sort of £250 quid to get a current account. Is there more focus anywhere to generate more current accounts and have potentially more competitive offers on that side potentially? Or do you see the potential incoming volumes from RBS coming through - will that help you there?

**Ian Smith**

Okay. Thanks, Martin. Pre-Virgin Money we had a sort of funding pyramid, if you like, of current account balances, savings, and term deposits that was much more akin to what you see in the big banks with a strong contribution from the current account side. Clearly Virgin Money's funding base on net deposits was focused on savings and very good at it, really, really good at it, both in terms of getting products out to market much quicker than we can on the heritage CYBG side and really strong retention, so a good savings business but a different balance than in the combined group.

Our strategy at the time, and I don't want to sort of front-run too much of what we'll say in June on this where we'll really go into detail of how we expect to do it, is to look to increase, to almost restore that balance. The real focus for us is two-fold. First of all on business current accounts, both through what we do organically and we've had a really successful last three years in opening new business current accounts, and that broader SME deposit offering, that together with the RBS scheme we think is going to be a strong contribution to cost-effective funding.

On the PCA side, that's a conundrum that we and other banks have wrestled with for quite some time. Broadly speaking, customers tend to move for incentives. There are a bunch of people out there who when we do customer focus groups—we did some stuff this week which we're developing our retail proposition. Those customers, they were particularly on the more affluent side, were saying look I go to Nationwide, because I want the £500 for the five friends I introduce. So it's very clear that you have to offer something other than nice digital capability to get people to move their payroll accounts, and that's a critical thing.

We have some I think really good ideas about how we do that and in particular leveraging some of the partnerships we have with Virgin Group and other things and the opportunity to deploy our current account offer into what is a very engaged Virgin Money customer base. Those are the things we'll work on. I think the immediate opportunity is business current accounts and in particular RBS and over the medium term it's that personal current account offering, with very strong collaboration with the Virgin Group.

**David Lock, Deutsche**

David Lock from Deutsche, two please. Firstly, just on the NIM and in part it's being impacted by liquidity balances, you've been sort of building up and then you gave colour on Q1 and also how you're thinking about the rest of the year. Should we expect that you'll build up the liquidity again by that sort of figure, so I think the Q1 last year was impacted by that? Second just to clarify, the Aberdeen Standard Investments, the 20 million of costs that are sitting in there, part of that I guess is going to come out this year. That's in the 950 guidance but is it in the cost-to-income ratio guidance?

**Ian Smith**

On NIM and liquidity, I suspect things will over the next couple of years be a little less lumpy across a bigger balance sheet, but we're still somewhat exposed to the peaks and troughs of going out into the market for wholesale funding and then deploying that liquidity.

Spots are always difficult to judge, but if we look at average balances over the last four quarters or so, you've seen peaks and troughs both in terms of lending and liquid asset balances and a very steady growth in deposits. It's pretty much the same number every quarter in terms of what we're adding there. So you do, as you look at full-year guidance for net interest margin, you're able to smooth out those lumps and bumps, but we'll see them from time to time in the different quarters, David. I'm kind of just explaining the arithmetic to you which you can do yourself, but I'm not seeing anything unusual, and actually we're still continuing to carry higher levels of liquidity than our sort of ordinary risk appetite would indicate and that's not least because we're still feeling our way in terms of wholesale markets.

**Ian Gordon, Investec**

Ian Gordon, from Investec. I just have four random things really. Firstly, can you just confirm your NIM guidance is still based on no rate rises in current calendar year or actual year? Secondly, kind of following up on David's point, you've already signalled that you're going to be re-financing TFS well ahead of maturity. I hear your comments on driving this forward, clearly there's been plenty of drift previously and what I think I hear from RBS suggests it may take a bit longer than you suggested today. Would it be reasonable to assume that that might put back your TFS re-financing plans if that occurs? And the fact that you have got TFS to run off would seem to suggest that you've got quite a lot of really tight control over your liquidity balances over the coming couple of years. Thirdly, the 120 million you hope you'll be getting in a couple of weeks, I think you indicated last year that would probably be P&L neutral as it's applied. Is that still your guidance? Then fourthly, I don't think you took an RBS style 'Project Fear' charge in your impairment? Is that correct? If so, well done. And would you mind articulating why you didn't see it as necessary?

**Ian Smith**

Okay. Well that was five Ian, but anyway. Yes to confirm, our guidance is consistent in terms of rate rises. We're not expecting a rate rise in that NIM guidance for the financial year. We don't go out beyond 2019.

So TFS, yes we do have some flexibility. Our view has been that we would seek to get ahead of the game in terms of repayments and that will give us some breathing space if we choose to use it if as you say it's possible with the timing on the RBS stuff if that is different to what we planned, but I think that's the right thing to do.

Any grants that we're successful in winning under the capability and innovation fund , I would expect that to be P&L neutral in that the amortisation of the grant money should match the depreciation amortisation on the assets that we use it to create, so should be P&L neutral.

In terms of Brexit provisions, we've seen a little bit of impact, because IFRS 9 requires you to come up with different macro scenarios and things like that, that read through into our impairment provisions, but we've done nothing specific in terms of setting aside money in relation to Brexit concerns. We think we're adequately covered in terms of that stage one, stage two stuff under IFRS 9. Clearly circumstances can change, but we didn't feel the need to put any extra weight.

**Andrew Downey, CYBG PLC**

I'm just going to come back on David's question on Aberdeen Standard. In terms of 20 million this year, there's only a quarter that needs to be taken out because it's calendar Q2 which is our Q3, so it will be one quarter's reduction. That is embedded into the less than 950 guidance already.

**David Lock, Deutsche**

Sorry and the cost income ratios?

**Ian Smith**

The cost income ratios, yes.

**James Invine, Societe Generale**

Good morning. It's James Invine from Soc Gen . A couple of the other banks have said what their retention rate is on mortgages. I'm just wondering if you can give us those numbers, for the different brands. Then also what's your SVR strategy going forward, you've got different SVRs for the different brands? Are you going to level up, level down, and given I know they're reasonably close together, do you think you're going to do the SVR more broadly at its current level?

**Ian Smith**

Okay. Thanks, James. Both heritages, well it's actually three brands in there aren't there, so the heritage brands have broadly similar retention performance, top quartile. I don't have the figures in front of me now, and that has continued to be a strength of ours. SVR, it's difficult to tell. As we bring that mortgage business together and particularly with regard to the FSMA Part VII later this year that no doubt will harmonise, but at the moment we haven't settled on where we'll be.

**Ed Firth, KBW**

I have two questions. One is what's the fully loaded impact of IFRS 9 on your Core Equity Tier 1? I think you told us it was like immaterial, but that was just on a transitional basis. What's the fully loaded impact?

**Andrew Downey**

I'll come back to you on the number. We did put it in the full year release. I'll come back to you with that.

**Ed Firth**

The other question, the other broader question, in terms of the funding market, what is the sort of feedback you're getting for why your funding seems to be so expensive? If I look at you versus some of the others you have a huge core tier one, your business mix is not particularly absurd relative to everybody else and yet if I look particularly at your bail-inable debt it's yielding a pretty chunky yield. I'll be honest, you might want to get clear why that should be.

**Ian Smith**

Yes. It's good you think of us as not particularly absurd, I have kind of a slightly more warm feeling about our business! I can see why the funding costs might cause people worries, but I'm of the view, and people might disagree with me, that I think broadly speaking markets are pretty skittish at the moment, both equity and debt. I think there was a general movement in our own credit spreads and also the spreads on our own issuance when we did the tier 2 before Christmas. I don't expect that to hold that particular dislocation but it will come back over time.

I'm not seeing anything different about us. The feedback that we're getting certainly in RMBS, which is a slightly different market and things, we're vulnerable with the rest of the world. I'm not seeing any particularly different areas. The feedback is I think maybe people were pricing in with the tier 2 issuance that that was the new normal. It was a trade where we thought it was sensible to do it, but we definitely paid a premium for it in those markets.

**Andrew Downey**

Just to confirm on the IFRS 9 it was 21 million net of tax on a fully loaded basis, about 14 basis points. Obviously as we said we'll use the transitional relief over time.

**Ian Smith**

I'm sorry, just the other thing is that obviously regular conversations with the rating agencies, and they're all sort of very comfortable and very positive and because of things like capital strength and indeed the MREL plans because that makes rating agencies feel better, so I am looking at this as a bit of a dislocation.

**Aman Rakkar, Barclays**

Hi. It's Aman Rakkar from Barclays. Three questions please. Just one clarification, when you were talking about NIM, what exactly drove the tightening of the guidance range for this year? I understand that Virgin Money's book behaved a bit better than expected but what exactly does that mean? A bit more detail if possible.

The next two are, obviously this year's been an acute year with re-pricing pressure on the mortgages in particular at Virgin Money. When you looked at 2020 and you looked at the schedules to mature if you were to re-price it at current levels, is next year another significant year of re-pricing pressure from what you can see, assuming pricing doesn't move?

And the last one was just on your structural hedge, I was just wondering if you can give us any disclosure on that in terms of the size, the yield, the duration on that, and how you think about that going forward, particularly your involvement, given your push into current accounts going forward.

**Ian Smith**

I'll start at the structural hedge, we'll give you the full detail at the half year. There isn't a significant contribution from structural hedging on the Virgin Money side. What we have on CYBG is in the public domain, so there's nothing particular going on there.

Why did we tighten net interest margin guidance? A couple of things. One is when we spoke to you back in November we'd had the business for a couple of weeks, and inevitably you add together the two plans of the businesses and you've got less opportunity to think about what you might do with the benefits of the combination. The principle around this combination in terms of just what's better in terms of net interest margin is first of all I think some good tactical thinking in terms of what we'll do in mortgages that should help stabilise a little bit. And, actually, some good news on the deposit costs. So, I think there's a combination of both real-world improvements and just a tightening that says look we've got our arms around this now. We have a better crystal ball, if you like, than we had back in November.

In terms of mortgage re-pricing and what we expect to see next year, my definite sense is that we'll see quite a bit more stability next year because there's less churn. 2019 is a big refinancing year, so we'd certainly expect to see less pressure from that into 2020.

**Aman Rakkar**

On the deposits point then, were you able to squeeze the deposit rates lower at Virgin Money or was there a benefit into the rate rise and you were able to just expand deposit margins a bit better than before?

**Ian Smith**

More the latter, but it's at the margin but we've just been able to price a bit more smartly. It's the one area of our business where we've been able to think about which brand we use to gather deposits for the whole group, but we were ahead of the game in that respect.

**Rob Noble, RBC**

It's Rob Noble from RBC. What's the front book ROE differential between SME lending and mortgage lending at the moment? How much wider do the mortgage spreads have to be to change your mind that protecting margins was worth it?

**Ian Smith**

We'll talk a bit more about that in the summer; it's a trading update today.

**Ian Gordon, Investec**

Well a bonus question please, Ian at Investec. On EIR you told us previously that you were going to a take a fairly brutal write-down, or conservative write-down in your parlance. The last time we saw any behavioural data from Virgin, I would put it to you that the performance was significantly better than market expectations. So is your decision simple, prudent conservatism or have you actually seen any material shift in those behavioural trends?

**Ian Smith**

Thank you. Our decision is based on wanting to be a bit more prudent, a bit less exposed to volatility, because you're right Virgin Money has got plenty of data to support longer lives. There's a strong indication that a good chunk of the customers stay around for up to ten years. Virgin Money were up to seven, and I think suffered a little bit of being regarded as outside the pack. To some extent that's quite a bind because you do what you see in your books and the data supported Virgin Money's approach.

I think the less you're required to go out and estimate future cash flows, the less exposure you have to volatility and therefore scrutiny and challenge and quite frankly risk in the book, so it's much more driven by, we have the opportunity to do this and to reset on acquisition in a way that it was quite hard for Virgin Money solo to do.

**Ian Gordon**

Certainly on timings if Virgin were right, you'll see the cash coming through.

**Ian Smith**

Yes, exactly.

**Chamsol Yoon, UBS**

This is Charmsol from UBS. One is do you have any remaining expensive time deposits that you can reprice? Secondly, on the loan-to-deposit ratio I think that Q1 was 117%. Does that mean that you will have to recalibrate this?

**Ian Smith**

While there are still opportunities to not refinance expensive deposits, I don't expect that to be material. Then in terms of loan-to-deposit ratio, I don't see that growing. As I said, the deposits engine is performing strongly and consistently quarter to quarter and we're guiding to lower loan growth in mortgages, you'd expect to see that LDR come down.

**Chris Cant, Autonomous**

If I could just come back on the comment you made about P&L neutrality in regards to any innovation money. [indiscernible] You were talking about P&L neutrality. How do you expect that to be reflected in terms of day one capital? Does the funding get recognised as an injection of equity or will it be recognised over time as you actually spend that on assets such as software in which case it won't necessarily be a capital uplift [indiscernible]? That's the second question.

**Ian Smith**

Hang on to your second question. I'll do that one. Most people in this room are far too young to remember what used to happen with accounting for grants under SSAP or whatever it was in the good old days, but broadly speaking this is capital and TNAV neutral. When we're awarded the cash, we would set up a deferred income balance I guess and it's a credit to the balance sheet. That credit to the balance sheet is then released as we depreciate the assets that we build. That's how you get both the P&L neutrality, and it's not going to be treated like a capital injection.

**Chris Cant**

But just to be absolutely crystal clear on that, if you are investing in intangibles, you can't really depreciate the asset [indiscernible], if you investing that into PPE and the branch network [indiscernible].

**Ian Smith**

I see your point. I'm not expecting, or rather our plans are not for significant investments in PPE. Definitely some expense on people capability and on sort of digital and other technology.

**Chris Cant**

Okay. Great. If I could ask one other one on your fair value unwind. I think in your first quarter you gave £161million for exceptionals and of this number you specifically explained that there was about £10 or £11 million that wasn't explained explicitly. In terms of this fair value unwind then, it wasn't very much, in the first quarter. I'm a bit surprised it's not higher given the 300 million. I'd expect some front-loading if anything on that one. I guess you're saying three to five years for unwind but at the end of the day, all of the assets, whatever their life are currently seeing fair value unwinds and I'd expect that to be a diminishing trend rather than an increasing trend. Was that part of the 161 or is this something separate to that exceptional cost?

**Ian Smith**

First of all the reason we specifically called out what was in the 161 was I suspect that people were not expecting that one. You're right, the impact of the fair value unwind in the first quarter, I see a sort of lower burden in the first year anyway; it was not significant. The pace at which you see the unwind is driven by a couple of things. One, you'll see the income or the net interest income piece unwind slower than the credit losses and really the sort of small impact on that first quarter is a result of that.

**Ed Henning, CLSA**

Hi, Ian. Thank you. A couple of questions from me. Firstly, the SME front-book margin just at the moment is there any adverse trends or positive trends there?

Secondly, you obviously haven't mentioned any of your other FY19 targets. I know the water's been a bit muddied with the Virgin acquisition. Are you walking away from any of those and especially the cost to income, where previously you'd kind of guided towards the bottom end of the range?

And just lastly, is it still your intention at the Capital Markets Day to update on your capital plans?

**Ian Smith**

Thanks, Ed. Good evening. Nothing untoward on SME margin, pretty steady, but a couple of basis points of improvement, but I sort of call that steady and certainly nothing adverse in terms of margin trends there, so a really good story for us. It's a great balance to have to our business in a difficult mortgage market.

No change to the FY19 targets certainly not walking away. To the extent that we have changes in guidance, we've explicitly called those out in the trading update.

Certainly it's absolutely our intention at Capital Markets Day to talk about that capital trajectory and how we think about it. Again, the basis for that is that we're currently working through an ICAAP for the combined group, and we'll be working with the PRA to determine capital requirements as a result of that.

**Ed Henning**

Okay. Just one more question while I've got you, you talked about the loan loss charge obviously trending up and there's a little bit Brexit-related to the accounting standard. Can you just talk about are you seeing any issues in your book in any particular geography or segment?

**Ian Smith**

Not so far in terms of issues in the book. I think it's performing in line with expectations. The increase, first of all, you have to be a wee bit careful with annualised figures based on a quarter particularly in relation to things like recoveries and write-backs and stuff. Broadly speaking, 22 basis points that's in line with where people thought we would be, so there's nothing untoward there. But the reason it's higher on an annualised basis than FY18, there's two things we talked about in the release.

First of all, SME was very low compared to historical norms in FY18. I think we scarcely saw a specific provision in FY18, so our sort of 60 to 70 basis points is where we expect things to be. This year is trending in that direction but nothing extraordinary or untoward in that.

We always said that one of the places you'd see the impact of IFRS 9 was in unsecured. Broadly speaking, in mortgages, IFRS 9 doesn't make a difference. SME a little bit in terms of 12-month ECL, but really specific provisions is what it's all about in SME, and there's no changes in IFRS 9 there.

What you have with the unsecured portfolio, first of all you reflect the trends you're seeing and then one of the comments we make is about portfolio mix. So one of the areas that our cards book grew over 2018 was in the Virgin Atlantic initiative where we signed up 100,000 customers, affluent customers, engaged customers who spend on their cards rather than borrow but have high limits and under IFRS 9 you provide against limits rather than exposures. That's the reason for a little bit of uptick on the unsecured side.

**Ed Henning**

Okay. Thank you.

**Gary Greenwood, Shore Capital**

Hi. Thanks for taking the question. I have a couple. The first was just on the fair value unwind. I was just wondering is this just accounting jiggery-pokery that we can largely ignore or will it have a sort of real capital impact as it comes through?

Then the second one was I think you mentioned earlier that you haven't taken any sort of Brexit-related impairment charges yet. I was just wondering how you think about the various Brexit scenarios. Do you factor in probabilities of the different outcomes in your thinking or are you sort of ignoring a no-deal potential at the moment in your provisioning?

**Ian Smith**

Good morning, Gary. Look, given that this is going to be a published transcript I couldn't possibly say that there was accounting jiggery-pokery going on, but it does have capital impact, Gary. As it unwinds through the P&L, it absorbs capital. And as I said earlier on the call, we were relatively conservative in our approach to valuation, because the other side of this is what's in day one and a higher fair value would have boosted day one capital but then it would have unwound in due course, so it does impact capital.

It is sort of accounting stuff. The one that you sort of scratch your head a bit is the TFS. I mean it's easy to understand the stuff on the asset side. So, we'll live with it and work with it but it bleeds into capital over time.

**Gary Greenwood**

Just a question on that is it basically one for one, i.e. the 300 million just flows straight through over time?

**Ian Smith**

Yes. On Brexit, there's nothing specific in there in terms of a Brexit-related charge, but one of the things that feeds into IFRS models is macroeconomic scenarios. We use a base case downside and slightly better side, if you like, in order to determine macro expectations, and that drives your 12-months expected credit losses particularly on the unsecured portfolio.

Our downside is a pretty horrible outcome on Brexit through that, so inevitably it does bake in some elements of pessimism or caution in relation to Brexit, but it's not as if we just stashed some impairment provision because we're a bit worried about Brexit.

**Gary Greenwood**

Can you reveal roughly what probability you applied to that downside scenario or how much weighting you give?

**Ian Smith**

It's a reasonable weighting; it's not negligible. I can't remember off the top of my head, but it's a meaningful probability.

But again, Gary, I want to be clear on this. I don't want anyone to take away that we've stashed away a substantial provision for Brexit. It's absolutely right that those macro scenarios, including a severe downside, have had an impact on our estimate of expected credit losses across the portfolio, but we haven't done an RBS and taken 100 million of Brexit-related provisions.

**Gary Greenwood**

Understood. Thank you.

**Fahed Kunwar, Redburn**

Hi. Fahed Kunwar from Redburn, just a couple of questions. Over the course of the rest of the year how exposed is that Virgin Money margin to funding pressures? Is it margin pressures that we see over the course of the year, or should we think about the pressure being all about the mortgage spread?

The second question is on MREL. I think we can all figure out what the Tier 2 costs at the current yields, but what are the costs of the funding you're hoping to replace over the next three years if you raise that 2.5 billion? You must have quite clear visibility on maturities of that funding that you could switch out.

**Ian Smith**

Sure. First of all, the wholesale funding plans for the group have all been baked into NIM guidance. I can't really say more than that. I suppose coming back to a couple points that others made, there is no expectation in that that the world gets better. I think that more costly MREL funding is here to stay for all of us, so baked into the NIM guidance.

**Fahed Kunwar**

There were caveats to the NIM to say broadly stable funding environment, so I assume that means the mortgage market doesn't get ridiculous. And I guess the question is more what do you mean by ridiculous? Are you talking about the mortgage spreads falling a lot or is it funding margins increasing a lot? What are you more geared to in that caveat I guess?

**Ian Smith**

We took a bit of pain, as you well know, in November with our net interest margin guidance, and a lot of that was driven by what we were seeing in both mortgage books. We took a pretty realistic view of the world there rather than assuming things will get better. I think our assumption is we're probably more sensitive to mortgage market than we are to wholesale funding costs. That being said, I think we're taking a pretty balanced view of what we expect to happen in the mortgage market in the next six months or so.

**Fahed Kunwar**

Sorry, on the MREL, the costs of replacing the MREL, the replacement cost of funding and I wasn't sure if for the next three years you have any sense of what funding is rolling off?

**Ian Smith**

I guess I'd point you to we're relatively clear about what we think our MREL requirement is, and we'll build to 2.5 billion over the next few years. You've seen the pricing of the stuff we're doing at the moment. TFS is at 75 basis points.

I do think though—let me sort of qualify that. We'd always said our TFS refinancing strategy in both heritages was a mix of retail and wholesale, so it isn't that it's entirely sort of one for one. At 75 basis points compared to our all-in funding costs of 100 basis points, there's not a big bridge there.

**Fahed Kunwar**

But there's no big expensive wholesale funding balances. There's nothing expensive there that you can roll off to replace with the MREL?

**Ian Smith**

No. I have a lovely expensive covered bond on the CYBG side but I'm stuck with it.

**John Cronin, Goodbody**

Just one final one following Chris's question on the fair value adjustment. As you work through 2019, clearly it should be instructive in terms of how customer behaviour plays out in our current book. Is it fair to say that at year-end you will look at the quantum of that fair value adjustment and you would recalibrate it down where the experience is pretty positive or is that too early? How are you thinking about it in that context?

**Ian Smith**

I would be surprised if we revisit it because we've done quite a lot of work on it, but I wouldn't rule it out. I don't expect to revisit it.

**Chris Cant, Autonomous**

If I could just quickly come back around on costs, just looking at the guidance and thinking about the comments about how 120 is becoming 150, it's really about the discount unwinding. The CYBG cost base last year was 635 and you told us there's a bit more to come on Sustain run rate saves so maybe another 10 million on top of that figure as a run rate in terms of what you are hoping to achieve. Then the Virgin cost base came in a bit higher than what I was expecting at 363 on Virgin Money underlying, but you used to talk about 350 as your benchmark when you announced the bid and also at full year results.

If you're looking to take 150 out of that based on a roll-forward of both things together say that sustain is twenty million then getting down to about 815 target run rate for 2022 seems achievable? So is the math that I just laid out there totally wrong or is there also potential for higher costs?

**Ian Smith**

I recognise your maths much more than I do a consensus.

**Andrew Downey**

I think one of the things that we very deliberately talked about in the Q1 trading statement was that the cost synergies are net of cost inflation and I think having seen the consensus that some had inflation in there as well. So that was another point we were quite clear on in the trading statement.

**Chris Cant**

In terms of the Sustain, is it a ten or twenty million additional run rate savings you gave us? Then in the Virgin cost base, so you have the 363 you've given us for the relevant financial period but you were always benchmarking 350 historically. So, is the 150 coming off the 350 or the 363?

**Ian Smith**

First of all in terms of Sustain, because we closed it and said it's now all about the integration, the benefits of the remaining things we did towards the end of the prior period, we're closer to 10 million I think. And in terms of where the start point is, the 985 was always the starting point we had in our head. I think this was already said, but feel free if you want to improve your synergy estimate so that we're coming down from that sort of 985 planning basis.

**Ed Firth, KBW**

I just have a real quick one. To just think about the credit cards now, as I understand it your accounting is using an EIR rate of 5%. Is that right and are you saying you are now in line with peers? Is that correct?

**Ian Smith**

So we said we brought the assumptions back into line. The most critical thing is a five-year life and that on new business drives a 5% EIR. The overall cash rate on the book is better now. Remember we have about a third of this book now that is effectively cash. It either has never been subject to a promotional offer or there's a chunk of it that is out of the promotional period and therefore past that peak risk of refinancing and also earning cash.

**Ed Firth**

I suppose that's coming to my question, too. How should we think about it now? You're not doing aggressive promotional rates in the same way as you were before. I think that's right.

**Ian Smith**

That's correct.

**Ed Firth**

If the 7% that Virgin used in the past is broadly correct, and I accept it was aggressive, but should we then expect as the other two-thirds of the book matures you effectively get a pick up on that?

**Ian Smith**

Over time, yes. The important thing is to think about how does this work in our hands. It's very different to be a solo position where they were managing or I guess dealing with the decisions that were made before; we can take a fresh look at it. You have a seasoned book where a third of it is already at cash. You have a good chunk of it moving into cash and post-promos over the next 12 to 18 months. So that enriches the rate and means that broadly speaking, that element of the book that is newer and EIR accounted, first of all is on a lower rate and is a much smaller part of the book.

**Ed Firth**

Do you have a sense of when should we imagine that reaches a sort of plateau, so like a two years out type of thing? I guess this year within your guidance you have an uptick in credit card book within that, so I guess that will continue to 2020 as well.

**Ian Smith**

Yes. I think so.

**Andrew Downey**

I think we're done with questions in the room. I'll just check any final questions on the call? Otherwise we'll just do cover closing remarks Ian has.

**Ian Smith**

Okay. Thanks for coming today. We covered a lot of ground. I hope you found it helpful. Just to close, we're very focused on getting the best out of this combination. Despite some of the current turmoil we're as confident as we ever were in the prospects. An encouraging start and plenty of self-help opportunities for things like costs, RBS and all sorts of other things.

We're looking forward to the launch of the RBS alternative remedies package. We'll hear in a couple weeks' time about the capability and the innovation fund, and as I say switching opens two weeks on Monday. We'll see you again at interims and Capital Markets Day in June.

# END OF CALL