Virgin Money
Q3 2017 Trading Update

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Introductory remarks

Good morning, everyone. I am really pleased that we can today report another strong quarter for Virgin Money. It has been a quarter that has seen our profitability and our return on equity make continued progress, and it is a sustainable set of results that has been supported by really strong customer demand, consistent consumer behaviour and an improved Net Promoter Score.

Lending activity

So, let me first turn to our lending activity. Growth in our cards and mortgage businesses has continued in line with our previous guidance, and we have been able to maintain our very strict credit risk appetite throughout the quarter.

Credit cards

The credit card business continues to perform exactly in line with plan, and customer behaviours continue to match all of our expectations. We remain on track to achieve £3 billion worth of prime credit card balances by the end of this year.

During the period, competition in the credit card markets has eased slightly. Many providers have shortened their 0% interest-free period for balance transfers, and the strength of our brand means that we can be placed, on average, in fifth position in the pricing tables while still managing the volume and quality of our business well within our risk appetite.

Mortgages

In contrast, the mortgage market has become more competitive during the quarter. In particular, we have noted that competitors have been slow to reprice their mortgage offers, despite recent increases in swap rates, although we have seen some movement from big competitors as well as small to reprice their mortgage products upwards in recent days.

During this period, we have been able to manage the financial impact on Virgin Money by holding price in key market segments, and so manage our overall mortgage volumes. As a result, we expect to end the year with our mortgage balances of around £33.5 billion, right in line with consensus.

Retail deposits

We have been especially pleased with progress on retail deposits. These have grown by 7% in the year to date, well in excess of the 1.6% growth seen in the market over the same period. So, we now have over £30 billion worth of stable retail deposit balances. We have achieved all this growth and, at the same time, reduced our weighted average cost of funds, which stood at 98 basis points at the half year and was 88 basis points in the third quarter.

Wholesale success

Our retail deposit success has been augmented by our activity in the wholesale markets. You will probably know that we raised £750 million worth of RMBS funding during the quarter, and we used this temporarily to repay £750 million of outstanding TFS. We do plan to redraw this amount in the coming weeks, but it has helped us to extend our refinancing profile.

Performance and capital ratios

Taken together, this commercial success has allowed us to maintain guidance for a flat banking NIM of 172 basis points for the full year, despite the competitive pressures that I referred to earlier. We remain confident of achieving the lower end of our expected range of 157–160 basis points of total NIM for 2017, which is exactly what we said with our half-year results in July.

Our other income lines have performed as we expected, and we are still expecting those lines to produce about 10% of our total income for the full year.

We have continued to focus on costs, and the cost:income ratio continued to improve further in the third quarter. That means we are confident of achieving our guided 50% exit rate for the cost:income ratio this year.

Our asset quality remains exceptionally strong. Cost of risk remained flat on the first half of 2017 and, to be clear, we see absolutely no evidence of any deterioration in arrears performance on either our mortgage or our cards books. Indeed, we continue to expect our through-the-cycle cost of risk performance to be better than the average for the industry, as a result of our continuing and robust focus on underwriting standards and customer affordability.

We are pleased with our strong capital position and our low-risk business model. Our capital ratios position us well above all regulatory requirements, and allow us room for growth. Looking forward, we expect to end the year with a CET1 ratio of around 13.5%.

Summary

In summary, the quarter has benefited from strong management, resilient consumer behaviour and continued economic stability, especially in the housing market. We note market expectations of an increase in the Bank base rate next month. Actually, we would expect this to be positive for our business, although just how positive depends of course on customer and competitor behaviour at the time.

So overall, our business continues to perform very strongly and in line with our expectations. During the quarter, as a management team we have also been focused on the development of both our core strategy and the build of our digital bank. As you know, I think, we will be holding an Investor Day in London on 16th November 2017, and much look forward to updating everyone on our exciting plans there. That will include our 2018 financial outlook, and so we are not guiding to next year today. So, we very much hope to see you at the 16th November 2017 event, and in the meantime, Peter, Hugh and I look forward to taking your questions on this call.

Q&A

Robert Noble (RBC Capital Markets): Good morning. Just a couple of questions from me. How flexible is your 12% capital target? If in the stress test, the Bank of England asks you to hold more capital against your credit cards, do you think that can be absorbed within your capital guidance as well?

Secondly, on issuance; I know you do not have any new AT1 issuance plans, but under what circumstances might that change? Then the same for – if you could update us on your securitisation plans for the future.

Finally, on the loan-to-deposit ratio, it is up to 119%. I think you previously said 120% was your limit, so should we expect deposit growth to pick up in the second half? Or are you happy to breach 120%? Or is it a constraint on growth at all? Thank you.

Jayne-Anne Gadhia: Thank you very much, Rob. So, I guess I should answer straight away your question about the 12% capital target. You refer to it as a target; we have always said it is a floor. So, in our plans we do not get to 12%, to be very clear; we are always above that. That 12% floor contains very significant buffers to our regulatory minimums, and so to the extent that there were any new add-ons required, and we have had no notification of that at all at this point – we have a new ICAAP to go through before the end of the year – but we remain very confident that those buffers are more than adequate to cover anything that might come out of that. From our perspective at the moment, it is very much very deep capital buffers, very strong capital position and no expectations of that changing at all, certainly not in the near future.

Peter, would you like to pick up on the other three points, please?

Peter Bole: I can do that. Regarding issuance of AT1, there is nothing in our plans at the moment on issuance of AT1. I guess that would change if we saw growth opportunity in the first place, but at the moment it is not in the plan.

We expect securitisation plans to be a regular issue under each of our programmes going forward. So, RMBS, we have a covered bond programme registered now; we do also have an MTN programme which will be used for MREL. So, across those programmes, we would expect to be an issuer each year.

Then the final question around the loan-to-deposit ratio, it is at around 119% as you rightly point out. We still think 120% is the right top end for the business, we have said that consistently. As TFS is repaid in the coming years, we would expect that to come back down. However, at the moment we see 120% as the upper end of what we want to tolerate. We do not see that as a constraint in growth; as Jayne-Anne has highlighted, the deposit franchise continues to flourish. We have seen good growth in that and the combination of that and the various streams of wholesale activity that we have. We feel pretty good about the funding base.

Robert Noble: All right, thank you very much.

Ian Gordon (Investec): Good morning. Could I have two please? Firstly, on credit performance within the cards portfolio, I think the further improvement in the cost of risk in the third quarter was better than the market was looking for. So, could you just within that, give a comment on how maturing balances are performing, i.e. balances coming off 0% deals? Are they behaving, from a credit perspective, better than you expected?

Secondly, just a point of clarification: does your original TFS guidance for usage by the end of the scheme next February still hold good? Thanks.

Jayne-Anne Gadhia: Thank you very much, Ian. So, the answer on TFS is yes, we are still expecting that to be between £5–6 billion by the time the scheme is closed. Hugh, would you like to talk please about the performance on cards?

Hugh Chater: Absolutely. Good morning, Ian. So, in terms of cost of risk on cards, I think what we are seeing is the benefit of the tightening which we have talked to you about previously flowing through to our cost of risk. So, it is not just that the maturing balances coming off promo are performing better, but generally across the portfolio we are seeing the benefit of that tightening that we talked about. Just to be clear, we have not further tightened since we last updated the market, but I think you are beginning to see now the evidence of what we have talked about in terms of the very high quality of the book that we have acquired, and then the high quality of the balances as they stay with us post the promotional period.

Ian Gordon: That is great. Thank you.

Edward Firth (KBW): Morning, all. I guess one of the biggest themes kicking around the sector at the moment is consolidation. I am sure, like all management teams, you think your stock price is too cheap, so I just wondered where you see yourself fitting in that landscape, and what thoughts you have about how that might play out in the next 12, 18 months?

Jayne-Anne Gadhia: Thank you, Ed, and good morning. I guess we have all sorts of thoughts when you ask a question like that. The key is that for us, we remain really confident about our organic plans. We said that from 2014 when we listed the business, we were very clear on how we expected the business to develop, and hopefully you will have seen that we have delivered everything that we said we would, despite the fact that the external environment has been very different to that expectation. When we come forward to the market on 16th November with our plans around our future, particularly including the digital bank and the fact that that is going to enable us, we believe, to raise significant balances in the current account market at low cost to really transform both our existing franchise and to enable us to develop for the future, then from our perspective our position is market-leading, low cost and one of growth in a digital world. That is absolutely what we, the management team and the board are focused on.

Edward Firth: Great. Thanks so much.

Nick Baker (Goldman Sachs): Good morning, thanks for taking my questions. Just two quickly from me. I just wanted to pick up on something you said around mortgage balances in your opening remarks, on the £33.5 billion that consensus has in. It would imply a slightly slower net lending growth in the fourth quarter; I was keen to understand if that is how you are thinking about it and, if so, what the drivers are behind that?

Secondly, on the existing deposit base, we have spoken before about the potential to reprice that. Do you have any incremental reprices currently in the works and planned for the fourth quarter? Any commentary around that would be helpful.

Jayne-Anne Gadhia: Okay, thank you very much, Nick. On mortgage balances, what we have always said, do not forget, is that we decide upfront how much absolute volume we expect to take, we gear up our operating centre in order to take it and then we deliver that sort of committed volume. We actually think that the mortgage market might be a little stronger than we expected at the beginning of the year as it ends, and that is good for everybody, I think. So, from our perspective, will we get to 3.5% of a bigger market than we thought about? Well, we could have done if we had decided to price down in the way that some competitors have. We have preferred to stick to our volume guidance and, as a consequence, to manage our margins. That has worked really well for us, so we will come in exactly where we guided and where we expected in terms of mortgage balances. We have done that every year. We have been able to do that despite the competition in the market by maintaining our spreads as strongly as we possibly can. We think that really sets us up well for the future, particularly now that we can see some more rational behaviour ticking into our competitor pricing, particularly the big banks like HSBC and Barclays, who are now starting to price up off the increasing swap curve. So, it is all about doing what we said we would do with volume, but managing our spreads accordingly, and we are pleased with the way in which we have done that both in terms of how we end this year and what that means for our momentum into next year.

As far as deposits are concerned, the implication of your question I think is exactly right, and we are actually going through a deposit reprice at this point in time. We still continue to be priced competitively from a customer's perspective, there is room for us to be able to do that. We will be repricing about £5 billion worth of the book, or just a little bit lower than that as Peter is telling me. However, there is certainly still room to go, and I think you can see that we have been able to achieve the management of our cost of funds just by the reduction in the weighted average cost of funding that we have been able to report for the quarter.

Nick Baker: Great, thanks. That is very helpful. Can I just follow up quickly on the mortgage side of things? You are obviously very careful in how you manage that margin. Is there any shift, or have you had any shift in the subsegments that you focused on through the last quarter or two, given the changes in pricing we have seen?

Jayne-Anne Gadhia: Hugh?

Hugh Chater: Thank you, Jayne-Anne. Essentially, we have been following the path that we talked about at half year. So, no material shift, but the investments that we have made and that we talked about in the half-year in some of the subsegment areas, such as first-time buyer, new-build and shared ownership, they are starting to come through now and they are definitely assisting as we manage the spread across the whole book.

Nick Baker: Thank you, that is helpful.

Rohith Chandra-Rajan (Barclays): Hi. Good morning, everybody. I have a couple please, if I could. One is just coming back to credit cards. I think you commented earlier about customer behaviour across all areas being in line with your expectations; I wonder if you could talk about your early experience on stick rates from the 0% balance transfers that will have started maturing in the last quarter or two? So, that was the first one.

The second one, on the mortgage market outlook. One of your major competitors, you mentioned in one your earlier comments, is pushing into the intermediary market where they have historically been underweight. That is clearly where you do particularly well; I am just wondering how disruptive you think that may or may not be? Thank you.

Jayne-Anne Gadhia: Okay. Well, if I start with HSBC and the intermediary market: from our perspective, of course, we are definitely not complacent in any way. However, that particular competitor has been planning to come into the market for a number of years. As you will have seen probably, Rohith, we have continued to build our relationships with intermediaries. Our Net Promoter Score is up to, I think, 61 in the intermediary marketplace. Somebody dropped me a note this morning and said something like, 'It would not just be banks that would be thrilled with that; other retail companies would be thrilled with that.' That is important. Our brand, our relationships and our service quality are what really give us the strength of franchise that we have in the intermediary market, and we think that serves us extremely well as competition hots up through new entrants in that way. So, as I say, never complacent, but the fact that we have built such strength of franchise there we think is a very, very positive thing.

As far as the early experience of stick rates on cards is concerned, you are right to say that some of the earlier cohorts are now starting to come to maturity. We are in a place where we are very pleased that our expectations and performance are largely in line. As you can imagine, there are some ups and there are some downs, but the financial consequences of that are immaterial, which is obviously extremely helpful. Peter, you look as though you would like to add to that?

Peter Bole: The only point I was going to add is at this point, the reality is it is pretty small vintages that have come through on particular card constructs. So, it is a very small set of tranches that have gone through that post-promotion period. The comment is right in that they are in line with our expectations in all material respects.

Rohith Chandra-Rajan: Thanks for that clarification. When do you think you will have a better data set to work with? I mean, probably not Q4 by the sounds of things, so is it as we go through 2018 that you will really get a better idea of what the broader stick rate is on those maturing balances?

Peter Bole: Yeah, I think that is right. There are larger cohorts to come through in the first half of next year, and then clearly it builds from there.

Rohith Chandra-Rajan: Okay. Thank you very much.

Guy Stebbings (Exane BNP Paribas): Good morning. Can I circle back to the earlier question on capital ratios and the stress test? Is part of your confidence on the capital ratio of 12% being more than adequate that in addition to already capturing a good buffer, an expectation that your card book will perform much better than, say, the average stress losses for cards that the Bank of England announced a few weeks ago?

Related to this, the FPC stated it wanted banks to consider these stress-level losses when setting overall lending plans; does that impact your own plans at all, or captured into guidance already?

Jayne-Anne Gadhia: Thank you, Guy, good morning. I will ask Peter to colour in the detail, but we stress our card book on an extreme basis, and because of the quality of the book, we do not get to the 25% level that the big banks get to. We are materially better than that, and so part of the confidence, of course, comes from that analysis. So, Peter, did you want to just add more to that?

Peter Bole: To be honest, I probably would not add much more. The point is that we would expect the stress test to reflect the underlying credit quality, and given all the analysis we have done on that, it does support a better-than-average credit quality. When we stress it, as Jayne-Anne says, it comes out with losses that are considerably below that market average that has been closer to 25%.

Jayne-Anne Gadhia: Correct me if I am wrong, Peter, but I think Marian said yesterday that we are stressing it at a 12.5% rate unemployment; to be clear, this is a severe and significant stress, and we will still come out at much better than that 25% position.

Peter Bole: Yes. It is probably worth just noting, Guy, as well that in terms of the stress test, it is very much treated as part of the BAU activity, so we will go through it in the ordinary course as part of the ICAAP process which, as Jayne-Anne said, we are just polishing off in the last couple of months of this year. We will be going through it with the regulator in the early part of next year, but it is very much within the realm of a business-as-usual-type activity.

Guy Stebbings: Okay, thanks. That is very helpful.

David Wong (Credit Suisse): Good morning, all. Three questions, if I may. Firstly, on the margin outlook, you are talking about probably sounding like a more constructive picture on the asset margin side, in terms of the mortgage pricing. Obviously, you have also referenced the competition in credit cards being a bit less, and you talked about the room on the deposit pricing. I am just interested to know: do you see upside risk, then, to your NIM guidance for the full year 2017? I am just wondering why one should not expect a bit of upside risk to that? That is the first question.

The second question would be back to credit cards. You very helpfully disclosed the P&L EIR accrual and the balance sheet adjustment at the H1 2017 results, those were £42 million and £124 million respectively; could I ask if you could update us on where those numbers have gone to?

The third question, just to quickly clarify on the capital ratios. You talked about the fact that you do not get to below 12% in your capital plans. Could I just double-check: how does the IFRS 9 adjustment play into that? Does that basically fully load the IFRS 9 adjustment, or do you build in some transitional benefit there? Many thanks.

Jayne-Anne Gadhia: Thank you, David. The easy question – well, they are all quite straightforward, but I will go bottom to top. On the capital ratios, we do assume a fully loaded IFRS 9 position in the comment that we have just made, so hopefully that is straightforward.

We are not putting figures on the EIR accrual at this point in time. However, I would probably reiterate what we said at the half year, which is that we would see that the position in 2017 is the biggest EIR position. We see that coming down from here on in, after we have ended this year. So, hopefully that is helpful, too.

As far as margin outlook is concerned, we are continuing to guide to the lower end of our range of 157–160, so you can assume 157 on that basis. However, of course, TFS and FLS make a difference to that. As far as banking NIM is concerned, it is flat at 172 basis points, to reiterate. We have to work pretty hard to keep that flat at 172 basis points, because of competition; particularly, of course, in the mortgage market. So, we would guide you very strongly not to assume any improvement on that. We do not think there is upside risk, there is a lot of management to get to that position. However, in a sense there is a sort of uncertain outlook, because we do not know what base rates will do, we do not know how competitors will react, and we think that TFS being withdrawn will make a difference to mortgage pricing. As Rohith said, of course, with HSBC and others talking about entering the market, that might make a difference to pricing as well. So overall, I would say that there are a lot of ups and downs, and as a result, for us to maintain a flat position for banking NIM this year is something we feel very pleased with. However, please do not model an uplift in net interest margin or banking NIM.

David Wong: Many thanks.

David Wao (EV Holding): Good morning, many congratulations on another successful quarter. I have a question on the bank's capital allocation strategy. I think with the bank being very profitable and cash generative and, as you guys said, you have more capital than the regulatory requirement, and card business reaching the targeted size by the end of the year, would you consider deploying the excess capital in buying back the owned shares, given it trades at quite a discount to the book value, for example?

Jayne-Anne Gadhia: Thank you, David. I think that you might ask the question differently when you have been to our 16th November 2017 Strategy Day. From our perspective, we see an opportunity to deliver shareholders returns in excess of our cost of capital, both through the strength of our core franchise and through the strategic outlook that I have just described in terms of building a digital bank and as a consequence, if you like, a high-volume, low-cost current account franchise. So, at some point your question may become relevant, but we do not think now is the time.

David Wao: Thank you very much.

Michael Helsby (Bank of America Merrill Lynch): Thank you. Good morning, everyone. Hi, Jayne-Anne. It was quite comforting what you just said on IFRS 9. I know capital has been a big focus post the first-half results, and this is one of the building blocks people were worried about. Is there any update you can give us on the size that you are allowing for in your fully loaded IFRS 9 that you just referred to? Thank you.

Jayne-Anne Gadhia: Good morning, Mike. I am going to ask Peter to answer that question, please.

Peter Bole: There is no real movement since the position we outlined at the half year, Mike. I think we said at the time that our capital plans assumed up to a £50 million adjustment on transition to IFRS 9. In practice, we expect it to be somewhat lower than that, but that is what is in our capital plans at the moment. We have not allowed for a transitionary relief at this point. However, I suppose the observation I would make is that the pronouncements on the subject from the Bank of England in recent weeks are relatively reassuring, in that they recognise that the change in accounting convention should not ultimately lead to a higher level of capital in the system. So, we think the position we have taken is a reasonably prudent one at this point.

Michael Helsby: Yes, good. All right, thank you.

Chris Cant (Autonomous): Good morning, thanks for the call. I just had a couple of follow-ups really on previous questions, mostly around capital. So, the PRA has put out some new

IRB benchmarks recently for Pillar 2 credit risk, where banks are using standardised models, and you have said in the past that you do have a Pillar 2 add-on for your card book. Based on the new benchmarks, post IFRS 9, there does not seem to be that much of an uplift between the standardised and IRB benchmark anymore. So, should we expect your Pillar 2 to go down as we head into next year and the IFRS 9 effects come through? That would be the first one.

The second one, you have talked about the significant management buffers within the 12% guidance, and that being sufficient to absorb any uplift from the stress-test performance. I am just curious: what do you think the right level of management buffer for the business is, given the profile of the bank? Other banks in the past have talked about 100–150 basis points, and I am just curious as to where you see yourselves there.

Finally, on the stress test, obviously you are very confident in the quality of your book. I thought the comment about the extreme internal stress test was quite interesting, although obviously we cannot see the whole scenario there. I do think it would really help, given some of the concerns around the stock and particularly around asset quality, if you were to disclose your PRA stress-test performance. I know that Aldermore was able to disclose their drawdown in their 2016 results deck, so is that something you would consider doing this time around? Thank you.

Jayne-Anne Gadhia: Thanks very much, Chris. Peter, I am going to ask you to talk about the Pillar 2 and IRB benchmark, and I will try and answer the other two questions. When we go through the ICAAP, Chris, then we will consider where we are at and talk to the regulator about the extent to which we are able to disclose that. As you clearly know, we do not have a requirement to do so, and sometimes we are asked not to do so. So, if I am really honest, I do not know what our regulatory position on that is at the moment. Just to be clear, it is not a process that we are actively engaged with specifically on this topic at this point with the regulators. So, as and when we do that, then we will certainly consider what we can rightly disclose. We are very happy to do that.

As far as buffers are concerned, you mentioned that other banks say that they look to buffers of between 100–150 basis points. I would say that is about right for us; towards the top end, that is the position we think about.

Peter, IRB and Pillar 2?

Peter Bole: The IRB piece that you talk about, at this stage we are not planning for that to result in an improvement to Pillar 2A, largely because it is a little bit of an unknown quantity as to how it will really be implemented in practice. So, we are just keeping our powder dry on that, and we will work through it as part of the next round of ICAAP, as Jayne-Anne said. At this point, I would be relatively cautious about it representing an improvement, but we will step through it with the regulator in due course.

Chris Cant: If I am thinking about your 12% aggregate capital guidance, and being very confident that you have ample room within that, essentially you are not assuming Pillar 2A comes down from current levels to allow for a minimum of the upper end of that 100–150bps management buffer on top of whatever the regulatory stack looked like.

Peter Bole: Correct, that is right. The thing that we would just flag, as well, to add to Jayne-Anne's comments, is it would be in excess of that range today, but clearly some of the regulatory buffers that are due to come in over the next couple of years will eat away some of that additional headroom. So, when we talk about the 100–150, that would be our view over time as an appropriate level.

Chris Cant: Yes, I understand. I am just trying to make sure I understand which are the moving parts and which parts are not moving, because obviously we understand how the CCB is going to phase in and what have you, but there is some concern in the market that 12% is the wrong number. So, I am just trying to understand the moving parts, but thank you.

Jayne-Anne Gadhia: Thank you. To be clear, we are very happy with 12% and the buffer that that implies, given everything that we can see about what we are dealing with at the moment, the quality of our asset portfolio and, indeed, the changes of a regulatory nature; including, as you say, the countercyclical buffer increase that we are all looking at, as well as IFRS 9, etc.

Chris Cant: Thank you.

Ibrahim Sayed (Deutsche Bank): Hi, good morning. Just two questions, please, if you have not answered them already. On your issuance plans, could you quantify on your holding company senior how much you expect to issue this year for the remainder of the year?

In terms of tier two, is that something you guys would consider issuing? If not, a little bit of context around why you would not or have not explored the tier two; and if you have, if you could then give some issuance guidance around that. Thank you.

Jayne-Anne Gadhia: Thank you, Ibrahim. I will ask Peter to answer the questions.

Peter Bole: We are not intending to issue holdco senior in the current year; it will be something that features in the plans in coming years, however, particularly in light of MREL requirements, so we will do that. It is all within a manageable scale for us.

In terms of tier two, it is something we keep on the radar and we will keep monitoring, but as we manage the balance between what we think is an appropriate level of leverage ratio and the risk-based measures, it does not feature as an efficient piece for the capital stack at this point in time, but that may well change over time.

Ibrahim Zeid: Thank you.

Jayne-Anne Gadhia: Okay. Well, thank you much indeed everyone for joining this morning, and for your questions. We hope that you will all join us in London on 16th November for our market update, and very much look forward to seeing you then. Thank you, bye-bye.

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