Virgin Money UK PLC Full Year Financial Results 2023 – Fixed Income Call Transcript

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

Justin Fox, Virgin Money UK PLC

Hi and good afternoon, everyone. I'm talking to you from our lovely office in Leadenhall, as I look out over a very sunny London afternoon. Thanks all for dialling in, I've got Richard, Gareth and Aarti and myself.

Unusually for us, we're hosting this in the afternoon, but that's because Richard and a good chunk of the executive team are leaving early tomorrow morning for Australia. And if we're lucky enough to have any Americans dialling in this afternoon, happy Thanksgiving.

Before we kick off the proceedings, I'd like to remind everybody that you can find a whole buffet of highly digestible financial information on our website, including a webcast of this morning's presentation from David and Clifford.

As you all know full well by now, our reporting cycle puts us in an interesting juxtaposition versus our larger peers, given they've recently announced their Q3s, or a half-year in the case of Nationwide, and we're presenting our full year results. That said, we think our story reflects similar themes discussed across the reporting period, and we remain grateful for any feedback you may have on any of the content in this afternoon's session.

Today's slides aim to provide you with an overview of our full year financial performance, walk you through the key elements of our capital, funding and liquidity position and update you on our issuance plan for the new financial year, and a few other key themes of interest that we think are worth sharing. At the end, we'll open up for Q&A.

But before I hand over to Richard, I want to take a moment to reflect on the progress the bank has made since the combination of 2018. It's fair to say that this reflection is driven, in part, by recent investor comments around, well, what's your high-level pitch?

An awful lot has changed in a really short period of time, both at the macro and the geopolitical level, but also from us as a firm. So maybe it's slightly better to set out our stall at the start of the call, rather than trying to summarise it at the end. Therefore, the first couple of slides that you will see are designed to highlight the progress we have made against what has been a challenging backdrop.

So, on slide 2, the combination of the two former banks was an opportunity to reposition both assets and liabilities away from the traditional challenger model, that is, to reposition ourselves away from mortgages into unsecured and commercial segments we knew best and we felt were underserved, but also to rebalance our deposit model to grow current accounts and linked savings, what we term relationship deposits.

And as you can see in the first graph, that's going well. This transition into better value segments, alongside the rate environment, has driven a sustained expansion in our net interest margin and contributed to a continued reduction of the cost-to-income ratio, all the while ensuring we remained well protected from any further credit deterioration with significant coverage above pre-pandemic levels.

So then, moving on to slide 3, it's worth reflecting that we are the only UK bank since the Global Financial Crisis to make the transition to being designated an O-SII or, as we'd like to think of it, as a Tier 1 bank. This hasn't resulted in additional regulatory buffers being added, but it has certainly meant that the bar has been permanently raised higher, given that we're now benchmarked to our larger peers across the regulatory universe and again, this is a point that David made this morning in the equity call.

At the balance sheet level, we have demonstrated resilience in capital generation, where a prudent capital target has resulted in a balanced approach to capital distributions. Wholesale funding has focused on diversification by investing in markets away from our core sterling base, but also optimising our capital stack and simplifying our secured platforms.

At the same time, we are diligent and cautious in managing liquidity risks, something that has increased in importance, certainly over the last couple of years. And then, finally, we've made steady progress in getting our sustainability story across. All in all, whilst there's more to do, our track record on delivery emphasises the progress we have made so far.

So that's enough from me for the moment. I'm going to hand over to Richard, and he'll talk you through the key elements of our full year results. Richard?

Richard Smith, Virgin Money UK PLC

Thanks, Justin, and good afternoon everyone. Starting with the key performance headlines on slide 5, if you look at the left-hand column there, you'll see that our NIM has increased from 1.85% to 1.91%, year on year, and we're guiding to a resilient NIM of between 1.90% to 1.95% in FY24.

Our NIM stability is underpinned by a variety of factors, including our hedge position and our proactive deposit migration management, as well as the growth momentum we've seen in target segments in 2023. Deposits have grown 2%, year on year, and growth in target lending segments has reached 9% and we're confident that these underpins will continue into 2024. In mortgages, we've traded resiliently, focusing on managing tight spreads and keeping our market share of around 3.5%.

Our pre-provision profit has increased by 9%, and our cost-income ratio of 51.9% is in line with the guided level. We've also delivered £130 million of the £175 million in cost savings that were targeted, and we're now planning to increase that savings target to £200 million.

As in previous years, our balance sheet is robust, with strong liquidity and a low arrears profile. Although we have increased our provision cover, this is mostly based on modelled ECL and a prudent macroeconomic set of assumptions, and is not driven by material increases in arrears.

Justin will touch on this shortly, however, our capital position remains strong, with a CET1 ratio of 14.7%, ahead of our committed range for FY24 of 13% to 13.5% and we're pleased to be able to announce a buyback of £150 million and a dividend of 5.3 pence per share for FY23.

Let me now turn to slide 6 and the macroeconomic backdrop. As we determine our allocation of capital in future years, we rely on Oxford Economics as a base data set and adjust for our views as appropriate. As we all know, the UK environment has remained remarkably resilient, despite inflation remaining higher for longer than forecast. We are now starting to see the impact of 14 consecutive base rate increases, with inflation reducing from the peak levels seen earlier in the year, to 4.6% following the most recent update.

Despite this improvement, it is still likely to take some time to return to the target range, and the market is assuming a more stable, higher-for-longer rate environment in the coming months. And this is consistent with the recent BoE commentary as well.

When we look at GDP, it's remained resilient, and whilst growth is expected to take time to improve significantly, overall, the UK now looks likely to avoid a significant recession. Compared to a year ago, the forecast for unemployment has reduced, and we're starting to see wage inflation ease some of the cost-of-living pressures.

The employment outlook has also supported consumer spending patterns. However, we expect to see muted new purchase activity for mortgages in the short term. For small businesses, we're optimistic about the growth potential in our core specialist sectors as we look out into next year, which moves us on now to slide 7.

Overall, we've delivered good commercial momentum in 2023, underpinned by the digital investments that we've made. Our business bank is a focused segment of the overall bank, with a defensive sectoral bias, deep expertise amongst the RMs and is a margin and brand-accretive segment. The Marketplace platform, which is a digital investment we've made, is contributing to our growth capabilities, and our relationship-driven model has delivered consistent net inflows in terms of the BCA side of the business for the past 22 months, as well as 11% growth in BAU business lending.

Our unsecured business continues to grow, albeit at a slower rate than in prior years, of 5.8%. This is due to adjusting credit scoring. And we've seen an increase of 11% in general card balances, with 21% increase in Virgin Atlantic balances, giving us a market share overall of 8.5%. The Virgin Atlantic growth contributed towards 540,000 overall new card sales and is a good example of how the combination of the Virgin brand and a great digital product can deliver strong growth overall.

Our current account business continues also to develop well and offers a linked saving product; this innovation has been a driver of the 4% growth in personal relationship deposits. In mortgages, we've continued to trade tactically, and we've broadly kept our market share stable. Although the environment is difficult for customers, our portfolio is performing well, and we are not seeing material arrears emerging.

Consistent with our intention to broaden our product offering for customers, we're also launching a range of new products. We've relaunched Virgin Money insurance and investment products, and we have seen a strong growth in insurance sales, and our investment business is starting out life with an existing £3.5 billion of assets under management.

We will launch a single app for Virgin Money, and this app will deliver a single interface for all products, cashback, and loyalty schemes, including those offered by the broader Virgin Group. Our wallet functionality is now live with a closed user group of VAA customers, and as we develop this functionality further, it will be integrated into the single Virgin Money app. The delivery of this fintech-style app will enable us to offer customers the full scope of benefits of Virgin Group.

And I'll now talk through key balance sheet items from slide 8. The deposit franchise has performed well, helped by our decision to proactively manage deposit migration this year, and supports our resilient margin outlook. I'll comment first on customer deposits and explain how we are positioned differently to the big UK banks.

Over the past year, the market has seen higher flows into term deposits as savers search for higher yield. We saw this early and increased our participation in the market for term deposits, enabling us to lock in term funding at pricing below swaps. We've also grown our relationship deposits this year, despite accelerated market deposit migration. This is a particularly strong performance and reflects the strength of our value orientated PCA and BCA propositions, including the linked savers.

This combination enabled our margin resilience this year, particularly in the second half. So, looking ahead, we are less exposed to further deposit migration versus bigger UK peers. We already have absorbed a significant shift in terms of the mix and our current customer pay rates are already materially higher as well.

During this year, we also successfully accelerated and accessed the wholesale markets, despite tricky market conditions. As Justin will comment on shortly, we repaid £1 billion of TFSME and will continue to do so ahead of contractual maturity, while maintaining a robust liquidity position throughout the year.

Moving on to slide 9. In lending, we traded well over the year against a mixed backdrop. Overall, lending finished broadly flat as good growth in our target areas of business and unsecured was offset by a modest reduction in mortgages. Mortgage balances were around 1% lower, a good performance in a challenging market with slowing activity. We performed particularly well in business, despite the slower market and the headwinds of reducing government-backed lending, with total balances increasing 6%. In unsecured, growth in credit cards was slightly offset by a reduction in personal loans. Card balances were up around 11% during the year against a strong market backdrop, with our market share increasing somewhat to around 8.5%.

Looking forward in mortgages, we expect market activity to remain muted and new business spreads to remain pressured. So, we'll continue to trade tactically, and aim to maintain our mortgage market share balances in the medium term. In business, we expect to grow balances further in FY24, growing our share. In unsecured, we'll target measured growth, and we've been pleased with our early trading performance this year.

I'll now talk through the structural hedge and rate sensitivity on slide 10. We reintroduced the structural hedge when the rate environment was significantly lower, so we now continue to benefit very materially from higher reinvestment rates. You can see, on the left, we expect the structural hedge to continue to support net interest margin. Even before reinvestment, hedges already written will deliver gross income in FY24 above FY23. In addition, as the structural hedge rolls, it is reinvested at current rates, significantly higher than the average 1.4% redemption yield in FY24. Given this reinvestment benefit, we expect the average yield on balances in the structural hedge to continue to increase, supporting margin.

On the right, we've set out the usual interest rate sensitivity, using our pass-through assumptions at this point in the rate cycle. You can see that we are less sensitive than some of our peers, which is helpful if we see rates come down further.

I'll now continue on asset quality on slide 11. We are pleased with our asset quality, which has remained resilient. You can see that during the year, our modelled ECL increased, while we broadly maintained overall management adjustments. The increase in modelled ECL relates mainly to cards, reflecting prudent macros, with a weaker economic outlook and latest credit bureau data. Both these factors have driven significant migration of card balances from Stage One to Stage Two, resulting in a mechanical provision build as we move from a 12-month loss outlook to a lifetime expected loss for those balances.

Our credit quality indicators remain benign, and whilst we have seen some pick-up in our card arrears, this mainly reflects our recent balance growth. In cards, the substantial majority of our

Stage Two balances - 97%, remains less than 30 days past due, with 95% of those balances fully up to date. Stage Three balances remain low and stable. So, while our credit quality is resilient and overall arrears low, we are well positioned for uncertainty that lies ahead.

You can see the effect of the higher ECL on our provision coverage on the right, which has strengthened further to 84 basis points. Included within this is a significantly higher credit card coverage of circa 7%, reflecting that higher modelled provision that I mentioned.

The net impact of all this is that total provisions have increased from FY22, resulting in a £309 million impairment charge, equivalent to a cost of risk of 42 basis points, modestly above our previously guided range. Looking ahead, we expect a lower cost of risk of between 30 to 35 basis points in FY24, having already digested the more negative economic outlook this year.

Continuing with asset quality on slide 12, we've set out here the strength of our portfolio and why we're comfortable with our credit quality. Overall, our total portfolio is defensively positioned, with balances strongly weighted to mortgages, at around 80% of loans. Our mortgage book is low risk, weighted towards owner-occupied and originated within strict affordability assessments, largely onto fixed rates. This has supported affordability headroom at higher rates and also a continued low arrears performance.

Our business portfolio remains well diversified, with strong collateral levels and skewed to lending to resilient sectors, with minimal commercial real estate lending. In unsecured, our underwriting criteria are prudent, and we've tightened further this year to reflect affordability stresses on customers. Our customers in the unsecured space are generally more affluent, and this has also supported our good credit quality, with our card arrears typically inside the industry for recent cohorts.

This year, the arrears rate on our overall cards book has risen from a very low level. That largely reflects the age profile of our book, that is, with a higher percentage from recent originations and a lower percentage from more mature balances where arrears are lowest, given the balance transfer model that we operate. As such, arrears emergence is more evident for us than some of our peers, even though our arrears performance by cohort is typically better. We've provided further detail on this in the appendix.

Finally, I'll conclude with our guidance on slide 13. Our guidance for FY24 is on the left, and our medium-term guidance is on the right. I've mentioned some of the details through the presentation, but just running through FY24, we expect NIM of 190 to 195 basis points.

We anticipate underlying cost-income ratio for FY24, excluding notable items, to be broadly stable at 52%. We expect the cost of risk to remain in the range of 30 to 35 basis points. And we expect to operate in our target range of 13% to 13.5% CET1, with shareholder distributions at around the same level as FY23.

Given this, we now expect to generate an underlying RoTE, excluding notable items, of circa 10% in FY24, and our underlying ROTE, it's important to note, also excludes the cash flow hedge reserve from equity to give a fairer reflection of the underlying performance.

For notable items next year, we expect £40 million of costs relating to the financial crime prevention programme, the majority of the remaining £60 million of restructuring charges and £15 million of residual IFRS 3 fair value charges. After notable items, we expect a stat RoTE of around 8%, lower than our medium-term ambition, but very much in line with the consensus for the year.

Now, turning to the medium term, we remain committed to our double-digit target for statutory returns. This will be supported by profitable growth in our target lending segments and resilient margin. Alongside this, our cost savings and lower inflation will enable a cost-income ratio of less than 50% in the medium term. Overall, our strategy remains very much on track, we're generating good business momentum, and our outlook is positive. I'll now hand back to Justin.

Justin Fox

Thanks, Richard. As you can see on slide 15, our capital position is very strong, and capital generation continues to be resilient, with 145 basis points of underlying capital generation. This capital position is also a key feature in our strong performance in our second Bank of England stress test scenario, which is shown later in the appendix.

Capital distributions consumed 70 basis points of this in FY23, comprising the total dividend of 5.3p for the year, the £50 million buyback announced last November and the further £50 million which was announced in August.

In terms of the other drivers behind the CET1 delta this year, adjusting items consumed 60 basis points, and the 30 basis points of CET1 impact from adopting mortgage hybrid models reflects our latest view. The final outcome remaining subject to regulatory approval. And then, finally, the remaining item primarily relates to FVOCI movements, which are largely driven by credit spread movements in our Treasury liquidity portfolio, which is fully hedged for market risk. Altogether, this resulted in a 14.7% CET1 position, considerably above our target range, as you can see from the next slide.

So, moving on to slide 16, we've set out here our expected CET1 path in FY24. Even after the £150 million buyback announced today, we'll have a CET1 ratio of 14.1% or £160 million of surplus, above the top of the target range of 13% to 13.5%. Our capital position is resilient, already incorporating the impact of hybrid mortgage models, no requirement to make further pension contributions having just completed our latest triennial, which shows a substantial surplus, and no material impact associated with Basel 3.1.

On this chart, we've set out our capital drivers for the coming year. As you can see, we're generating capital through profitability. We expect RWAs to increase somewhat as we grow into our target lending segments. We also assume some mortgage RWA migration, with prudent assumptions in HPI. And as Richard mentioned earlier, we'll be looking to manage towards our target capital range by the end of this financial year.

Turning now to the breakdown of our total capital stack on slide 17. As we've said consistently before, our issuing entity structure is very simple, straightforward, and it's dull, and it's set out on slide 26. As a reminder, all of the Group's regulatory capital and MREL is issued by our holding company, Virgin Money UK PLC. It's fully eligible, so there are no issues around grandfathering. Also, there's no FX exposure in the capital structure, providing stability during periods of market volatility.

We have excess total capital of 5.7% over our regulatory minimum, or a buffer of around £1.4 billion. I've said before that I'm happy with the overall percentage of capital that we hold, but the mix could be improved. With the retirement of lower Tier 2 in the next few weeks, I believe that job is now done.

Going forward, we will look to ensure that we keep a sensible buffer over the efficient regulatory requirement at each level, and as a result, future issuance will primarily be focused on refinancing needs. Clearly, as CET1 moves towards our target range or as RWAs grow in line with what I said earlier, we will adjust issuance plans modestly to maintain the overall size and mix of the stack.

Turning to our MREL position on slide 18. You will remember that we evolved this slide at the interims to display the leverage based and the RWA based LAC requirements, both expressed as a percentage of RWAs. As you can see, there remains very little difference between the two. Over time, though, we expect to revert to the RWA measure being the binding requirement for MREL purposes, again for the reasons I gave earlier.

With this in mind, as at the end of last financial year, the Group's leverage-based LAC requirement of 7.8% of leverage exposures, or 26.6% when expressed as a percentage of RWAs, was greater than the RWA-based LAC requirement of 26.4% of RWAs, meaning the leverage measure is the binding requirement at present.

MREL resources were at £8 billion, equivalent to 9.3% of leverage exposures, or 31.9% when expressed as a percentage of RWAs. This provides plenty of headroom in the form of £1.3 billion or 1.5% above the LAC requirement of 7.8% of leverage exposures, or 5.3% above the LAC requirement of 26.6% when expressed as a percentage of RWAs.

Again, we do aim to maintain a suitable buffer over our end state requirements to help better manage maturity risk. Finally, it's just worth highlighting that our total capital and MREL buffers would remain comfortable even at our target operating CET1 range.

Turning to funding on slide 19. As Richard mentioned earlier, the deposit franchise has performed really well. One of the benefits I personally found from being a compact and bijou entity is the high degree of alignment between Treasury and the customer product teams on pricing strategies, but also the speed at which we can react to market conditions.

Changes in customer behaviours, which have been driven by deposit market migration, have been very well managed, as Richard has outlined. We have also successfully accessed the wholesale markets in FY23 despite challenging times, issuing a total of £1.8 billion of secured funding across our Lanark, RMBS and capital bond programmes.

And from a capital perspective, we successfully managed and refinanced a maturing Euro trade with a new €500 million issuance in February, and successfully tapped the Sterling MREL market in August, having been away for a number of years, allowing us to refinance the maturing Tier Two instrument. We continue to keep our toe in at the short end but given regulatory rules and the relative small scale of the GBP market, this isn't a meaningful area for us as it would have been in the past.

Borrowings of less than one year's duration refer to short-term funding transactions with a range of clients through our broking relationships or they represent repurchase agreements on our self-issued RMBS securities with market participants, or they reflect our use of Bank of England facilities such as short-term repo or the indexed long-term repo. These are BAU facilities offered by the Bank of England as part of their Sterling monetary facilities, which we occasionally use for operational testing, and we consider an extension of normal repo activity.

Of our total debt securities in issue, only 19% have less than one year to effective maturity, reflecting term issuance roll-downs, again, both drivers of our NSFR strength. As the slide highlights, we repaid £1 billion of TFSME in the period and now have just over £6 billion outstanding, with contractual maturities ranging from the end of this financial year to FY26 and beyond, noting there's about £1 billion that is eligible for term extension.

Now, whilst we recognise the increasing focus of TFSME refinancing, given the significant outstanding volumes in the sector, especially in 2025, we feel well placed to manage this refinancing requirement well ahead of contractual maturity, given the funding levers at our disposal, including the strength of our deposit franchise as we continue to focus on relationship deposit growth, our well-established wholesale funding programmes, which we will look to strengthen further as we investigate the use of credit cards as a supplementary asset class, and consistently proven market access and funding diversification progress, previously discussed.

Consequently, we expect £1.5 billion to £2 billion of secured issuance in FY24, of which we expect to split this roughly 50-50 between the covered bond and RMBS programmes. All of this is subject to deposit flows and the relative cost, of course. With regards to future capital issuance, as I mentioned on slide 17, we expect capital issuance to be broadly limited, to maintain the current surplus to regulatory requirements.

And finally, yes, we are all aware of our £250 million AT1 first call in June of next year, and as always, and 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 cost, current and future regulatory capital and MREL value, rating agency treatment, wider wholesale funding needs, and prevailing circumstances at the relevant time. I think that's probably enough caveats. And of course, calls are subject to the PRA's approval, with whom we have an active dialogue.

Moving to slide 20. This year has seen unprecedented market volatility, and we prudently opted to hold more liquidity on balance sheet. This has provided additional headroom to both internal and regulatory requirement, the average LCR increasing by six percentage points compared to last financial year to 146% on the 12-month-average measure. As you can see from the slide, we have consistently held prudent buffers in excess of regulatory requirements and would expect this to continue, going forward.

Our liquid assets are high quality and consist primarily of cash that we keep at the Bank of England and the remainder consisting of UK government securities and AAA-rated listed securities, i.e. bonds issued by supranationals and covered bonds. From an LCR perspective, that means that the majority of our HQLAs are classified as Level One, with only 3% classified as Level 2A.

And just as a reminder, our liquid asset portfolio is fully hedged from interest rate, inflation and FX risk, and the portfolio is accounted for at fair value through OCI, meaning movements in fair value are recognised in our CET1 position via the FVOCI reserve.

We also have an unencumbered, pre-positioned collateral at the Bank of England, representing £7 billion of secondary liquidity, drawing capacity via the bank's Sterling monetary framework. It does not form part of the liquid asset portfolio for LCR or internal stress outflow purposes though.

Over time, we think the stock of unencumbered, pre-positioned collateral will increase as the remaining TFSME drawings are repaid. In addition, the Group has a further £18 billion of unencumbered assets, eligible and readily available, but not currently pre-positioned at the Bank of England.

Moving finally then to slide 21. As I said earlier, a while back at an investor event, a comment was made that the problem with the UK is that no one focuses on the optimism. So, when we were thinking about what messages we wanted to get across today, we did want to focus on the positives.

The point of the slides at the start is to explain how far we have come against what has been an extraordinary few years. Then, as Richard and I peel back the onion layers, we believe we are showing elements of core underlying strength, and a very solid balance sheet remains the foundation to all of that.

Sure, not everything has been perfect, and there's still plenty of work to do, but being a Tier 1 bank is not an easy transition process, and requirements like Consumer Duty compliance, or the need to put more investment into financial crime because of how technology is evolving aren't necessarily eye-catching but are critical cornerstones of what being a proper customer-driven bank is all about these days.

So, to summarise and to echo what Richard said earlier, we believe our strategy remains very much on track. We're generating good business momentum. Our outlook is positive. We will continue to focus on managing down the overall difference to larger peers. We will continue creating proof points as a Tier 1 bank, continue to tell our story and actively seek opinions from you all, which will hopefully create that compelling investment proposition and support further spread compression to peers.

As for our performance in wholesale markets, I think we've done a decent job in working with investors to explain our story and how we fit into the market. Not a lot of fun to see you widen us faster than others when the market turns, but the execution of the two MREL trades gives me comfort that the market gets our story, and we have just got to keep on grinding away.

Maybe then, it's apposite to remind everybody that tomorrow is Black Friday, and whilst I cannot say anything about any fancy new products that could come to market, I will point out there is a decent amount of inventory already out there, and there are plenty of stores listening in to this call. So, if you like what you heard, then I suggest you take hurry while stocks last. And don't worry, with us, at least there's hopefully no buy now, pay later.

That concludes the presentation. Thank you for your attention. We'll now open up the line for questions. Operator, please go ahead.

Conference Call Operator

Currently, we have no questions, so I'll hand back to Justin Fox for any further remarks.

Justin Fox

Thank you very much. Listen, thank you, everybody, for dialling in and listening this afternoon. We look forward to engaging with as many of you as possible over the coming days. You know where we are, so, if you have questions, there are things you'd like to know, do get in touch. And we appreciate all the support you've given us in the last financial year. Have a great afternoon. Thanks, everybody.

Richard Smith

Thanks.

[Ends]