Virgin Money

Q1 2015 Trading Update

Friday, 1st May 2015

Jayne-Anne Gadhia, Chief Executive

Good morning everyone.

I'm here this morning with Lee Rochford, our CFO, and I'm sure that many of you will already have had time to read our trading update this morning, so I thought I'd just run through some of the highlights and then Lee and I will be really pleased to answer any questions you might have.

So this year started really well for Virgin Money and that's given us confidence that we can deliver our 2015 plans, despite the headwinds of political and economic uncertainty that we face with the election coming up and the reality of compressed asset spreads.

Our gross mortgage lending of £1.6bn is up 34% in quarter one this year compared to the same time last year, that means that our mortgage balances at the end of March stood at £22.6bn. Now, to be clear, this is exactly where we planned to be at this point, despite the fact that we've got a smaller market which looks like it's almost 4% down on Q1 last year.

This gives us a 3.7% share of gross lending according to the Bank of England data released this morning, and given our strong retention performance in the quarter our net lending was up 82% from Q1 2014 to £664m. And based on today's Bank of England figures we can see that that's a 22.4% share of the net lending market this quarter. So we're very pleased with that.

Front book mortgage spreads for the quarter were moderately, by which I mean less than 5%, below our annual target of 200 basis points, and we addressed this challenge by changing our business mix, albeit it within our pre-agreed and prudent risk appetite and as a result, and that means increasing some of our writing of buy-to-let business, current experience is slightly ahead of the 200 basis points front book spread that we target.

And moving on to retail deposits, they performed in line with our price and volume expectations during this quarter, and we closed the period with retail balances of £22.2bn. And deposit growth in April actually is moderately ahead of our plan.

We managed the retail portfolio really efficiently during Q1 and we were able to optimise our funding mix, and importantly, we finalised a further re-pricing of our back book of deposits with customer retention exceeding our expected level, so we kept more customers than we expected during that back book re-pricing exercise.

Our loan to deposit ratio increased as planned during the quarter and we have subsequently optimised this even more through the successful MTN issuance in April which you'll have seen I'm sure and which raised £300m of five year money at a rate inside that available in the retail market for a comparable term.

A particular success for us in quarter one has been the full and final migration of 675,000 credit cards from MBNA onto our own systems; that was no small task but we did it on time and on budget and there's been no customer detriment of anything significant at all.

The planned moved on to our systems has meant that we have crystallised significant and planned cost savings because we've moved on to our own platforms and away from the expensive MBNA platform. That means that we're now fully in control of our £1bn worth of customer balances on our own systems as we beginning to grow our credit card outstandings towards the planned £3bn worth of balances by 2018 which, as you know, has always been our target.

You may have seen that our new product range is now available on a leading aggregator website and it's receiving very positive press coverage. The 36 month product is only one part of our new product portfolio and cards margin continues to contribute positively and as planned to Group NIM.

Now, during the period our net interest margin performed exactly in line with our expectations. The successful re-pricing of the deposit back book gives us room to compensate for asset spread compression and to confirm our expectation of an annual NIM of up to 160 basis points for the year. And of course the acceleration of our credit card business now will allow us to build from there in accordance with our plans to achieve a net interest margin of 170 basis points in 2017.

So to be clear, during the period we slightly overachieved on volumes and the benefit of the deposit re-price more than outweighed asset spread compression. As a result we are pleased to confirm that the evolution of NIM is as expected and is on track to deliver up to 160 basis points for this year.

Other income grew in line with our expectations during the period and in particular growth in pension sales, whilst modest, slightly exceeded our expectations and we continue to make planned progress in developing our insurance and our current account businesses.

Asset quality remained strong in the quarter, cost of risk grew as expected following the acquisition of the second tranche of cards business from MBNA in November, but cost of risk overall remains at the low end of our guidance.

We've been especially focused on managing our costs during the quarter and we have achieved a result moderately better than plan. This level of cost flexibility gives us confidence in managing our bottom line outcome for the year, with the added potential for slight outperformance in the short term if our cost income ratio improvements can be accelerated.

I'm pleased to say that Virgin Money continues to enjoy strong capital ratios and they position us both for growth and to be able to meet known changes to the regulatory capital requirements.

We've also improved our liquidity efficiency during the period, although of course we've remained squarely within our conservative risk appetite. And despite M&A news in the sector during the quarter our plans remain firmly based on organic growth. To reaffirm our position with respect to acquisition opportunities we will of course consider potential opportunities but only to the extent that it's economically sound and within our prudent risk appetite so to do.

So my summary for the quarter would be that we've delivered on our plans and grown our business in line with expectations. We do see some headwinds in terms of asset pricing in line with many of our competitors but close management of our cost of funds gives us confidence in our annual NIM target and benefits from our operating leverage coming through more quickly than expected gives us some cost upside in the short term. In other words, and to quote an earlier call this morning, we believe that tailwinds are likely to outweigh headwinds. There's been no change at all to our medium term outlook for the business and so there's no change to our medium term guidance which we are strongly reiterating here today.

So thank you for listening to that. Lee and I now look forward to any questions that you may now have.

Q&A Session

<u>Question 1</u>

Arun Melmane, Canaccord

Morning Jayne-Anne and Lee. Congratulations on a good quarter. I had a couple of questions, one was on the asset side of the balance sheet as you would expect. You stocked about 5%, that's roughly about ten bps give off margin. I just wondered, are you actively giving margin away to get the volume in or is that just the sector pressures that are coming through, and what kind of LTVs are you writing the front book at? Is it very similar to the distribution we sort of saw at IPO. That would be one, shall I give you all three?

Jayne-Anne Gadhia

Yes please, Arun, why don't you do that? That would be great.

Arun Melmane

Perfect. And the second one was on credit cards, I just wondered if there were any organic originations in the quarter or is it too early? When do you foresee that coming through?

And the third one is I think you've got quite a good pick up in terms of the marketing spend that you're doing and the reception you're getting from customers, how long is the tail on that? Do you see people come in actively on day one and then does that fall off immediately or are you seeing the hits to websites and stuff like that continuing for a longer duration? Thank you.

Jayne-Anne Gadhia

Okay, well thank you, Arun. Well they're all quite commercial questions so I'll answer those and then we'll ask Lee to talk more specifically to any of the finance points afterwards.

On assets, the point that you make is sort of right, the reason that we have been managing our spread in the way that we have is really to do with competition in the market and particularly in the two year low LTV residential space. And as I said earlier, the way in which we've been addressing that competitive position really is within our existing risk appetite to extend our product types.

We have increased our flow of buy-to-let business slightly but we still expect that to come in lower than the market average for buy-to-let which we think that about 20% of the total mortgage market is in buy-to-let at the moment. We are not close to that position yet and so from our perspective writing very good quality buy-to-let business has been margin and spread enhancing for sure.

And so I'll just reiterate the point that we are slightly below the 200 basis point asset spread position in Q1. Q2 is starting in a place slightly higher than that and we're still reiterating our guidance that our expectation over the year is to come in at the 200 basis point level, based on the mix of business that we are currently writing.

On credit cards, we as you'll have seen successfully built our own systems which is no easy task and migrated the cards that we've acquired from MBNA in two tranches to our systems, we did that before the end of March. And as a result we have been taking a first slow step into organic origination just through our website until this week actually when we went live on the main aggregator site and we're very pleased with the take up so far we we've really started now to be able to open the doors to write credit card assets in the volumes that we plan and expect.

And as far as marketing spend, forgive me if I haven't quite understood your question correctly, but if you're referring to the ad campaign that went live two or three weeks ago, it's been an extremely successful campaign. Obviously the marketing spend that supports it is entirely within plan. It's on TV, in the press and on social media, and our experience on all of those channels is very strong, but particularly strong on social media where, to date, we've seen 5 million hits on our TV ads. And obviously that massively increases our spontaneous awareness and we know that there's a direct link between spontaneous awareness of our brand in financial services and ultimate sales.

I looked last night, actually, at some of the marketing updates that we got and when our savings ad, the pigeon ad, first went out on Coronation Street, around Easter Monday I think, over the course of the next 17 days the hits on our website for the savings business was 45% up on the previous 17 days. And that just gives you an indication, I hope, as to the initial marketing effectiveness that we expect to continue over the next weeks as we continue to be exposed on a range of media.

Question 2

Mike Trippitt, Numis

Morning, just two or three quick questions actually. Just for clarification when you talk about the 200 bps asset spread, what's the reference rate for that? Is that your internal transfer price or is that against base or Libor?

Secondly, could you just say where the SVR Book is now? I think it was £4.1bn at June last year and I'm not sure if I've seen an update since then.

And then just finally on buy-to-let, I think at IPO time, your risk appetite was 15% of gross and clearly that sounds like it's moved up, and obviously it picked up at the end of last year, so could you just say a little bit more about that market and where you think volumes, where you will be and where the market will be in buy-to-let this year? Thanks very much.

Jayne-Anne Gadhia

Thanks very much, Mike. Can I ask Lee to answer those questions?

Lee Rochford

I think the first one was on the spread, Mike, and that's a spread over Libor and that's how we look at everything, we swap back all the fixed rate products that are Libor-based, so the 200 basis points is over Libor.

On the SVR Book, we've seen only minor movement on SVR book. As a proportion of the book as a whole, it's gone from just under 19% to around 17%, and that's been mainly because of the growth in a fixed rate product because of the strength of the front book origination. So the size of the book in total is marginally below the £4bn mark, but not much and its roll-off has been in line with our expectations.

And then your final point around buy-to-let, 15% of stock is where we're at. As Jayne-Anne said, we think the market as a whole is nearer 20%. Therefore, as a proportion of flow, as we grow, so that our book starts to look like the UK market as a whole, we'd expect to be running in flow at a higher proportion than that, and at the moment, I would say that's in the mid-20s, something like that, if that helps you.

Jayne-Anne Gadhia

And your specific question, Mike, on risk appetite for buy-to-let, we have discussed this with our Board and agreed an increase in the risk appetite to something slightly below 19%.

Mike Trippitt

Sorry, I'm just trying to understand the mechanics of the confidence around the 160 target for the year. You've gone through the deposit re-pricing exercise, you've raised some wholesale, and it's a pretty good rate actually, 275 coupon, I think. We've got front book pricing pressure and a little bit of attrition in the SVR book. I probably need to go away and put a towel over my head to think about this, but I'm just trying to understand why margins will move from 150 to 160 this year.

Jayne-Anne Gadhia

And I'm guided to think about two levers that we have, Mike, in that respect. One is the growth in the credit card business now that we've stuck to our platform, which, as we speak, is an immediate opportunity. And the other is that, as we've all discussed over a number of months, we still have headroom in our deposit pricing and that's something that we expect to take advantage of towards the end of the year.

<u>Question 3</u>

Richard Smith, KBW

Hi guys, thanks very much for doing the call and for taking my question. I've just got a couple of quick questions. The first one is on the funding mix side of things and I appreciate very much the comments that you made in terms of looking to fund in the best optimised way. How do we think about the evolution of the PCA proposition from here? Would you be looking to grow that slightly faster in terms of getting a better optimised mix, or is it more going to be a slower approach?

And just on the asset side of things, looking at the Mortgage book, it looks as though redemptions picked up slightly quarter-on-quarter and I was just wondering if you could give us a bit of colour here? I understand the comments on the SVR book not moving substantially, but should I be assuming then that you're seeing a greater move away at cessation, or is there some other factor that's weighing into that?

Jayne-Anne Gadhia

I'll answer the first and, Lee, perhaps you could give some thought to the second whilst I do that.

So on the specific of the PCA proposition - and I take your point completely - we've been pleased with where our current account proposition has been over the quarter, we've rolled out now our capability to sell current accounts through all of our branches nationwide, but, as you know, we've been limiting volume to branch distribution in order to manage volume down, to be absolutely honest, and we're actually slightly ahead of plan in terms of volume.

We're holding back to understand where the Competition Authorities might come out in Q1 2016 before we decide whether or not we should… It makes economic sense for us to really accelerate on an organic growth plan for current accounts. And to the extent that it does make economic sense, then we have the complete platform ready and available to do that, so we feel that that gives us really strong strategic options. So at the moment, our funding plan looking forward does not include any material current account capability, as it were, or volume, but depending on the outcome of the competition enquiry, as I say, Q1 2016, then that's something that we're ready to take advantage of, if and when that becomes relevant for us.

Lee, did you want to answer the asset question please?

Lee Rochford

I think on redemptions, actually we're very happy with the way redemptions are going and they're in line with our plan, so although gross lending is up 34%, redemptions are up nearer 13%, which is what's driving the very, very strong uplift in net lending. And of course the book, last year, grew year-on-year. So redemptions are performing really well and we're actively managing retention of customers and seeing those come out in line with what we'd expect at this stage.

Question 4

Chris Cant, Autonomous

Good morning. I have a couple on asset spread, if I may. You say in the release that you're moderately inside your target of 200 basis points. I was just wondering if you could give us a sense of what moderate means? One of your peers this week was talking about spreads on residential mortgages that they were experiencing in the first quarter being around the 150 to 180 basis points mark and I just wondered whether you identify with that as a general range, 75 percentage of your flow.

And as a second question, I was wondering if you could give us some indication of the kind of spread you're currently getting on the buy-to-let piece within your flow of business? Thank you.

Lee Rochford

So we haven't given out the spread for products, but we've seen much better performance on our front flow spreads than you're indicating one of our peers might have given. So when Jayne-Anne talked about the moderately below 200 basis points, that's less than 5%, so that's around 10 basis points or less lower than the 200, not the 20-50 that you're seeing elsewhere. Part of that is by addressing mix, and buy-to-let spread for us is very healthy, it's about 1% higher than it is for the book as a whole. But I haven't got the exact numbers off the top of my head now, but we can provide that.

<u>Question 5</u>

Nick Baker, Goldman Sachs

Just one quick one from me. You've mentioned that a lot of the asset spread competition on the mortgage side was concentrated in two-year low LTV segments. Would you consider looking at potentially moving more flow further up the LTV risk curve, or doing a higher share at five-year rather than two-year going forward? Or is the two-year low LTV still where you see your sweet spot? Thanks.

Jayne-Anne Gadhia

Thank you. Well, when I look at the numbers, we've actually done less lending in Q1 in the higher LTV space than we did in Q1 2014, if that helps slightly. So we've got some room there within our risk appetite to continue to develop that spread. We've still seen a very good share of the resi low LTV market and still been able to deliver the asset spread that Lee and I both talked about. So room to grow and it's certainly an area that we'll be looking at going forwards.

<u>Question 6</u>

Ian Gordon, Investec

Just a quick one on other income. I noticed in the release that you referenced growth versus the Q4 run rate. My expectation was that growth in other income would be back-ended into the second half and beyond, driven by the pace of product rollout on the life and insurance space, and the slight headwind coming from the cards business. I wonder if you could just give me a little bit more colour on firstly, the rollout of those product offerings; and secondly, your more general expectation on the timeline of growth of other income.

Jayne-Anne Gadhia

I suppose the first thing that I would say is I think we guided the market at our flotation to say that we would expect to have other income to be a mid-teens percentage of total income, and we're happy with where that's coming out for Q1.

As far as the rollout of products is concerned, we've rolled out our life insurance business; that's started already to be active in the marketplace. Home and motor go live in the summer – I can't remember if it's July or August off the top of my head – but in the summer.

And we've also launched three new investment funds. As I said, in relation to the pensions business, the same is true of the pension funds actually, the growth is modest at the moment as we just start, but it's actually slightly ahead of our expectations. So a good start in terms of that product capability.

As far as credit cards are concerned I wonder if you're referencing Interchange, which I know has been a drag on some of the other income with some of our competitors. Of course, given the portfolio that we've had, we have not had a reliance on Interchange, and that's not something that will negatively drag our other income.

Ian Gordon

Actually I must admit my reference on the cards was just the absence of ongoing fees from MBNA obviously that drops away and is replaced on the NII line.

Jayne-Anne Gadhia

Yes, that's true. Lee, do you need to add anything?

Lee Rochford

No, I think you've said it. You're absolutely right, Ian, it won't be a straight line growth of OOI given the product rollout over time; but we did have a very strong quarter despite that.

<u>Question 7</u>

Michael Helsby, Bank of America Merrill Lynch

You've covered very well actually most of the points. I was wondering if I could invite you to comment a little bit more on the cost performance. Clearly it's going well - you said it's better than expected. It's an important lever that you've got there, so I was just wondering if you could put a little bit more colour around that for us. That would be helpful. Thank you.

Jayne-Anne Gadhia

I guess the very straightforward answer on cost is that, I think I've always said publicly, without being very clever that it's easier to manage costs than income. The first year of flotation ahead of us we've focused very hard on managing costs.

During Q1 we said in the note that our mortgage pipeline is very healthy as we go into Q2. And of course that's meant that we have had a very healthy flow of applications during Q1, particularly on the mortgage business. And we've been very pleased that actually our operating leverage has been slightly ahead of where we've expected. So we've been able to handle an increase in applications without a corresponding increase in cost.

Now we've been very pleased with that. At this point in time we're only in Q1, and who knows what the year ahead holds. But we see in the cost line an ability, should economic or political uncertainty mean that income headwinds become realistic, as it were, or become realised, then our ability to manage costs means that we have the flexibility to manage the bottom line. If, on the other hand, we continue to make the sort of progress on the income side that we're currently making then we would expect because of our cost management to achieve a slight beat in the bottom line performance.

Question 8

Fiona Simpson, Morgan Stanley

Good morning. Thanks very much for the call. Just one general question: I'm just wondering what are your thoughts on the intermediary channel and what you're seeing. I guess last year we saw quite a pick-up in the amount of flow coming via the intermediary channel for the market as a whole whether there's been any change in that in the first quarter of the year? And also what the influence has been of more entrants coming into the intermediary channel, be it TSB and I believe HSBC; just interim thoughts on how that is impacting that channel of origination?

Jayne-Anne Gadhia

I can't remember the exact numbers, Fiona, but you're quite right that the intermediary channel has accelerated during Q1.

Lee, can you remember the exact numbers?

Lee Rochford

No.

Jayne-Anne Gadhia

But they've definitely seen a pick-up which is as we expected and as you indicate.

We have been very pleased with the relationships that we've built with intermediary mortgage partners. Over the course of last year we were creating a sort of intermediary promise – if that's the right way of putting it – and that includes in particular £100 fee or penalty, if you like, to a customer if we fail to offer them a mortgage within ten days of receiving a fully packaged account [application].

It's interesting none of our competitors have picked up on that, but we know that intermediaries very much value it. As things stand somebody told me we've paid out on nine cases, although I'm sure there are more in the pipeline, but not materially so.

So, our service proposition has been really valued by intermediaries, and we've put our money behind that, as it were. And that's given intermediaries and their individual brokers the confidence to recommend Virgin Money in more and more cases, which is obviously an important way to go. And I think reinforces for us, given the success of the volume increases that we've had in the quarter, the fact that it takes a long time to build really effective intermediary relationships, it's not just about price.

And I think of course TSB and HSBC coming into the market they've taken some share. But despite that we've seen both very effective completions position and extremely strong applications during Q1. And we're, as you can see, very able to deliver on the market targets that we've set ourselves. And that's, as much as anything, to do with the strength of our intermediary proposition.

Question 9

Chris Cant, Autonomous

I thought I might come back for one more because I thought the call was going to end very quickly.

I just wanted to ask on other income: you guided us quite well on net interest income in terms of margin and obviously volumes are doing a little bit better. And some of the commentary you're given around product launches seems quite positive. But I do still struggle a little bit to plug in a number for other operating income into my model. What do you think the overall trend this year is going to be relative to the performance we saw last year given the headwinds you face from things like Interchange?

Lee Rochford

Just to pick up on that last point. We don't face headwinds from Interchange, because the nature of the book being primarily a balance transfer book on the credit card side of the business isn't Interchange dependent, so we won't have pressure there.

The way to think about it, Chris, is going forward over the life of the plan, so the three years out to 2017 that we talked about, mid-teens trajectory is the right one. But it's not necessarily a straight line because, although we're having good start to the product rollout, we're rolling them out through the course of the year, and we're also increasing the origination of the credit card book more back-ended than front-ended in the year. So I'd think of it in mid-teens level but not as a straight line from this year to 2017.

Question 10

Arun Melmane, Canaccord

I just had one question on the current account. I wondered whether it was a loss leader for you, given the scale, and how much of a loss leader it is. And were that to grow where the breakeven point is and have you considered that in your margin assumptions?

Jayne-Anne Gadhia

It's a small business, it is a loss leader. In our cost base we have put aside £2m to support our current account development during the course of this year, it's all fully budgeted. And as I said earlier, the reason for that is we see not as at this point a sort of cost of funds enhancement or profit driver for the business per se, but as a strategic option in advance of the Competition Authority's findings in 2016. So certainly an area of investment but, as I say, I think it gives us very material strategic options.

Thank you very much indeed everyone for your time and look forward to speaking with you at the half year. Thank you.