Half Year 2019 CYBG PLC Earnings Call

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Corporate Participants

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* David Joseph Duffy

CYBG PLC - CEO & Executive Director

* Ian Stuart Smith

CYBG PLC - Group CFO & Executive Director

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Conference Call Participants

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* Amandeep Singh Rakkar

Barclays Bank PLC, Research Division - European Banks Analyst

* Azib Khan

Morgans Financial Limited, Research Division - Senior Banks Analyst

* Charmsol Yoon

UBS Investment Bank, Research Division - Equity Research Analyst of UK and European Banks

* Christopher Cant

Autonomous Research LLP - Partner, United Kingdom and Irish Banks

* Edmund Anthony Biddulph Henning

CLSA Limited, Research Division - Research Analyst

* Guy Stebbings

Exane BNP Paribas, Research Division - Analyst of Banks

* Ian David Gordon

Investec Bank plc, Research Division - Head of Banks Research

* Jennifer Cook

* Martin Leitgeb

Goldman Sachs Group Inc., Research Division - Analyst

* Robert Noble

RBC Capital Markets, LLC, Research Division - Equity Analyst

* Robert Ian Sage

Macquarie Research - Research Analyst

* Shailesh Mansukhlal Raikundlia

Panmure Gordon (UK) Limited, Research Division - Analyst

* Victor German

Macquarie Research - Analyst

John Cronin – Goodbody in Ireland

Hi guys, thanks for taking my questions. And the first one is a follow-up on the credit cards book, just to check, are the retention assumptions that you made as part of your assessment at acquisition holding (inaudible) with respect to those balances that are transmitting across to cash -- from zero balance? **And then my second question is just on the fixed rate tailored business loans. We've heard you before make very strong remarks in relation to the level of work you've done to support your views in terms of provisioning adequacy. We**

have seen recent media commentary around a claim being -- papers being filed in the High Court. Any further comment you could make on that at this point would be helpful. Thank you.

David Joseph Duffy, CYBG PLC - CEO & Executive Director [17]

Sure. Just on the latter part, and Ian can talk about the retention assumptions. Nothing has changed in terms of our views of any of the claims on TBLs. I think what you're referring to is some recent noise around certain of the customers and some case filings that have been advertised. **The short way to look at this is we've had 3 cases filed. So after multiple years and claims of extraordinary amounts and numbers of customers, we've had 3 filed**. So I would put it in that context and probably, just add to it that there is no change in our assumptions about the defensibility of our position on a small number of these that are out there; absolutely no change.

Am I correct in saying (inaudible) ventures was first in the media in July 2017 or potentially earlier in terms of the noise it was making?

Ian Stuart Smith, CYBG PLC - Group CFO & Executive Director [19]

Sorry (inaudible)

David Joseph Duffy, CYBG PLC - CEO & Executive Director [20]

(inaudible) that, John.

Unidentified Analyst, [21]

Yeah. I think, if I remember correctly, I think it was July 2017 when we first learned of potential claims (inaudible) unless it was perhaps earlier. It seems like a long time in any event I would have thought.

Ian Stuart Smith, CYBG PLC - Group CFO & Executive Director [22]

Yeah, that's right.

David Joseph Duffy, CYBG PLC - CEO & Executive Director [23]

The point that we were saying that, nothing has changed since we first started talking back then. If you recall, those early days, there were very big numbers and many customers. And it keeps getting smaller and smaller. And 2 years on, we've had 3 cases filed recently. So I think we're -- and nothing's changed around our assumptions or logic around the defensibility of any of the matters involved. So, that's -- hopefully, John, that gives you an answer there. And just on the retention assumptions?

Operator [42]

We now have a question from Vic German calling from Macquarie Bank.

Victor German, Macquarie Research - Analyst [43]

Thank you. I was hoping just to follow up on actually on capital and margins as well. The second half margin guidance implies a pretty wide range there. And given the trends that we've seen this quarter, I'm just interested -- in terms of (inaudible) on this. And I appreciate that obviously you perhaps didn't really want to change your guidance from what you'd given earlier, but I'm just interested in sort of why is the range so wide for the second half? And is there anything in particular that we should be thinking about?

Ian Stuart Smith, CYBG PLC - Group CFO & Executive Director [44]

I mean -- so Victor, the range is one that we specify for the full year. And I think guiding to within a sort of 5 point range feels reasonable to us. I think -- I'm inferring from your question is, how big is the step-down in the second half? I mean, broadly speaking, I've talked about the influences on that margin. I'm not sure how much more I can give you. I'm not going to narrow the range for the full year because there's a degree of uncertainty out there.

Victor German, Macquarie Research - Analyst [45]

Right. And those uncertainties predominantly relate to that mortgage issues that you've talked about? Or is it more relating to potential MREL issuances, what's the -- where are the sort of potential question marks?

Ian Stuart Smith, CYBG PLC - Group CFO & Executive Director [46]

Yeah. So 2 inferences, and apologies if it hasn't come through clearly on the call. There is absolutely pressure on the average yield in the mortgage book. We're going to see very substantial refinancings in the second half of the year. That will obviously be replaced with frontal business that is at a lower rate, and that introduces some substantial pressure to mortgage margins. We'll offset that with a little bit with everything else we do in the book. In terms of funding costs, not really sort of pinning this on MREL, per se. Our MREL issuance will be towards the end of the year. There's new issuance for this year. But you'll have seen a 34 basis point increase in the blended average cost of wholesale funding over the last half and that's contributing to just pressure on funding costs and margin. So those are the moving parts. And as I say, it is a step-down. We saw our mortgage margin in the second quarter come down also -- not mortgage margin, the Bank's net interest margin in the second quarter come down to 169 basis points. So the exit rate, if you like, is within that guidance range, and we expect to stay in that guidance range for the second half.

Victor German, Macquarie Research - Analyst [47]

Okay. Thank you. And then maybe just very quickly on capital. I appreciate your comments around dividend, and you haven't paid dividend in the past. Out obviously, your capital position has improved since your standalone entity. Just interested in kind of where is the hesitation coming from? Is it simply a historical issue? Or, are you waiting for more clarity on capital and sort of where would you like the capital position to be to have a sort of a more stable dividend?

Ian Stuart Smith, CYBG PLC - Group CFO & Executive Director [48]

Yeah. So we are, as I say, CYBG is in the early stages of being a dividend payer. So you'd expect us to build on this. But you have highlighted one of the key determinants, which is getting clarity on capital requirements from PRA, which we've always said was going to be one of the key determinants of where we would want to operate from a capital perspective. And so, if you'll allow us, Victor, we'll come back to that and talk about capital much more holistically at the CMD in June.

David Joseph Duffy, CYBG PLC - CEO & Executive Director [49]

I think we have another call on the line as well.

We now have a question from Azib Khan calling from Morgans Financial.

Azib Khan, Morgans Financial Limited, Research Division - Senior Banks Analyst [51]

Thank you very much. Couple of related questions from me on capital. So, Ian, following on from your response to the last question, does that mean you anticipate the ICAAP to be complete by the Capital Markets Day and can we expect you to announce the CET1 target operating range at the Capital Markets Day? And a second question on capital formation: with your CET1 ratio now at 14.5% and your fully loaded CRD4 for minimum CET1 sitting at 11.6%, is it fair to say -- would you agree that it doesn't look to be much capital management?

Ian Stuart Smith, CYBG PLC - Group CFO & Executive Director [52]

Hi Azib. We're certainly hopeful that we get the ICAAP outcome by Capital Markets Day and we're absolutely prepared to dig into capital in some depth at that point. But we're in the hands of the PRA to a certain extent in terms of timing, but let's see. I'm not going to get into specific discussions around capital levels and what we might want to hold as buffers and things like that. Not because I'm sort of dancing around the topic. But we need to have a holistic conversation here. We've got investor requirements, we've got a bunch of moving parts, and we're going to bring all that together for your at Capital Markets Day. So forgive me, but I'm going to not be drawn any further there.

SUPPLEMENTARY NOTES

National Australia Bank Limited SCHEME BOOKLET Pages 31 and 32

Conduct issues and the Conduct Mitigation Package

In common with the wider UK retail banking sector, CYBG Group has been required by the Financial Conduct Authority (“FCA”) to redress customer complaints arising from historic sales of Payment Protection Insurance (“PPI”), the historic sale of certain Interest Rate Hedging Products (“IRHP”) (which comprise standalone interest rate hedging products (“Standalone IRHP”) and certain tailored business loans, with additional features such as interest rate protections, functionality, structured collars, collars or caps (“Voluntary Scope TBLs”)) to small and medium-sized businesses, and other conduct-related matters. In addition, CYBG Group has undertaken a complaints-led review of certain Fixed Rate Tailored Business Loans (“FRTBL”) and paid redress where appropriate.

As announced by NAB on 7 May 2015, to achieve the Demerger, the UK Prudential Regulation Authority (“PRA”) requires that there be a capital support package for potential losses related to legacy conduct costs not covered by existing provisions, to a total cap of £1.7 billion (“Conduct Mitigation Package”). The £1.7 billion cap was determined by the PRA having regard to severe stresses to provision assumptions as at 30 September 2014 and was substantially in excess of NAB and CYBG’s assessment of CYBG Group’s potential liability in a severe conduct stress scenario.

As part of the Demerger arrangements, and as a term of the Sale and Purchase Agreement, NAB and CYBG PLC have entered into the Conduct Indemnity Deed under which NAB has agreed, subject to certain limitations, to provide CYBG PLC with an indemnity in respect of certain historic conduct liabilities (_Capped Indemnity_) up to a specified cap (“Capped Indemnity Amount”).

As at the Demerger Date, the Capped Indemnity Amount is expected to be £1.115 billion (and will not be more than this amount). This amount represents the £1.7 billion of capital support to be provided under the Conduct Mitigation Package less (i) £465 million of CYBG Group provisions for conduct matters recognised in the year ended 30 September 2015 (covered by NAB through a capital injection into CYBG Group in September 2015) and (ii) £120 million for which CYBG Group will take responsibility as part of the Loss Sharing Arrangement.

Should there be any further amounts paid by NAB to CYBG Group in respect of any additional provisions for conduct matters before the Demerger Date, then the Capped Indemnity Amount, and thus NAB’s remaining exposure under the Conduct Mitigation Package, will be reduced by such amounts.

The support provided by the Capped Indemnity is in addition to CYBG Group's unutilised provisions for conduct liabilities. As at 30 September 2015 there were £986m of such unutilised provisions comprising:

• £774 million in respect of PPI;

• £192 million in respect of IRHP (Standalone IRHP and Voluntary Scope TBLs) and FRTBLs; and

• £20 million of other items.

From the Demerger Date, NAB is required to collateralise its obligations under the Capped Indemnity by placing a cash deposit with The Bank of England in an amount equal to the Unutilised Indemnity Amount, and take a CET1 deduction for the Capped Indemnity Amount.
The Capped Indemnity will be accounted for as a contingent liability by NAB, with any potential future losses incurred under the indemnity expensed within discontinued operations.

The Capped Indemnity is perpetual in nature and will only terminate in certain limited circumstances. See Section 4.9 for further details on the Capped Indemnity.

Capital injections
NAB made capital injections of £205 million in the 6 months ended 30 September 2015 (in addition to the £465 million injection for conduct provisions described above), to strengthen CYBG Group's capital position and to ensure that it has a prudent buffer to minimum regulatory capital requirements upon separation, resulting in CYBG Group having a CET1 Ratio of 13.2% as at 30 September 2015.

Funding repayments and intercompany settlements

In anticipation of the Demerger, the amounts due to NAB from CYBG Group have been reduced with CYBG Group having repaid to NAB £741 million of senior debt funding over the course of the year ended 30 September 2015.
In addition, since the end of September 2015 a further £100 million of senior notes were repaid by CYBG Group to NAB, and £101 million of amounts outstanding in relation to historic (pre 31 March 2015) IRHP/FRTBL conduct charges were paid by NAB to CYBG Group.

<u>Page 165 of CYBG Financial statements as at 30 September 2018</u>

Exposures

There continues to be a great deal of uncertainty and significant judgement is required in determining the quantum of **conduct risk-related liabilities** with note 3.14 reflecting the Group's current position in relation to redress provisions for PPI, interest rate hedging products (IRHPs) and other smaller historic conduct matters. **The final amount required to settle the Group's potential liabilities for these matters is materially uncertain. The Group will continue to reassess the adequacy of provisions for these matters and the assumptions underlying the calculations at each reporting date based upon experience and other relevant factors at that time.**

Monitoring

This is a principal focus of the Board, senior management and regulators, and the Group seeks to ensure customers are treated fairly and products are designed and sold to meet their needs. The Group also works to ensure that customer expectations are met and complaints are dealt with effectively and fairly. All Three Lines of Defence consider conduct risk as part of their oversight and assurance activities.