Banking

Resilient performance in a challenging environment with all three divisions profitable

Key Financials

Continuing operations[1]	**2020 £ million**	2019 £ million	Change %
Adjusted operating income	**586.0**	602.6	(3)
Adjusted operating expenses	**(303.4)**	(300.5)	1
Impairment losses on loans and advances	**(183.4)**	(48.4)	279
Adjusted operating profit	**99.2**	253.7	(61)
Net interest margin[2]	**7.5%**	7.9%	
Expense/income ratio	**52%**	50%	
Bad debt ratio[2]	**2.3%**	0.6%	
Return on net loan book[2]	**1.3%**	3.3%	
Return on opening equity	**6.5%**	17.5%	
Average loan book and operating lease assets	**7,854.3**	7,654.0	3

1 Results from continuing operations exclude the unsecured retail point of sale finance business, which was classified as a discontinued operation in the group's income statement for the 2019 financial year and sold on 1 January 2019.
2 The calculation of the bad debt ratio, net interest margin and return on net loan book excludes the unsecured retail point of sale finance loan book from both the opening and closing loan book.

Banking adjusted operating profit decreased to £99.2 million (2019: £253.7 million) reflecting the forward-looking recognition of impairment charges under IFRS 9 and lower income driven by the impact of Covid-19. Statutory operating profit from continuing operations decreased to £97.2 million (2019: £251.8 million).

Despite subdued new business volumes during the lockdown period, the loan book remained broadly flat in the year at £7.62 billion (31 July 2019: £7.65 billion) as we experienced an encouraging increase in client activity as lockdown restrictions eased. The return on net loan book, although lower, remained resilient at 1.3% (2019: 3.3%).

Adjusted operating income decreased 3% to £586.0 million (2019: £602.6 million), reflecting the impact of lower customer activity and forbearance measures, with a reduced net interest margin of 7.5% (2019: 7.9%).

While we remain focused on our pricing and underwriting discipline, the reduced net interest margin reflected a period of lower fee income, as some fees were waived due to forbearance and transaction and utilisation levels dropped significantly. Adjusting for certain items including modification losses arising from the onset of Covid-19, the monthly net interest margin remained broadly stable in the period prior to the Covid-19 outbreak, with a sharp drop in April and May before partially recovering in recent months as activity levels and fee income benefited from the easing of lockdown restrictions.

Adjusted operating expenses increased marginally by 1%, to £303.4 million (2019: £300.5 million), primarily driven by investment in strategic projects, including our multi-year investment programmes in Motor Finance and Asset Finance, investment to support our IRB application and enhancements to our cyber and data security.

Recent investment to improve our operational capabilities and our proposition to customers has been critical to our effective response to Covid-19. This included our remote lending capability which supported our Motor Finance dealers during lockdown, our deployment of Salesforce aiding the rapid set-up of a portal to streamline CBILS applications in Asset Finance, and our online deposit portal which allowed us to continue raising deposits remotely throughout lockdown.

Investment costs increased £10.7 million on the prior year to £57.2 million, and are expected to increase further in the year ahead as we continue to progress these important initiatives. Excluding these costs related to investments, operating expenses decreased £7.8 million on the prior year to £246.2 million, mainly reflecting our focus on cost control and lower variable compensation. Given the current environment, we will continue to review and prioritise investment spend while maintaining our focus on cost discipline.

The compensation ratio remained stable at 28% (2019: 28%). A reduction in operating income and continued investment spend resulted in an increase in the expense/income ratio to 52% (2019: 50%).

Impairment charges increased significantly to £183.4 million (2019: £48.4million) corresponding to a bad debt ratio of 2.3% (2019: 0.6%). Provisions increased across Commercial, Retail and Property, primarily to reflect the impact of Covid-19 on impairments, taking into account loan book performance, forbearance measures, and the macroeconomic outlook across our diverse portfolio of lending businesses.

This resulted in an overall increase in provision coverage to 3.0% (31 July 2019: 1.3%), while underlying loan losses and write offs remained broadly stable on the previous financial year.

Return on opening equity was resilient at 6.5% (2019: 17.5%) and reflected the impact of the pandemic on the profitability of the division.

Loan Book

Loan book growth has always been an output of our business model, and we continue to prioritise our margins and credit quality. We have a diverse portfolio of businesses, which ensures that our model remains resilient through the cycle.

The loan book remained broadly flat in the year at £7.62 billion (31 July 2019: £7.65 billion) as growth in our Commercial and Retail businesses was offset by a contraction in our Property loan book, reflecting a resilient overall performance in a challenging year with the general election, continuing uncertainty over the final Brexit settlement and the Covid-19 pandemic impacting customer demand.

The marginal reduction in net loan book over the year was a result of the increased provisions to reflect the estimated impact of Covid-19, but we remain confident in the overall credit quality of the loan book. The group's largest single sector exposure is to residential property development and construction (c.21%) predominantly through the Property loan book. Consumer lending represented c.30% of the group's exposure with Motor Finance and Premium Finance personal lines comprising c.23% and c.7% respectively. Sector exposures to retail, hospitality, leisure, air transport and oil and gas are minimal.

The Commercial loan book increased to over £3.0 billion (31 July 2019: £3.0 billion) reflecting good growth in our Asset Finance business, although this was partially offset by a marked reduction in utilisation levels in our Invoice Finance business. We experienced a recovery in new business volumes in Asset Finance in June and July, as lockdown restrictions eased, supported by strong demand for loans under CBILS.

Loan Book Analysis

	31 July 2020 £ million	31 July 2019 £ million	Change %
Commercial	**3,048.0**	2,991.3	1.9
Asset Finance	**2,167.4**	1,946.4	11.4
Invoice and Speciality Finance	**880.6**	1,044.9	(15.7)
Retail	**2,834.5**	2,810.7	0.8
Motor Finance	**1,749.4**	1,775.6	(1.5)
Premium Finance	**1,085.1**	1,035.1	4.8
Property	**1,734.2**	1,847.6	(6.1)
Closing loan book	**7,616.7**	7,649.6	(0.4)
Operating lease assets[1]	**221.9**	220.4	0.7
Closing loan book and operating lease assets	**7,838.6**	7,870.0	(0.4)

1 Operating lease assets of £2.9 million (2019: £4.2 million) relate to Asset Finance and £219.0 million (2019: £216.2 million) to Invoice and Speciality Finance.

Key Performance Indicators

Net interest margin
Per cent

Bad debt ratio
Per cent

Return on net loan book
Per cent

Return on opening equity

6.5%

2019: 17.5%

Banking continued

In Retail, the loan book remained broadly flat at £2.8 billion (31 July 2019: £2.8 billion). Although the UK lockdown resulted in the temporary closure of motor dealerships which led to a reduction in new business for Motor Finance as dealers adapted to trading remotely, volumes showed strong recovery following the re-opening of dealerships, resulting in overall growth in the UK loan book. A modest reduction in the Irish Motor Finance business resulted in a slight decline in the Motor Finance loan book as a whole. Premium Finance continued to see solid demand for insurance finance, resulting in an increase in loan book to £1.1 billion (31 July 2019: £1.0 billion).

While the pipeline for new developments remains good, Property experienced fewer drawdowns on lending facilities as construction activity remained subdued throughout the second half of the year. Higher repayments also contributed to a reduction in the property loan book of 6% to £1.7 billion (31 July 2019: £1.8 billion).

Commercial

The Commercial businesses provide specialist, predominantly secured lending principally to the SME market and include Asset Finance and Invoice and Speciality Finance. The latter includes smaller specialist businesses such as Novitas, a specialist provider of finance to clients of the legal sector, Brewery Rentals, which provides service and finance solutions for brewery equipment and containers, and Vehicle Hire, which provides heavy goods and light commercial vehicles on a predominantly long-term hire basis.

The Commercial loan book increased to over £3.0 billion (31 July 2019: £3.0 billion), reflecting good growth in our Asset Finance business, although this was partially offset by a reduction in utilisation levels in our Invoice Finance business.

The Asset Finance loan book increased 11% in the year as new business volumes recovered in June and July supported by strong demand for loans under CBILS for which a solid pipeline remains. Invoice and Speciality Finance saw lower utilisation of Invoice Finance facilities due to softer demand reflecting economic uncertainty for most of the year, compounded by Covid-19 in the second half.

Adjusted operating profit of £4.8 million (2019: £86.5 million) included £99.2 million of impairment charges predominantly driven by Covid-19. Statutory operating profit was £3.1 million (2019: £84.9 million).

Banking: Commercial

	2020 £ million	2019 £ million	Change %
Operating income	**246.6**	249.9	(1)
Adjusted operating expenses	**(142.6)**	(140.1)	2
Impairment losses on financial assets	**(99.2)**	(23.3)	326
Adjusted operating profit	**4.8**	86.5	(94)
Net interest margin	**7.6%**	8.1%	
Expense/income ratio	**58%**	56%	
Bad debt ratio	**3.1%**	0.8%	
Average loan book and operating leases	**3,240.8**	3,078.9	5

Banking: Retail

Continuing operations[1]	**2020 £ million**	2019 £ million	Change %
Adjusted operating income	**218.4**	223.2	(2)
Adjusted operating expenses	**(126.9)**	(125.5)	1
Impairment losses on loans and advances	**(56.6)**	(25.2)	125
Adjusted operating profit	**34.9**	72.5	(52)
Net interest margin[2]	**7.7%**	8.1%	
Expense/income ratio	**58%**	56%	
Bad debt ratio[2]	**2.0%**	0.9%	
Average loan book	**2,822.6**	2,740.6	3

1 Results from continuing operations exclude the unsecured retail point of sale finance business, which was classified as a discontinued operation in the group's income statement for the 2019 financial year and sold on 1 January 2019.
2 The calculation of the bad debt ratio and net interest margin excludes the unsecured retail point of sale finance loan book from both the opening and closing loan book.

Operating income of £246.6 million (2019: £249.9 million) was marginally lower than the prior year, despite a higher average loan book, due to a reduction in the net interest margin to 7.6% (2019: 8.1%), driven by subdued customer activity including low rentals utilisations and actions taken to support our customers following the UK lockdown.

Adjusted operating expenses increased 2% to £142.6 million (2019: £140.1 million) mainly reflecting investment related to the Asset Finance transformation programme. This programme is aimed at increased sales effectiveness through enhanced data capabilities and technology, with the first phase expected to deliver additional new business volumes over time. The next phase will focus on optimising our operational efficiency, with upgraded systems and processes to support the long-term resilience of the business. This investment spend resulted in cost growth higher than the subdued growth in operating income for the year and the expense/income ratio increased to 58% (2019: 56%).

Impairment charges increased significantly to £99.2 million (2019: £23.3 million), with a bad debt ratio of 3.1% (2019: 0.8%), primarily reflecting a review of staging and provision coverage to reflect the increase in Covid-19 forbearance across the portfolio, as well as the incorporation of more severe macroeconomic assumptions. This resulted in a coverage ratio of 3.9% at 31 July 2020 (31 July 2019: 1.7%).

Our Commercial loan book is predominantly secured, with minimal exposure to higher risk sectors and those impacted most severely through the recent crisis, such as travel and leisure, hospitality or oil and gas. Our loans are conservatively underwritten with prudent LTVs, supported by our specialist expertise on the underlying assets and long standing industry relationships.

As at 31 July 2020, around 7,300 customers, representing 26% of the Commercial loan book by value, were subject to forbearance measures as a result of Covid-19, principally in the form of payment deferrals with fees and charges waived in the Asset Finance business, and flexing of repayments percentages and overpayments on invoice discounting and factoring facilities. We remain in close contact with customers who have been granted Covid-19 forbearance, and the majority of these, accounting for over 70% of the forborne loan book, have now resumed payments.

Retail

The Retail businesses provide intermediated finance, principally to individuals and small businesses, through motor dealers and insurance brokers.

The Retail loan book was broadly flat at £2.8 billion (31 July 2019: £2.8 billion) as 5% loan book growth in Premium Finance offset a slight decline of 1% in the Motor Finance loan book.

The Premium Finance loan book increased 5% to £1.1 billion (31 July 2019: £1.0 billion) against a challenging backdrop with growth across the business, with strong demand for insurance finance. The business continues to be well positioned competitively, following the multi-year investment programme in its infrastructure over recent years to improve both broker and end customer experience.

Despite the impact of the temporary closure of motor dealerships during lockdown, the UK Motor Finance loan book remained resilient, benefiting from recent investment in sales capability and grew overall following a sharp recovery in volumes as lockdown restrictions eased in June and July. This was offset by a modest reduction in Ireland, which accounts for 26% (2019: 28%) of the Motor Finance loan book, where we operate through a local partner, First Auto Finance, who provide the distribution and dealer relationships. The Motor Finance loan book reduced 1% overall at £1.7 billion (31 July 2019: £1.8 billion).

Overall, adjusted operating profit for Retail was £34.9 million (2019: £72.5 million) and included higher impairment charges of £56.6 million driven by Covid-19. Statutory operating profit was £34.6 million (2019: £72.2 million).

Adjusted operating income was down 2% year-on-year at £218.4 million (2019: £223.2 million) with a decline in net interest margin to 7.7% (2019: 8.1%), reflecting a reduction in fee income driven by lower activity levels and forbearance in both businesses, particularly in the latter half of the year.

Commercial adjusted operating profit

£4.8m

2019: £86.5m

Retail adjusted operating profit

£34.9m

2019: £72.5m

Property operating profit

£59.5m

2019: £94.7m

Banking continued

Adjusted operating expenses increased 1% to £126.9 million (2019: £125.5 million), and the expense/income ratio increased to 58% (2019: 56%), reflecting a reduction in operating income along with volume-driven costs and ongoing investment in both Premium Finance and Motor Finance. We are making good progress with our Motor Finance transformation programme which is aimed at improving the service proposition, enhancing operational efficiency, improving our credit acceptance process and increasing sales effectiveness.

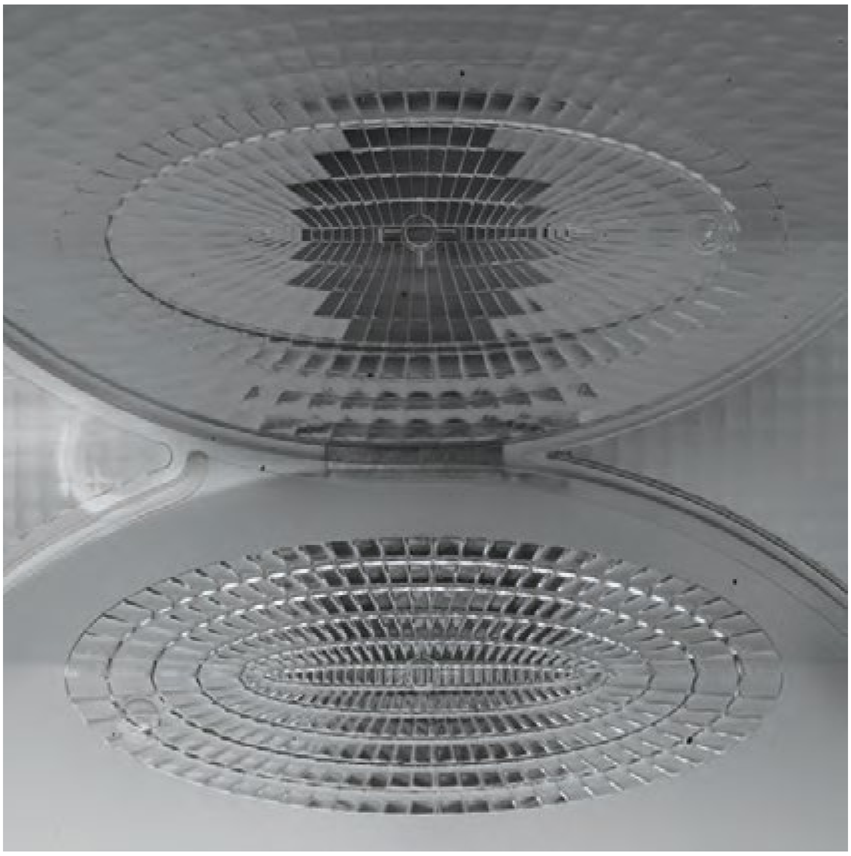
Impairment charges increased to £56.6 million (2019: £25.2 million) with a bad debt ratio of 2.0% (2019: 0.9%), primarily reflecting movement between stages in the Motor Finance loan book, including the impact of Covid-19 forbearance in the second half, with a more modest increase in Premium Finance. This resulted in an increased provision coverage ratio to 2.5% at 31 July 2020 (31 July 2019: 1.3%).

We remain confident in the credit quality of the Retail loan book. The Motor Finance loan book is secured on principally second-hand family vehicles which are less exposed to depreciation or significant declines in value. Our core Motor Finance product remains hire-purchase contracts, with limited exposure to residual value risk associated with Personal Contract Plans ("PCP"), which accounted for only 11% of the Motor Finance loan book at 31 July 2020. The Premium Finance loan book benefits from various forms of structural protection including premium refundability and broker recourse for the personal lines product.

As at 31 July 2020, around 58,600 customers across Motor Finance and Premium Finance, accounting for 9% of the Retail loan book by value, were subject to forbearance measures as a result of Covid-19, principally in the form of payment holidays. We continue to closely monitor the performance of the loan book as customers emerge from Covid-19 concessions, with over three quarters of forborne loan balances currently up to date, settled or having recommenced payments.

Property

Property comprises Property Finance and Commercial Acceptances. The Property Finance business is focused on specialist residential development finance to established professional developers in the UK. Commercial Acceptances provides bridging loans and loans for refurbishment projects. We do not lend to the buy-to-let sector or provide residential or commercial mortgages.



Our long track record, expertise and quality of service ensure the business remains resilient to competition and continues to generate high levels of repeat business. The regional market remains important to us and we launched an office in Manchester in 2019 to progress this initiative.

We experienced fewer drawdowns on lending facilities as construction activity remained subdued for most of the second half of the year. Higher repayments also contributed to a reduction in the Property loan book of 6% to £1.7 billion (31 July 2019: £1.8 billion). Following the easing of the lockdown in June and July, customer demand for new housing appears to have rebounded, supported by the temporary reduction in stamp duty. Our new business pipeline and committed facilities remain strong.

The business delivered an operating profit of £59.5 million (2019: £94.7 million) which included higher impairment charges of £27.6 million (2019: (£0.1) million) predominantly driven by Covid-19.

Banking: Property

	2020 £ million	2019 £ million	Change %
Operating income	**121.0**	129.5	(7)
Operating expenses	**(33.9)**	(34.9)	(3)
Impairment losses on loans and advances	**(27.6)**	0.1	na
Operating profit	**59.5**	94.7	(37)
Net interest margin	**6.8%**	7.1%	
Expense/income ratio	**28%**	27%	
Bad debt ratio	**1.5%**	(0.0%)	
Average loan book	**1,790.9**	1,834.5	(2)

Operating income was down 7% year-on-year at £121.0 million (2019: £129.5 million) reflecting the reduction in loan book and net interest margin which decreased to 6.8% (2019: 7.1%) driven by actions taken to support our customers such as waiving of fees on term extensions.

Operating expenses of £33.9 million (2019: £34.9 million) reduced 3% despite the opening of the new Manchester office and continued technology investment across the Banking division. Although the expense/income ratio increased to 28% (2019: 27%), it remained low reflecting the lower operational requirements of the business with larger transaction sizes and a relatively small number of loans.

Impairment charges increased to £27.6 million (2019: (£0.1) million) primarily reflecting more conservative macroeconomic assumptions, and review of provisions for individual impaired loans. This resulted in a bad debt ratio of 1.5% (2019: (0.0%)) and a provision coverage ratio of 2.5% at 31 July 2020 (31 July 2019: 0.8%).

The Property loan book is conservatively underwritten with a maximum LTV of 60% at origination on residential development finance, which accounts for the vast majority of the loan book. We work with experienced, professional developers, with a focus on mid-priced family housing, and have minimal exposure to the prime central London markets.

As at 31 July 2020, 187 customers, accounting for 18% of the Property loan book by value, were subject to forbearance measures as a result of Covid-19, principally in the form of fee-free extensions for residential development loans, where we remain confident in the quality of the underlying borrower and security. Forborne loans continue to be assessed on a case-by-case basis and we remain in close contact with each of our customers.