NatWest Group plc
H1 2023 Results Fixed Income Presentation
Hosted by Katie Murray (CFO) and Donal Quaid (Treasurer)
1pm, 28th July 2023

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Katie Murray, CFO

Slide 2: Welcome

Good afternoon, everyone - thank you for joining our second quarter Fixed Income results presentation.

I'm joined today by Donal Quaid, our Treasurer, and Paul Pybus, Head of Debt IR.

I will take you through the headlines for the first half before moving on to some of the detail for the second quarter.

I'll be focusing on financials today, so if you'd like to see more of our business update, I'd encourage you to read the equity presentation released this morning.

Donal will take you through the balance sheet, capital and liquidity and then we'll open up for questions.

Before that I'll start with some words from Howard on recent events.

On Wednesday the Board announced that Alison Rose had agreed to step down as CEO with immediate effect by mutual consent.

Subject to regulatory approval, the Board has appointed Paul Thwaite, the current CEO of our Commercial and Institutional business, as interim Group CEO.

Paul has been a member of our Executive Committee since 2019 and has played an important role in delivering our current strategy which remains unchanged.

Slide 3: Strong H1 2023 performance

So turning to the headlines on slide 3.

The business continues to perform well, and we have delivered a strong first half with growth in lending of 6 billion pounds and new customer acquisition in key areas.

We delivered first half operating profit of £3.6 billion and attributable profit of £2.3 billion.

Income grew to £7.4 billion, and costs were £3.8 billion.

Our strong capital generation gives us the flexibility to invest in the business, consider other value creating strategic options and return capital to shareholders.

We are proposing an interim dividend this year of 5.5 pence, up from 3.5 pence last year.

We have completed the 800 million on-market buy back announced in February;

and today we announced another on-market buyback of £500 million which we expect to start next week.

Together with the directed buyback of £1.3 billion in May, this brings our CET ratio to 13.5%,

within our target range of 13 -14 % for the first time.

Our return on tangible equity was 18.2%, on track for our target 14-16% range by the year end.

Slide 4: Strong Q2'23 operating performance

Turning to slide 4 and our performance in the second quarter, using the first quarter as a comparator.

Total income was stable at £3.9billion.

Income excluding all notable items was £3.6 billion, down 6.7%.

Within this, Net interest income was 2.7% lower at £2.8 billion and non-interest income was down 19.5% at £739 million.

Operating expenses fell 3.1% to £1.9bn.

The impairment charge increased to £153 million or 16 basis points of loans, driven by higher Post Model Adjustments.

Taking all of this together, we delivered operating profit before tax of £1.8 billion.

We incurred some notable charges bringing profit attributable to ordinary shareholders to £1 billion.

And return on tangible equity was 16.4%.

I'll move on now to income on slide 5.

Slide 5: Income on track to meet guidance

Income excluding all notable items was 3.6 billion, down 6.7% on Q1.

Net interest income was 2.7% lower at 2.8 billion, driven by lower margins on mortgages and deposits and lower Group average interest earning assets, which reduced by 1.5% to £514 billion, driven by a reduction in liquid assets which more than offset loan growth.

Non-interest income, excluding notable items, was down 179 million to £739 million.

We continue to expect full year income excluding notable items of around £14.8 billion, however we now expect Net Interest Margin of around 3.15%, down from around 3.20%.

This assumes the UK base rate increases by a further 50 basis points in Q3 to 5.5%, and remains there for the rest of the year, and the average reinvestment rate of our product structural hedge for the full year is 4.4%, up from 3.6%.

The benefit from higher rates on bank NIM is more than offset by our expectation of further deposit mix changes and pass-through, and a reduction in the product hedge notional from £202 billion to around £190 billion by the year end, reflecting a catch up with eligible spot deposit balances

Turning now to Costs on slide 6.

Slide 6: On track for ~£7.6bn other operating costs in FY'23

Other operating expenses were £1.9 billion for the second quarter. That's down £57 million or 3% on the first quarter driven by lower severance and consultancy costs.

In Ulster Bank we have incurred £163 million of direct costs in the first half, and we continue to guide to around £300 million for the full year.

We continue to expect other operating costs of around £7.6 billion for the full year, in line with our guidance.

This cost performance is delivering a cost income ratio of 49.3% for the first half, benefiting from the notable income gains. Excluding these the cost income ratio is 51.6%.

I'd like to turn now to impairments on slide 7.

Slide 7: Our impairment guidance remains unchanged at 20-30bps

We booked a net impairment charge of £153 million in the second quarter, equivalent to 16 basis points of loans on an annualised basis.

This was driven by an increase in our post model adjustment for economic uncertainty of £129 million to £462 million, together with further reserve building, that more than offset the £98 million Expected Credit Loss release from the update to our economic assumptions.

The PMA increase is largely against our wholesale book to cover any potential cash flow issues as a result of higher interest rates and inflation.

Excluding this, we would have had further net impairment releases in our Commercial & Institutional business.

In Retail overall, stage 3 charges and defaults remain stable. The impairment charge driven by new day 1 provisions relates to unsecured lending growth.

Our 2023 impairment guidance is 20-30 basis points. We see this as prudent, and we would need to see a material deterioration in performance to be inside the range.

Looking at lending now on slide 8.

Slide 8: Further loan growth in target segments

We are pleased to have delivered further net lending growth in the quarter.

Gross loans to customers across our three businesses increased by £0.3 billion to £356 billion.

Taking Retail Banking together with Private Banking, mortgage balances grew by £1.9 billion or 1% in the quarter.

Gross new mortgage lending was £8 billion, representing flow share of around 15%.

And our stock share has increased from 12.3% at the start of the year to 12.6%, demonstrating how we are delivering on our growth strategy.

Given volatility in swap rates during the quarter, our average application margin was below our intended range of around 80 basis points, but we were back to this level at the beginning of July as we repriced customer rates.

Unsecured balances increased by a further 600 million to £15 billion, driven by additional card issuance and ongoing share gains.

In Commercial & Institutional, gross customer loans decreased by £2.3 billion.

At the mid to large end, we saw some demand for Asset Finance and Revolving Credit Facilities.

At the smaller end, demand remains muted, and customers with surplus liquidity continued to deleverage, including repayment of government scheme lending.

I'd like to turn now to credit risk on slide 9.

Slide 9: Well diversified, high-quality loan book

We have a well-diversified prime loan book which is performing well, and which demonstrated its resilience in the recent Bank of England stress tests.

Over 50% of our Group lending consists of mortgages, where the average Loan to Value is 55% or 69% on new business.

We continue to have low levels of arrears and forbearance in our mortgage book. 91% of our book is fixed, 5% are trackers and 4% is on a Standard Variable Rate.

Over two thirds of mortgage balances are fixed for 5 years and less than a quarter are fixed for 2.

The composition of our mortgage book means a lower proportion of our customers will face a change to their mortgage repayments in the second half, relative to the sector average.

The majority of our customers are rolling off 5-year fixed rates where the uplift is lower than for those rolling off 2-year rates.

Since mortgage rates began to rise in Q4 last year, more than 70% of our customers have taken the opportunity to refinance early and take advantage of lower rates.

Our personal unsecured exposure is less than 4% of group lending and is performing in line with expectations.

Our corporate book is well diversified, and we have brought down concentration risk over the past decade, including reducing Commercial Real Estate which is less than 5% of group loans, with an average Loan to value of 48%.

With that I will hand over to Donal.

Donal Quaid, Treasurer

Slide 10: Introduction

Thanks Katie. Good afternoon and thank you for joining today's call.

I will start by sharing some highlights from the first half of the year before moving into more detail on deposits, liquidity and capital. I will then give an update on our progress against our funding plans for the year before we open for questions.

Starting with the highlights on slide 11.

Slide 11: Strong capital, MREL and leverage positions

We ended the first half with strong capital, MREL and leverage position; comfortably above the regulatory minima with a CET1 ratio of 13.5%, a Leverage ratio of 5% and a total MREL ratio of 31.2%.

The group's funding is well diversified, and we have a strong deposit franchise and a robust liquidity position.

The Liquidity Coverage Ratio was 141%, giving us a comfortable surplus over minimum requirements with the liquidity portfolio primarily concentrated in central bank deposits.

We've made good progress against our funding requirements in the first half, achieving over 60% of our annual issuance requirements for the Holding and Operating companies, despite challenging market conditions.

It was pleasing to see further progress on our credit ratings in April, with S&P upgrading all NatWest Group entities, recognising the Group's strong earnings outlook, robust balance sheet and solid funding and liquidity.

Turning to liquidity on slide 12.

Slide 12: Strong liquidity portfolio and key metrics

Our liquidity position remains robust, with an LCR ratio of 141% at the end of Q2, reflecting around £45bn of surplus primary liquidity above minimum requirements. Our Liquidity coverage ratio was 145% on a 12-month rolling average view.

The increase in the ratio in the quarter from 139% at Q1 was primarily due to a higher customer funding surplus and an increase in Treasury funding activity, including issuance.

We continue to manage a high-quality liquid asset pool with primary liquidity of around £148 billion and secondary liquidity of £79 billion.

Primary liquidity is concentrated in cash, with 81% deposited with central banks. The remainder comprises highly rated Level 1 LCR bonds, the majority of which are held on the balance sheet at fair value.

Our secondary liquidity increased by approximately £18 billion during Q2 after we increased the nominal value of assets pre-positioned at the Bank of England in April.

Looking at customer deposits on slide 13.

Slide 13: Robust deposit funding – balances stable in Q2'23

We operate with a diverse deposit franchise, with a mix of retail and commercial deposits, across interest bearing and non-interest-bearing product offerings.

Customer deposits across our three core businesses were £421 billion at the end of first half, resulting in a loan to deposit ratio of 83%.

We saw limited movement in deposits during the second quarter, compared to a reduction of approximately £11 billion in the first quarter from higher tax payments and a reduction in system wide liquidity.

Retail Banking deposits reduced by £0.9 billion, as growth in interest bearing savings was offset by lower current account balances. Private Banking deposits decreased by £0.8 billion in the quarter. Commercial & Institutional deposits increased by £1 billion.

During the quarter, we continued to see migration from both non-interest-bearing accounts and instant access into fixed term accounts. Term deposits are now around 11% of total deposits, up from 6% at the year end. Interest bearing balances now account for 63% of total deposits up from 60% at Q1.

Our cumulative pass through is now around 50% across instant access deposits, up from 40% at Q1, which includes pricing decisions after the base rate increase to 5% in May.

Around 40% of total deposits are insured, although this varies by franchise and customer type with a much higher percentage of our retail balances insured.

Turning to our capital and leverage position on slide 14.

Slide 14: Strong capital and leverage positions provide confidence and flexibility

Our CET1 ratio at the end of the quarter was 13.5%, within our target range of 13-14% and well above the current Maximum Distributable Amount of 10.4%, which increased 90 basis points earlier this month as a result of the UK countercyclical buffer moving from 1% to 2%, as previously announced by the Financial Policy Committee.

Our total capital ratio for the first half is 18.8%. Given our CET1 target range of 13-14%, we expect to operate with optimal levels of AT1 and Tier 2 capital going forward relative to our minimum requirements.

We have a comfortable AT1 position with £3.9 billion in issue, an AT1 ratio of 2.2% compared to a minimum regulatory requirement of 2.1%. We have no near term AT1 considerations, with the next call date not until August 2025.

Our Tier 2 ratio is 3.1%, which currently shows a buffer to our 2.7% minimum requirement, following our recent issuances last December and in March of this year.

Our UK leverage ratio was 5%, leaving around 145 basis points of headroom above the Bank of England minimum requirement.

Moving to slide 15 and returns and capital generation.

Slide 15: Continued sustainable returns and strong capital generation and distribution

We are pleased to have delivered a 16.4% return on tangible equity this quarter, driving capital generation of 51 basis points, excluding non-recurring impacts such as our acquisition of Cushon.

This brings capital generation to 101 basis points for the first half.

We ended the quarter with a Common Equity Tier 1 ratio of 13.5%, down 90 basis points on the first quarter. This was driven by distributions which account for 115 basis points.

That includes the £1.3 billion directed buy back which consumed 71 basis points of capital; an ordinary divided accrual equivalent to 16 basis points, in line with our 40% pay-out ratio; and further £500m on-market buyback programme announced today, which is fully accrued in our 13.5% CET1 ratio.

Moving to slide 16 and the results of the 2022/2023 Bank of England Stress Test that were released earlier this month.

Slide 16: 2022/23 ACS stress test results demonstrate a robust balance sheet and solid capital position

The stress test explores whether the Group has sufficient capital to withstand a severe but plausible outcome starting with the Group's balance sheet as of 30 June 2022, and a CET1 starting point of 14.3%.

As you can see on this slide, on an IFRS 9 Transitional basis, the Group's low point CET1 ratio would have been 11.1% on a minimum stressed ratio basis after the impact of strategic management actions. This is well above the Group's 7.0% hurdle rate, our H1'23 MDA of 9.6% and current MDA of 10.4%.

The Group's Tier 1 leverage ratio would have been 5.2% after the impact of strategic management actions. This is also well above the hurdle rate of 3.7%.

I am very pleased that stress testing exercise has once again highlighted NatWest Group's robust balance sheet given the significant de-risking completed over the last 10 years, providing further confidence that we are well able to withstand a severe shock and enabling us to support our customers and the UK economy.

Looking at our issuance during the first half on slide 17.

Slide 17: Good progress against 2023 wholesale funding plans

I'm very pleased with the transactions we've executed this year, particularly in light of challenging market conditions, and once again thank you for your continued support for NatWest Group and NatWest Markets.

From NatWest Group, we've issued around £4 billion equivalent in senior MREL format in the first half, being active in USD and EUR.

Our H1 transactions leave us well placed against our £3-5 billion issuance requirement for 2023.

In addition to issuing MREL, we also issued €700 million of Tier 2 in H1.

While for NatWest Markets plc, we have issued around £2 billion equivalent in EUR, CHF and most recently in GBP, in fixed and floating format. That leaves us around 50% complete against the mid-point of our £3-5 billion guidance for 2023.

We therefore expect to be active across the group in both HoldCo and OpCo transactions in H2 and will also give consideration to the potential of pre-funding our 2024 requirements if the right market conditions prevail.

Turning to credit ratings on slide 18.

Slide 18: Credit ratings

It's pleasing to see further progress in our credit ratings this year.

In April, S&P upgraded the ratings of all NatWest Group entities.

The NatWest Group Holding company is now rated BBB+, the ring-fenced bank core operating companies are now A+ and our non-ring-fenced banking operating companies are now single A.

The outlook from Moody's, S&P and Fitch are Stable across all group entities.

We will continue to proactively engage with the agencies to support ongoing progress in our credit and ESG ratings.

With that I'll hand back to Katie.

Katie Murray, CFO

Thank you, Donal.

I'd like to finish with guidance on slide 20.

Slide 20: Our FY'23 guidance

We expect income, excluding notable items, to be around 14.8 billion, at a UK base rate of 5.5%.

Net Interest Margin of about 3.15%, and group operating costs, excluding litigation and conduct, to be around £7.6 billion, delivering a cost income ratio below 52%.

We anticipate a loan impairment rate in the range of 20-30 basis points, and together we expect this to lead to a Return on Tangible Equity at the upper end of our 14 to 16% range.

With that I'll open the line for questions.

Operator

We have our first question from Robert Smalley. Robert, please go ahead.

Robert Smalley, UBS

Hi, good morning. Thank you for taking my questions and doing this call.

Katie Murray

Hi Robert.

Robert Smalley

Couple of questions on asset quality first, and I'm going into the release this morning on page 23 where we talk about ECL post model adjustments, and it seems that you've increased the allowance for economic uncertainty around C&I a lot more in the first half.

Am I reading that correctly? And could you talk a little bit about that?

On the mortgage side, things continue to hold up. Could you talk a little bit more about stress testing customers that might be a little cuspier with respect to their ability to pay and affordability?

And then third, you talked about deposit shift. Where do you see that going in the second half and were there any surprises that came out of that?

Thank you.

Katie Murray

Thanks very much, Robert. Donal I'll do the first two and I'll give you the deposit one. Okay.

So, if I look at the asset quality sorry, in terms of the PMA, first of all. So, yes, we've put a bit more into C&I. And the way that we did it is we basically went through and compared all of our sort of different sectors and thought which ones are most likely to be kind of impacted by liquidity issues in terms of the kind of tightening system liquidity that we're seeing as well as the kind of persistent inflation.

And then when we finished that, we then applied to kind of PD move from 1 to 1 and a half on those sectors. And that's really what's given rise to that kind of increase.

We felt as you as we looked at the retail banking side, we already had 102 in there and we made some small changes. But actually given, as we know historically, mortgages, they don't bump up in the same way even in them in in difficult times that we kind of felt we were adequately provided from within the model. So, the need for the PMA was that much smaller, but it was definitely just that kind of the checking of, of the kind of the sectors that were more impacted by liquidity on that side of things.

In terms of the stress testing piece, if I look at someone who is mortgages renewing today, they we're renewing at a level that is lower than we would have stressed them at when they took that mortgage out. What we have done is we have increased the level of stress test. So, if you're paying a 6.5% mortgage, you're probably being stressed somewhere between seven and 10% at the moment in terms of where you are and more likely up to that kind of 10% sort of level. So it is definitely, that makes it just a little bit harder at the moment.

Donal do you want to take the deposit question?

Donal Quaid

Yeah, sure, hi Robert. So, in terms of deposits shift, I don't think there's any major surprise of what we've seen in H1. It's probably, I think the shift we've seen in the fixed term has maybe moved a little quicker than we'd expected.

But then rates, I suppose the movement in rates is also surprised on the upside. So as Katie said this morning, in terms of the percentage of fixed term deposits has moved from 6% at the end of the year to 11% currently, which has reduced our non-interest-bearing balances 40% to 30%. I think as we look forward into H2, we do expect UK based rates peak in Q3.

So even though we do expect some further continuation move in mix shift, I do expect it to slow as we approach peak rates. But probably the caveat is like, you know, customer behaviour is just very, very difficult to forecast to predict. But that's kind of how we're how we're looking at it for the for the next six months.

Operator

Thank you. Our second question comes from Corinne Cunningham from Autonomous. Corinne, please go ahead.

Corrine Cunningham, Autonomous

Good afternoon, everyone. Brief question for me, it's about capital buffers and what you think is kind of the right level to manage to. So, you see AT1 is kind of now where and where you want it to be in terms of the target. And if I look at the buffers that you're running on tier one and Tier two and the Tier one is fairly low now just 10bps in Tier two is a bit bigger at 40bps.

How do you think about those? Do you think that AT1 buffer is big enough or did you just roll that into your overall thinking on your CET1 buffer and particularly I'm going to ask the question particularly because investors obviously get twitchy when it comes to call dates and the bigger the buffer you run, I guess the more relaxed investors can be.

Thank you.

Donal Quaid

Yeah, I'll take that one. I think in terms of our AT1 and Tier 2 buffers, we you know, our plan is kind of always to run to, to more optimal levels. So, I think in terms of where we're currently running, yes, we're close to probably what our minimum requirement is in AT1, a bit of more of a buffer on Tier two.

But I think that's primarily probably driven by just the timing of some of the issuances we have done over the last six months. I don't expect to run any significant buffer across either AT1 or Tier two going forward. And you know, in terms of our overall CET1 target of 13 to 14%. I'm kind of comfortable there that there's enough CET1, you know, headroom to run at those optimal levels.

And then I think, you know, we don't have the same level of FX volatility or anything like that through our risk weighted assets, just given our UK focus. So, I think that gives us more comfortable to run towards that towards the optimal levels.

Operator

We have no further questions. I'm now going to hand back to Katie for closing comments.

Katie Murray

Great. Thanks very much indeed. Look, as ever, we do appreciate you coming in, listening into these calls. I know you do find them useful.

If you have any questions after the event, Paul Pybus, our Debt IR is there to be your first port of call, and Donal and I look forward to meeting many of you over our various IR interactions over the next few months. And we'll talk again more formally when we get together in February.

Thanks very much. Take care. Bye, bye.