Chief Executive Officer's statement

Continued strong performance

Underlying earnings per share

51.1p

+23%

2016: 41.7p

Dividend per share

12.8p

+22%

2016: 10.5p

I am delighted to report another excellent year for OneSavings Bank ('OSB'). The Group's clear strategy and unique business model have proven robust as we successfully navigated significant regulatory and tax changes during the year. Underlying basic earnings per share grew by 23% to 51.1 pence with underlying pre-tax profit up by 21% to £167.7m. We finished the year with a strong balance sheet, a high quality secured asset portfolio and an excellent reputation for customer service. Our strategy continues to provide the platform for us to grow and develop our business.

The Group grew its loan book by 23% to £7.3bn in 2017, whilst maintaining its strong discipline on understanding and pricing for risk, and delivering a stable net interest margin ('NIM') of 3.16% for the year.

Balance sheet growth was achieved whilst delivering a best in class return on equity of 28% and a low cost to income ratio of 27%. Our Common Equity Tier 1 ('CET1') capital ratio increased to 13.7% from 13.3% in 2016, demonstrating the strength of our organic capital generation capability to support significant growth through profitability. I am very pleased that we further optimised our capital structure through the issuance of £60m of Additional Tier 1 securities ('AT1 securities') in May 2017.

The Board is recommending a final dividend of 9.3 pence per share. Together with the interim dividend of 3.5 pence this gives a total dividend per share for the year of 12.8 pence, in line with our stated dividend policy.

Best specialist lender
OneSavings Bank continued to grow its loan book through its specialist lending brands, with total organic origination up by 14% in 2017 to £2.6bn. Our core Buy-to-Let lending sub-segment grew by 39% to £5.0bn, with our target audience of professional landlords continuing to deliver strong application and completion volumes.

This performance has been achieved despite the overall Buy-to-Let market shrinking in response to tax and regulatory changes. These changes have reduced the attractiveness of the sector to amateur investors, whilst largely maintaining the interest of professional landlords, and have driven the reduction in gross advances from £40.6bn in 2016 to £35.8bn[1] in 2017. In this context, the Bank's performance demonstrates the sustainable strength of our proposition targeted at professional landlords, particularly our specialist, manual underwriting, and our deep relationships with mortgage intermediaries.

New Buy-to-Let mortgage origination increased during 2017, reflecting our specialism and expertise in lending to limited companies and large portfolio landlords. Professional/multi-property landlords accounted for 80% of completions for OSB by value during 2017, up from 75% in 2016.

We have also seen significant growth in the commercial side of our Buy-to-Let/SME segment. Organic origination grew to £176m, as we focused on innovation and building scale in our established InterBay Commercial business. In March, we successfully piloted an entry to the bespoke bridging market, again leveraging the Bank's strengths in asset risk assessment and manual underwriting.

We saw a reduction in originations in the residential segment in 2017. This contributed to the first charge gross loan book reducing to £1,241m from £1,322m in 2016, with new organic lending more than offset by redemptions in the back book and acquired mortgages in run-off. However, we see opportunities for growth in the residential market in 2018 and beyond.

I am pleased that our more cyclical commercial businesses continued to perform strongly. The Bank's Heritable Development Finance business provides development finance to smaller residential developers, with a preference for forging relationships with those active outside prime central London. The business continued to grow in 2017, in spite of new entrants to the market, as customers sought an experienced and pragmatic lender.

In addition, we have also grown the provision of secured funding lines to other lenders that operate in certain high yielding, specialist sub-segments, such as residential bridge finance and asset finance.

Whilst we continue to carefully consider inorganic acquisition opportunities, market pricing did not meet our high return targets during the year.

Our broker net promoter score ('NPS') recovered from the short-term negative NPS of -7 in the first half of the year, the result of a surge in Buy-to-Let volumes. For the second half of the year, our NPS was +25.

1. UK Finance, New and outstanding buy-to-let new mortgages, 2 Feb 2018.

We continue to deliver exceptional performance and reinforce our position as a leading specialist lender, supported by our stable, long-standing retail savings franchise and efficient, scalable back office function.

We made significant investment in our sales capability and continued to gain recognition from mortgage customers and intermediaries, winning multiple awards during the year. I am particularly pleased that OSB won the Mortgage Strategy Awards, Best Specialist Lender and The Mortgage Introducer Awards, Specialist Lender of the Year in 2017.

To encourage greater levels of retention amongst borrowers reaching the end of their initial product term, OSB offers a mortgage product transfer scheme ('Choices'). Under this programme, borrowers are encouraged to engage with their broker to receive advice and select from a bespoke product set. Since the implementation of the scheme in mid-2016, we have seen a consistently strong proportion of our borrowers choose a new product within three months of their initial product ending, at around 60% by December 2017. This is driven by success in switching borrowers who were otherwise remaining on standard variable rate ('SVR') and who, by definition, were therefore in the market for other lenders.

Sustainable funding model with award-winning savings
Our stable and award-winning retail funding franchise continues to support lending growth, with retail deposits up 12% to £6.7bn during the year. Over 27,000 new savings customers joined the Bank during 2017 and our successful programme of creating long-term savings relationships by offering market competitive rates to all customers, including those with maturing fixed rate bonds and ISAs, continued to deliver a very strong 90% retention rate. The strength and fairness of our retail savings proposition, coupled with excellent customer service and high retention rates, continues to allow the Bank to raise significant funds without needing to price at the very top of the best buy tables and provides a consistent and stable source of liquidity.

I am delighted that Kent Reliance has been recognised by Moneyfacts in 2017 as the Best Cash ISA Provider for the fifth year running. The Bank also received the ISA Provider of the Year Award from Consumer Moneyfacts for the second consecutive year. These awards are a testament to our savings proposition and to the outstanding customer service delivered by our staff.

Chief Executive Officer's statement continued

We continue to gain recognition among customers and intermediaries, winning multiple awards during the year.

The Bank remained predominantly retail funded during 2017, with a loan to deposit ratio for the year of 92%[2] delivering on our strategy to primarily fund our loan book using retail deposits. We continued to make judicious use of the Bank of England's Funding for Lending Scheme ('FLS') and the Term Funding Scheme ('TFS'), drawing down additional net funding of £624m in the year. The Bank completed its planned transition out of the FLS into the TFS by year end. As at 31 December 2017, TFS drawdowns stood at £1.25bn.

Leveraging our unique business model

As the Group has grown, costs and efficiency have remained a key focus for the business, resulting in a stable cost to income ratio of 27% (2016: 27%[3]) despite significant investment during the year. We continued to invest in our risk management and modelling capabilities in preparation for IFRS 9 and our planned internal ratings-based ('IRB') application. We also invested in technology to offer an automated solution to brokers to help the Bank meet the PRA's new specialist underwriting rules in an efficient way.

OSBIndia continues to undertake a range of primary processing services at a significantly lower cost than an equivalent UK-based operation and with very high quality levels. I am especially pleased that we achieved this whilst maintaining our focus on customers, borne out by an increase in customer NPS to an outstanding 62 (2016: 59).

We continue to differentiate ourselves from the competition by offering well-defined propositions in high margin, underserved markets, where we have the experience, as well as the internal and intermediary infrastructure, to successfully develop and service those markets.

Building our business for the future

The Group continued to exercise strong diligence over loan and customer assessment. The loan loss ratio fell to 7bps in the year to 31 December 2017 (2016: 16bps) mainly due to assumption updates that took place in 2016. We remain particularly pleased with the performance of the front book of mortgages. From more than 38,500 loans totalling £8.3bn of new organic originations since the Bank's creation in February 2011, we have only 137 cases of arrears over three months in duration, with an aggregate balance of £18.4m and an average loan to value ('LTV') of 63%, reflecting the continued strength of the Bank's underwriting and lending criteria.

2. Excluding the impact of TFS/FLS drawdowns. The unadjusted ratio was 109% as at 31 December 2017 (2016: 100%).
3. Prior to 2017, OSB deducted coupons on equity Perpetual Subordinated Bonds ('PSBs') accounted for as dividends from underlying profit before and after tax, net interest margin and cost to income ratio. Following a review of market practice in advance of the Bank's AT1 issue in May 2017, OSB no longer deducts these coupons from the calculation of these key performance indicators. The comparatives have been restated accordingly. Interest payments on AT1 securities classified as dividends are treated in the same way.

The weighted average LTV of the overall mortgage book remained low at 64% at the end of 2017, with an average LTV of 69% on new origination during the year.

In 2017 we saw the market adjusting to the new Buy-to-Let underwriting standards, including ensuring that lenders reflect the changes to personal tax on landlords within their affordability assessments. We have seen a clear trend for borrowers to seek to mitigate this by opting to borrow via a limited company during 2016 and 2017, with a continued increase in the proportion of purchase applications via limited companies for our main Buy-to-Let brand, Kent Reliance, to 69% in 2017. The Group has always specialised in lending to limited companies, and given market trends, this gives us a competitive advantage over those lenders without such a capability.

From 1 January 2017, The Prudential Regulation Authority ('PRA') required lenders to adopt more stringent affordability assessments. We have always assessed affordability for borrowers through our specialist underwriting model and applied stringent stress tests, so were well-placed to benefit from these changes. This can be seen in our weighted average interest coverage ratio ('ICR') for Buy-to-Let origination during 2017, which increased to 185%, demonstrating our cautious approach to the assessment of customer affordability.

Further market-wide measures to strengthen underwriting standards were implemented from October 2017. We already substantively met the regulatory requirements for assessment of landlords with four or more mortgaged properties, and sought to enhance this proposition through the use of technology, creating a simple and automated way of providing comprehensive portfolio information. This has been embedded within our underwriting process to create a strong proposition for brokers and borrowers alike.

These measures, and an expectation of further interest rate rises, also caused a shift in the demand amongst our professional landlords towards five-year fixed rate products which accounted for c.43% of our Buy-to-Let completions in 2017. Competition has increased in this area, and the market has not yet fully repriced following the Bank of England base rate rise in November 2017 or for subsequent widening of swap spreads, putting pressure on margins.

Outlook

Trading conditions in our core markets are positive and current application levels are strong. In line with UK Finance forecasts, the overall Buy-to-Let market is expected to contract further in 2018, however, we expect to continue to grow market share through the relevance of our proposition to professional landlords.

The Group's IFRS 9 models and first generation IRB models were delivered on schedule in late 2016 and we ran the models in parallel throughout 2017. We remain pleased with progress towards our IRB application and also welcomed the recalibration of risk weights in the final revisions to the Basel III reforms on standardised capital requirements published in December 2017. We believe that these new calibrations combined with the final IRB output floor will be beneficial to the Bank's capital requirements, however we remain cautious until the final rules are adopted.

The market sub-segments targeted by OSB, principally professional landlords, including limited companies, have remained strong despite the overall slowdown in the Buy-to-Let market in 2017. We remain confident in the underlying strength of the Private Rented Sector and believe that we are well-placed as the Buy-to-Let market continues to professionalise in response to tax and regulatory changes. We will continue to concentrate on what we have proven we do best: using our relationships, manual underwriting expertise and secured lending strategy to lend responsibly to our customers.

We see opportunities for growth in other segments of the lending market where we already have expertise and a platform to build from. In particular, we expect to grow commercial and bridge finance lending through our InterBay Commercial brand and see further opportunities to grow our residential lending franchise.

We will remain predominantly retail funded, aiming to fund our loan book through our Kent Reliance savings brand. In addition, we intend to invest in our online savings platform during 2018 to attract a broader customer base and grow SME and other lower cost deposits in future years. Our additional liquidity will continue to come from wholesale funding, and we intend to return to the securitisation market during 2018 following the closure of the TFS in February. We drew down an additional £250m in 2018 before the scheme closed, bringing the total balance to £1.5bn. Over time we will use these different funding sources to optimise our cost of funds.

The pipeline of regulatory change continues to grow, with GDPR and PSD 2 both going live in 2018 and work continuing on IRB and other smaller regulatory projects. We expect to expense c.£7m on regulatory projects in 2018, around double the total in 2017. In addition, we plan to continue to invest in our technology infrastructure, mortgage origination system and online savings platforms to support our future growth strategy and enable us to broaden our reach into adjacent markets, such as sub-segments of residential mortgages, where we see opportunities, particularly once we transition to IRB. All of these projects are expected to lead to a significant increase in operating costs in 2018. However, we expect to offset this in part, by delivering further efficiencies in the cost of running the Bank on a ‘business as usual’ basis, by continuing to focus on cost discipline and leveraging our unique operating platform in India.

We are now live with IFRS 9 after a successful parallel run throughout 2017. The day one impact of the implementation of IFRS 9 is an increase in the provisions of c.£4m, representing 9bps on the Bank’s CET1 ratio as at 31 December 2017, on an end game basis, reflecting the strength of security underpinning our loan book.

Our achievements in 2017 are a testament to the management and staff of OSB and I would like to thank my colleagues for their hard work and commitment throughout the year.

We are a responsible lender and will continue to manage the business prudently.

Looking forward to 2018

Over the coming year, organic lending through the Buy-to-Let segment will remain the key driver of loan book growth, but we expect to grow our residential lending, and our commercial and bridge finance lending through our InterBay Commercial brand.

We expect to deliver net loan book growth in the mid teens in 2018 and NIM of c.3%, reflecting current asset pricing, in particular for five-year fixed loans and an expectation of a rising cost of retail funds after the end of TFS. We anticipate a cost to income ratio of c.30%, reflecting the significant increase in the cost of regulation and planned additional investment in the business.

We start 2018 with a fully loaded CET1 ratio of 13.7% and a proven organic capital generation capability through profitability. We anticipate maintaining a CET1 ratio at a minimum of 12% going forward. Our dividend policy remains a payout ratio of at least 25% of underlying profit after taxation attributable to ordinary shareholders.

Our primary growth strategy remains organic origination, but we continue to look at inorganic opportunities, including portfolio purchases, where they meet the Bank’s return hurdles.

I believe that OneSavings Bank is well placed to take advantage of opportunities that arise and we remain capable of generating attractive returns for our shareholders.

Andy Golding
Chief Executive Officer
15 March 2018