The co-operative bank

FIRST QUARTER TRADING UPDATE CALL

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Speakers:

Andrew Bester, Chief Executive Officer

Nick Slape, Chief Financial Officer

Gary McDermott, Treasurer and Head of Investor Relations

This transcripts accompanies the Bank's 1Q 2020 results investor presentation, a copy of which can be found at: https://www.co-operativebank.co.uk/investorrelations

Gary McDermott, Head of Investor Relations

[Introduction] I will now hand over to Andrew Bester, Bank CEO, to begin the presentation. Andrew.

Andrew Bester, CEO

Many thanks Gary and welcome everyone to our Q1 results call. I was reflecting on the fact that only two months ago, almost to the day, that we were presenting our year end results and it's quite extraordinary to think just how much has changed in that short two months. What I'm going to do is run through a little bit of the way that the Co-operative Bank has responded to COVID-19 challenge and then and talk through what we've been doing in terms of delivering the Plan and then I'm going to hand over to Nick Slape, our CFO, to run through the financials.

[Page 2] So firstly, in terms of the results, the COVID-19 challenge has been quite extraordinary in terms of what it has done in our organisation around how we have had to respond. I am delighted to say that we have been able to keep all our branches open and contact centres, and we have had to adjust at very high pace to be able to serve our customers safely. With that, we have granted 15,000 payment holidays for mortgage customers; that is circa 10% of our mortgage book and 2,000 payment holidays for credit card and personal loan customers; representing less than 0.5% of the book. We are also the first bank to offer a £500 interest free overdraft, and that is helping 350,000 of our current account customers. Quite extraordinarily, this quarter end, we delivered our whole quarter end results virtually and we have had 95% of our non-customer facing colleagues working from home, with a lot of the IT enablement that we put in our Plan to deliver. So I am very glad that we did invest when we did, and clearly also making sure that we create a safe environment for all colleagues, in terms of social distancing and the clean environments that we have for our colleagues that are on sites here with me in Manchester.

The second area has been our support for small businesses. As you all know, we have 85,000 SME customers and the seventh largest SME bank in the UK but it's a bit of a hidden gem, and is something that has not been exploited over the last seven or eight years, and when I arrived, I moved quickly to upgrade the team we had but also to effectively start looking at how we might grow that business. In terms of the CBILS scheme, we launched that last week, and quite quickly after that, we signed the contract for Bounce Back loans yesterday. We are in the second wave of CBILS and the Bounce Back loans, and I am looking forward to having that made available to customers from tomorrow. As you know, CBILS is 80% guaranteed by the government, and Bounce Back loans are 100%. We have also moved to temporarily remove fees and charges for SME lending facilities, and crucially given our important partnership and heritage in the co-operative movement, supporting co-operative businesses through the pandemic. Encouragingly in the SME world, what we have seen is 11% deposit growth in the quarter, and actually what we've seen as we have moved through April is actually that deposit growth has now climbed to 22%. So positively, our customers are trusting us with their deposits in SME, but also actually in our Retail business as well, and we have a strong close to the quarter in terms on Incentivised Switching. We have managed to get 16% of incentivised switching in the first quarter against our plan of 6%.

In terms of the specific impact of COVID-19, the impact in Q1 was circa £12m, and overall despite that we were in line with our original budget and plan expectations. As you all know, our lending book has always been very low risk, 93% of our lending is secured and at very high-quality LTV, and Nick will run through that number in a little bit more detail, and our corporative exposures are low, and again Nick will run through that. So, we finish the quarter bang on where we expected to be from a core Tier 1 point of view and liquidity is strong, so LCR of 159%, and initial allowance, we estimate that we will be able to draw another £1.75bn of liquidity. So I think that sends a good picture.

[Page 3] If I turn now to specifically to some of the financial impact, we are obviously having to adjust to this extraordinarily fast changing world, and we are looking very hard at both the pace of our investments and what we can do to drive ever more cost efficiencies. As you all know, last year we renegotiated our partnership with Capita and IBM, and that has created some benefit for us this year. We have also now signed up with Visa for them to provide more strategic support for us in our digital payments, so that again provides some opportunity for us.

In terms of the brand, which is the key differentiator of the Co-operative Bank, given that we still remain the leading ethical bank in the UK, and our NPS actually climbed again. There was a 29 at year-end, and it is now +30, firmly in third place in the market. And we were very happy to win our first payments awards in a number of years for 'Changing Lives in the Community' which is a 'Cards and Payments' award which again we haven't been present at but as we fix and transform the organisation we have been able to start to get recognition for that work.

In terms of the franchise, we saw a 2% asset growth in the franchise through the quarter, and that was supported by the strong deposit momentum that I have described with that SME growth of 11% and the strong switching performance. The other thing which has been key, and certainly when I think about the support that we have had from our shareholders in the transformation plan that I put together, effectively over eighteen months ago, it was key that we did separation and we simplified the IT infrastructure of the Bank. I am glad we did because it is certainly what that has meant is that we have resilience in our platform which means we have been able to provide very high levels of service to our customers, which has been good. In addition to that, we continue to invest the BCR money that I described earlier, and as ever, we will continue to look at windows to issue MREL. With that, let me pass to Nick to run through some of the Financials. Nick, over to you.

Nick Slape, CFO

Hi everyone, thanks Andrew. If we start with the income statement on **Page 4**, we are reporting an underlying loss of £14.3m vs. a £5.1m loss in Q1 2019. Our loss before tax has improved by 6% to £27.0m, as the adverse underlying position is offset by a reduction in strategic change spend. As Andrew mentioned, we have seen roughly £12m of impacts from COVID-19 in the quarter across income, impairments and non-operating income.

Year on year, total income is down 20%; this is a function of a 26% reduction in net interest income at £64.8m, with a small offset from an increase in other operating income, up 55% to £11.0m. Net interest income has reduced by £23m of which there are two primary drivers. Firstly in Treasury, due to the expense of the Tier 2 debt that we issued in April 2019 and some volatility that we have seen in the quarter as a result of COVID-19. Secondly, we have seen reduction in mortgage income due to continued pressure on mortgage margins. We have also taken a £4.8m adjustment for EIR in the quarter, following the reduction in the Bank of England base rate to 0.1% and lower expectations for future rises.

Although customer NIM has reduced by 55bps year on year, if I focus on the last quarter, the reduction is only 11bps, which reflects continued mortgage margin pressure and volatility in treasury as a result of COVID-19.

In other operating income there are a couple of offsetting factors including benefits from renewed partnership arrangements with our suppliers, offset by volatility in Treasury.

I am pleased that we have been able to offset a large part of the income reduction through cost management. Operating expenditure is down 12% year-on-year to £87.2m, with efficiencies in both staff and non-staff costs. We have already taken action to mitigate part of the COVID-19 risk by removing reward-based pay in 2020, which has seen a £4m benefit in the quarter. Our underlying cost:income ratio of 115% is expected to fall in the year as reduced income is offset by actions on discretionary spend to mitigate the impact of COVID-19.

We have reported a net impairment charge of £2.9m, the majority of which is the result of a one-off legacy corporate unrelated to the pandemic. Following a revision to our base scenario and increased weighting to the downside scenarios for IFRS 9 modelling, we have booked an impairment provision relating to COVID-19 of £0.3m. This charge reflects our low risk, almost entirely secured portfolio following a sustained period of de-risking in our higher risk corporate and Optimum portfolios. I expect there to be additional impairment charges in the coming months as we obtain more reliable information on customer behaviour through the pandemic.

The difference between our underlying loss of £14.3m and statutory loss before tax of £27.0m is driven by strategic project costs and non-operating expenses. Following the conclusion of key strategic initiatives in 2019 the levels of strategic investment have reduced in 2020, and are 68% lower year-on-year. The movement in non-operating expense is a result of COVID-19 volatility impacting the share price of Visa Inc. offset partly by movements in exchange rates. I am pleased to report that in April we have seen signs of recovery in the value of the share price, and the value of our holding is now higher than what it was at the end of 2019.

We maintain a strong CET1 ratio of 18.3%, down 1.3 percentage points since full year as a result of anticipated losses and RWA growth.

In summary, despite the impacts of COVID-19, our underlying results are in line with expectations following management action. I do note, however, that COVID-19 and the resulting economic impact will continue to affect performance in 2020. We have options available to offset income and impairment challenges in 2020, although we need to observe how the pandemic evolves over the next couple of months before we consider revising our guidance. I will now talk through the lines of the income statement in detail.

Turning to **Page 5**, where total core income is down 18% to £76.4m, driven by Retail interest income.

You can see on the top chart that year-on-year there has been impacts from both our customer balance sheet and Treasury. The customer variance is driven by reducing mortgage margins, as higher margin maturing business reverts to lower margin new business. We have also seen a reduction in SVR balances over this period. The variance in Treasury is a result of the Tier 2 debt expense, which was issued in April 2019, volatility observed in the first quarter of 2020, and a change in asset mix over the period.

Whilst you will recall that we reported a full year customer NIM of 175bps, which was in line with guidance, we have seen in the past quarter underlying customer NIM adjusted for EIR reduce by 11bps. This is broadly tracking to our guided c.155bps for 2020.

I have highlighted in the chart the £8.5m EIR adjustment in December 2019, reflecting changing customer behaviour on SVR. We have also booked a further £4.8m adjustment in the quarter following the reduction in the base rate and expectations that rates will be lower-for-longer due to COVID-19. The EIR asset relating to SVR is now £17.5m, compared to £27.1m at the end of 2018, and £22.5m at the end of 2019. I am not expecting this asset to grow in 2020.

The 11bp underlying reduction in the quarter is primarily a result of Treasury volatility and continued mortgage margin erosion.

I expect pressure on customer NIM to continue through 2020 due to lower base rates.

Turning to **Page 6**, the customer balance sheet. It is pleasing that in the quarter we have continued the positive trends across our franchise that we reported through 2019, as growth in our Retail franchise and SME deposits funds mortgage growth.

Core mortgage lending is up £423m or 2.6% to £16.7bn year to date with new business volumes of £1.1bn. We have also seen a year-on-year increase in the amount of customers taking out a new product with the bank at the end of their existing deal. As social distancing measures have come into effect in March we do not expect this level of growth to continue and application volumes have dropped substantially in recent weeks. The extent to which volumes will grow through the year will depend largely on how the pandemic unfolds in the coming periods.

We have also seen a net 1.0% increase in core customer deposits, specifically in current accounts, variable savings and SME. Retail current account balances have increased by 3% in the year so far, and franchise savings have increased by 1.5%, primarily through our SAS 10 acquisition product. Growth in SME deposits is particularly pleasing, which have grown 3% in the quarter, and 11% year on year.

Growth in these lower cost franchise deposits equates to £330m, or 78% of core mortgage net lending. This is offset by a reduction in more expensive term deposits as we continue to optimise these balances through repricing. This has helped to keep the cost of deposits low, with a blended cost of customer funding of 61bps in the quarter.

These deposit trends have continued through April. SME deposits have now increased 12% in the year so far, and over 20% year on year.

Turning to **Page 7** and operating expenditure, which is down 12% year on year, reducing to £87.2m.

The walk at the top of the page shows that we have seen reductions across staff, non-staff and continuous improvement projects.

Firstly, staff costs have reduced primarily due to the removal of variable pay for 2020 in light of COVID-19. Non-staff costs have benefited from a number of efficiencies, some relating to the completion of IT separation.

We have focused our efforts on reducing costs further than planned in the year to mitigate risks to income and from potential further impairment charges. As a result we believe that costs in 2020 will be lower than budgeted and will help maintain the cost:income ratio that we guided to at the end of 2019.

Moving to strategic change, we had already planned to reduce strategic change spend in 2020 as we completed the 'Fix the Basic's' phase of our strategy with completion of Desktop Transformation and IT separation from the Co-operative Group in January 2020. A review of the portfolio is underway and we expect cash spend to reduce significantly vs guidance of c.£80m. We remain committed to delivering on our BCR commitments but will prioritise mandatory projects to keep the bank safe and postpone those that do not meet this criteria in order to preserve capital.

In the quarter, strategic spend has reduced 68% to £9.4m and of this £9.4m, £4m related to non-recurring IT separation costs.

The next three slides focus on our credit quality.

Page 8 outlines some characteristics of our portfolios, which give us comfort that the credit quality of our book is sound as we enter the crisis.

You can see in the top left of the page that 93% of our customer loans are secured mortgages, with minimal exposure to unsecured and corporate lending. As the average LTV of the secured book is 57%, increased defaults are unlikely to drive material credit losses, as the collateral would be sufficient to offset losses in most cases. We have seen nearly 15,000 mortgage payment holiday requests, of which 98% were up to date with payments in February at a blended LTV of 61%. I will talk more on our mortgage book on the next slide.

Moving to unsecured, you can see that this comprises only 2% of our customer assets at £345m. We have received under 2,000 payment holiday requests, approximately 0.5% of the book. Through March and April we have seen a reduction in our credit card balances as customers are transacting less through the pandemic.

I have grouped our SME and Corporate exposures together and the chart on the bottom left shows you the split between core and Legacy. SME and corporate exposures are 5% of our customer balances, or £975m.

Of the £975m exposure, 77% relates to social housing and Private Finance Initiatives (PFI) lending, which is low risk and government backed. There is no expectation for these loans to drive an increase in ECL at this time.

Commercial real estate comprises about £90m, or 9%, of which 90% are at an LTV below 50%. A review has been completed on the loans in this portfolio, and whilst there is some exposure to higher-risk COVID-19 sectors, the low LTV nature of the book minimises this risk.

Some of the remaining assets will be exposed to risk during COVID-19 in sectors such as hospitality and charities but the exposures total £60m, 0.3% of total customer lending.

Turning to **Page 9**, as previously mentioned you can see that we continue to run a low risk, high quality mortgage book with an average retail LTV of 57.2%, up just 0.1% in the quarter. Completion LTV remains stable at 68.1%, down 0.5% in the quarter.

Exposure to London and South East continues to reduce sequentially to 38%, with the lowest LTV of our geographic segments at 54.8%.

Approximately 50% of the book is less than 60% LTV, and only 13% of the book has an LTV greater than 80%.

As at end-March only 0.14% of the secured book is greater than 3 months in arrears, consistent with experience through 2019.

Turning to **Page 10** and reflecting on the performance of the loans, you can see that we have a high-quality book with low levels of non-performing loans following a sustained period of low-risk lending and de-risking.

Non-performing loans have remained stable at 0.5% of the book, and coverage of these loans has increased following the increased impairment charge taken in the quarter.

The £2.9m net impairment charge is primarily driven by one legacy corporate case unrelated to COVID-19. We have made a £0.3m charge in relation to COVID-19, which is lower than our peer group, but reflects the high quality of the portfolios as I have just discussed. The £0.3m reflects a revised base scenario and increased weightings to the two downside scenarios. The £0.3m charge reflects the limited sensitivity to these scenarios modelled, although I am expecting further developments on this in the coming months.

Exposure by IFRS 9 stage has remained stable in the quarter, and no change has been made in relation to payment holiday requests. As more reliable information becomes available on the performance of these cases we will know more on how this will impact on ECL.

Turning to **Page 11** and capital; our capital position at the end of the quarter. I am pleased to say that we are entering the crisis from a strong position, with a CET1 ratio of 18.3%, and significant headroom against the minimum requirement of 10.9%. Our total capital ratio at the end of the quarter is 22.6%.

The CET1 ratio has dropped by 1.3% in the quarter, which is in line with our expectations, as we remain loss making.

Our RWA increase is driven by mortgage growth of 2.6% and we have also seen a 10% increase in non-customer RWAs driven primarily by interest rate volatility.

The removal of the countercyclical buffer is a welcome benefit to our capital position and reduces our overall capital requirements by £50m.

I told you on our full year results call that I expected to make considerable progress towards required MREL issuances in 2020 subject to market conditions. Clearly market conditions are not supportive at this point, but the bank remains fully prepared to issue MREL-qualifying debt when market conditions change. We have a surplus of £200m to our MREL requirements at the end of the quarter excluding the CRD IV buffer.

The leverage ratio on an EBA basis has reduced in line with expectations to 3.8%.

Lastly, turning to **Page 12**, as well as a solid capital foundation, we are also entering the crisis with a strong liquidity position.

Our Liquidity Coverage Ratio has normalised at 159% following an uplift at year-end due to timing of Silk Road 6 issuance. We have £1.1bn of excess liquidity at the end of the quarter, which has grown further in April as deposits continue to grow as previously outlined.

We have applied to participate in TFSME, and our initial estimate is that we could access £1.75bn of funding.

The Loan-to-Deposit ratio is stable as net growth in customer assets continues to be funded through net growth in customer deposits and Legacy asset attrition.

With that I will hand back to you Andrew.

Andrew Bester, CEO

Thank you Nick. **[Page 13]** So in terms of summarising the performance during the crisis and how the Bank has responded, it is really, in my mind brought to bear some of the key strengths of the Bank; the phenomenally strong customer franchise we have and the support that those customer continue to have in us and the trust they show, be that with the deposits they place with us and the services of our business. Equally the culture and commitment of our colleagues and servicing customers through the crisis has been humbling to see and I am very proud of the team and the way they have responded. I think the key thing also is the operational resilience and I think this is testament to the work that has been done in upgrading our digital infrastructure, getting our desktops upgraded so our colleagues could work remotely and indeed getting separation done, so we are operationally in a resilient place, and as Nick's highlighted we have a high-quality, low-risk business model so we are thinking about impairments and flex it so that in future we still feel that we are in a resilient position. Clearly lots of uncertainty as we all navigate the COVID crisis and the coming months, but we certainly feel that the franchise is in a sound position and we will continue to look at ways to optimise as we move forward.

So with that happy to take any questions.

We have not had any pre-submitted questions, so if anyone wants to ask a question, if you just unmute yourself and give us your name and Nick or I are happy to take the questions.

Morgan Stanley

Just a question, I mean as you kind of stabilise the business model and obviously entering the crisis with a high quality book, the next leg really requires growth of the book to close the operating deficit. How do you think about that and the timing of that in light of the crisis? And to what extent are inorganic measures available as well in terms of the ability to acquire bolt-on portfolios.

Andrew Bester, CEO

Yes good question, thanks for that. In terms of, as you say, one of the features is that we end up in a position as a Bank where the good work done in making our credit book safe means that we are resilient from a credit risk point of view, and certainly having been through the financial crisis myself in a former life, the key things you want to have in a crisis is that you want to have a strong credit book and you want to be able to have lots of liquidity, and as Nick has highlighted, we have lots of liquidity, and so we need to see how the crisis unfolds over the coming days but if there is anything, I think for me, I feel like we're in quite a resilient place to be able to be doing.

In particular, the SME business in support of CBILS and Bounce Back loans is a good opportunity and Bounce Back loans, just to bring it to life, I signed a contract last night and we are active and we have got 700 customers in the pipeline so we are looking forward to seeing those operationalise through this week. And CBILS, we were in the second wave and started last week and so we have got a pipeline of about 40 odd million pounds at the moment there, and with 85,000 existing customers we are very keen to support our own customers, but you know we need to see, obviously the good news is that you have a shock of this scale from a financial point of view with COVID-19 and the things you want to have is, you want to have strong credit and a strong credit position and you want to be liquid, so we've got those, but we need to navigate safely through the coming months and we will keep looking at what we need to do going forward.

Sounds like no other questions, so I just wanted to make a big thank you to you all for joining the call and please do reach out to me, Nick or Gary if you do have any specific questions and very happy to take those and we will look forward to catching up with you all soon. So thank you very much and have a good afternoon.