The co-operative bank

2020 THIRD QUARTER TRADING UPDATE CALL

Friday 6th November 2020, 2pm

Speakers:

Nick Slape, Chief Executive Officer

Louise Britnell, Interim Chief Financial Officer

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

[Introduction]

Nick Slape, CEO

Morning all and welcome to the Co-operative Bank's third quarter results and progress update. Let me first start by saying I hope you're all well and remaining safe in these unprecedented times. Secondly, I'd just like to thank Bob Dench, our Chairman, the rest of the Board and the shareholders for entrusting me in the role of CEO. I've worked closely with Andrew as you know during the two and a half years and was here at the beginning when we first started the 2018 turnaround strategy and continue to remain very focused on moving us forward in terms of the next stage of that strategy.

I would also like to welcome to the investor call for the first time Louise Britnell, our Interim CFO, who has been a part of my team since 2018. Louise has played a key role in the Bank's turnaround plan and will continue to do so in her new role. Louise will take you through financials shortly but firstly let me kick off with a few slides on the Bank's strategy.

Turning to **Page 2**, I'm encouraged that despite the current macroeconomic environment we have a lot of positives to report. Our financial performance continues to be in line with plan as we respond with agility to the challenges and opportunities that COVID-19 has presented. The mortgage market is buoyant, with applications up following the historical low that we experienced the second quarter lockdown, predominantly driven by pent up demand and stamp duty relief. This has led to higher application volumes, approximately double what we observed on average during 2019 with £2.4bn of applications in 3Q. Post swap application margins are up 50bps in the quarter at around 210bps.

Our SME lending portfolio has grown 122% to £409m, enabled by government-backed lending schemes. Our CET1 ratio remains strong and is up 0.9 percentage points in the quarter to 19.1%. Strong, low-cost, customer deposit growth of 6% and TFSME lending has presented opportunities to optimise our balance sheet with surplus liquidity. We have implemented significant re-pricing actions in the year following base rate changes, bringing our gross cost of deposits down to just 28bps, without any significant balance attrition. Louise will show later we expect this to land closer to 20bps at the end of the year.

Our low-risk balance sheet means that we can deliver this growth while impairment charges remain low, with an asset quality ratio of 12 basis points. In this space we're benefitting from the progress made in recent years to de-risk the Bank, and excluding the impact of COVID-19 our underlying asset quality ratio is just three basis points.

Operationally, we have had difficult decisions to make and in the third quarter, when we announced the closure of 18 branches and 350 redundancies. This decision is in line with what we're seeing across the industry as a result of reduced reliance on branches and increased digital engagement, accelerated by COVID-19.

I am pleased to report that our NPS for current accounts continues to increase, now +28, which is testament to the hard work and dedication of our front line colleagues despite all the challenges they face.

Customer needs remains at the forefront of our priorities, whilst at the same time delivering a sustainable and leaner business model with new and agile ways of working.

In the fourth quarter we also expect to strengthen the capital position of the Bank through completion of an MREL transaction, which will ensure we meet our binding MREL requirement of TCR plus £400m from January 2021. Louise will pick this up on slide 9.

[Page 3] Turning the page, I've detailed some of the ways we've been helping our customers, colleagues and local communities through COVID-19.

We've supported over 8,000 businesses in our SME segment, with £234m of government backed lending, primarily BBLS at £213m, with an average loan size of £25,000. This has accelerated our expansion into our target small and medium enterprise growth segment and we've dedicated more resource and personnel to support the rapid growth we've seen here.

For our retail customers we have granted circa 20,000 payment deferrals across mortgages, loans and credit cards. As at the end of October just 0.5% of mortgage customers, 1.4% of loans and 0.1% of credit cards remain on payment deferrals. We have been adapting to serve our customers flexibly with the introduction of virtual appointments and the roll out of our fully electric pop-up branch. We've also supported almost 9,000 customers buy or remortgage their home in 2020.

We are supporting our front line colleagues still in the office with measures to ensure they remain safe, and for those working from home we've implemented a range of welfare and support measures. I would like to offer a huge thank you to all of our colleagues for their hard work and dedication during these unprecedented times.

And in the community we're the first financial services organisation to have been recognised in Greater Manchester's Good Employment Charter and we're pleased to be on track with our targets to reduce greenhouse gas emissions. We have engaged in some fantastic work with our partner charities this year including an awareness campaign with Refuge to provide support for victims of economic abuse, for which we've had national press coverage, and some socially distanced fund raising activities for Centrepoint which myself and the rest of the executive team also got involved in.

If we turn to **Page 4**. I mentioned earlier some of the key priorities for the Bank and I just wanted to provide a little more detail on the progress we're making in simplification and digitisation.

The current macroeconomic environment has led to a re-profiling of our investment portfolio. An alternative solution is underway to simplify our mortgage and savings platform. We continue to rationalise the relationships we hold with 3rd party suppliers, and in the year we've made great progress in reducing the number by over 25%.

Progress with our digital offering continues, with 24 releases this year, including new digital applications. Our move to the Cloud will help accelerate these deliveries further and in 2021 we will continue to build out our digital services for Retail and SME customers, with new functionality being delivered through our existing scrum team capability.

The progress that we've made in our digital capability is reflected in the stats for Retail and SME growth; growth in the SME franchise across deposits and lending, a large share of Incentivised Switching scheme customers choosing to Bank with us, YTD mortgage applications being 13% higher than this time last year and the pipeline for mortgages as I said being very strong going into the 4th quarter.

So with that I'll hand over to Louise, who will take you through the financials.

Louise Britnell, Interim CFO

Thanks Nick. So starting with the income statement on **Page 5**, the first thing to say is that whilst we are reporting an overall loss before tax of £68.1m this is in line with our expectations for the year, despite the impact that COVID-19 has had on the Bank.

Both net interest income and other operating income are down 20%. Net interest income has reduced by £48.7m driven by lower lending margins in 2020 vs 2019 and a first quarter adjustment for EIR that we have referred to in previous results calls.

Other operating income is impacted by lower levels of gilt sales in Treasury and subdued transactional activity during the first half of the year, offset by benefits from renewed strategic partnerships.

Operating expenditure has improved 10% year-on-year, with efficiencies in both staff and non-staff costs. I'll pick that up in more detail later.

We have reported a net impairment charge of £16.7m, the majority of which is the result of adjustments made earlier in the year in light of COVID-19. £5.5m has been charged in the quarter to adjust for payment deferral risk, as well as charges unrelated to COVID.

Our statutory loss before tax of £68.1m also reflects strategic project costs, restructuring programme costs and non-operating income. As we've reported all year, following the conclusion of the 'fix the basics' stage of the strategic plan in 2019, the levels of strategic investment have reduced in 2020, and are down by 74%. Restructuring costs, shown separately, relate to branch closures and the significant redundancy programme that Nick referenced earlier in the presentation. The gains in non-operating income are a result of an increase in the value of our holding in Visa preference shares, as well as a £10.4m gain realised on partial disposal of these shares in Q3.

We maintain a strong CET1 ratio of 19.1%, down 0.5 percentage points since full year, but up 0.9 percentage points in the quarter, as losses are offset by a reduction in RWAs.

Now turning to **Page 6** for some more detail on income. Year to date customer NIM is 144bps, down 40bps year on year, but in the chart on the left I wanted to highlight the quarter on quarter movements that we've seen in 2020. Throughout 2019 and the first half of 2020 we've been reporting reducing NIM driven by sustained margin pressure on mortgages and the cost of tier 2. We also reported previously the impact of EIR adjustments driven by changes in customer behaviour and interest rate reductions that we have not seen repeat in this quarter. In the third quarter of 2020, NIM has increased 11bps following repricing actions and higher margins on mortgage lending.

We've included a segmental split on the right hand side of the page and I'll highlight a couple of key movements:

Firstly, in Retail an 11% reduction in net interest income, which is driven by reducing yields on mortgages, and the timing lag between pricing actions taken on retail deposits following the base rate reduction. This is partially offset by an increase in fee income, driven by the renewal of strategic partnerships.

In Treasury, returns on assets have been lower due to the reduction in the base rate and also the mix of assets, with cash balances now representing a higher proportion of the total. Interest expense has also increased following the Silk Road 6 issuance in Q4 2019. Lower volumes of gilt sales in 2020 causes the reduction in Treasury other operating income.

The extended lockdown period in the first half of the year has had an impact on year to date fee income, with lower transactional volumes affecting credit cards, current accounts and SME. During the third quarter, lockdown measures have eased, fee income recovered however, given the recent announcement of a second national lockdown we may see another suppression of activity during November.

SME net interest income is up 3% YoY, driven by higher deposit balances and lending growth through CBILS and BBLS.

On **Page 7** we highlight the changing customer asset and deposit mix, as well as changes in the customer rate corridor.

On assets, we're pleased with 1.5% net growth in mortgages year to date, with new mortgage lending of £2.1bn of which £530m relates to the third quarter. Looking forward, we're very encouraged that applications are at the highest level we've seen in recent times and totalled £2.4bn in the third quarter. Post swap application margins are also up 50bps in the quarter. We expect strong growth to continue in the remainder of the year.

In SME, we've seen 122% net growth in assets, with £21m in CBILS and £213m driven through BBLS. A further £18m CBILS and BBLS lending has been written in October, slowing down vs previous months, although we've yet to see how the second lockdown and the extended application deadline of January 2021 may change this. Total net core customer assets flows for the year are up 2.4%.

On deposits, we continue with the trend we've been reporting all year, with growth in low cost Retail franchise and SME deposits primarily driven by customer behaviours. At the same time we have actively managed outflows of more expensive term deposits.

You can see in the bottom left chart that our customer corridor has widened, driven by repricing action taken on our variable deposits. A full quarters benefit of these actions will widen the customer corridor marginally more in the fourth quarter, but we expect it to remain broadly stable from this point, subject to further changes in the base rate.

[Page 8] On the next slide, we cover operating expenditure and strategic project costs. In order to mitigate the impact on income, and impairment losses, we have taken strong action on both operating expenditure and strategic investment. Operating expenditure is down 10%. Strategic investment is down 74% in light of these management actions, but also as a result of completion of the 'Fix the Basics' phase of our strategy.

At the top of the page we show that we have seen reductions in both staff and non-staff costs. Firstly, staff costs have reduced in part due to the removal of variable reward for 2020 in light of the pandemic. We will revisit this in the fourth quarter, but any future variable pay is dependent on delivery of a range of performance measures.

Non-staff costs have benefited from a number of efficiencies, including those driven by the renegotiation of key strategic contracts and the completion of IT separation. There has also been a reduction in discretionary spend, such as marketing, as we have looked to preserve capital during the pandemic.

As I referenced earlier, in the third quarter the Bank has incurred £19.8m in restructuring costs. This relates to the redundancy programme and branch closures we announced in August. This restructuring activity drives approximately £20m of annualised savings and supports our progress towards sustainable profitability.

On strategic project costs, the completion of the 'Fix the Basics' phase of our strategy has enabled a significant reduction in spend in 2020, and is now down to £18.8m year to date on a P&L basis. Re-profiling of the investment portfolio in light of the change in the current economic climate and the associated impacts on projections and investment benefits, was also a factor in reducing 2020 investment spend. The focus of spend in 2020 has been to deliver our Banking Competition Remedies programme for SME and projects associated with regulatory developments around controls and technology.

If we now turn to capital on **Page 9**. We have a strong CET1 ratio of 19.1%, with a 5.6% surplus to minimum requirements plus CRD IV buffers. Including tier 2, our total capital ratio at the end of September is 23.7%.

Following the 1.4% drop in the CET1 ratio in the first half of the year, we have seen recovery in the third quarter as a result of a reduction in risk weighted assets. Partially offsetting this, CET1 resources have reduced by £18m in the quarter, primarily driven by losses.

Our RWAs have reduced by 3% this year. Balance sheet growth in the SME book, has been through BBLS and CBILS, both of which have very low risk weight density given they are largely government protected. We have also embedded the SME supporting factor, which drives a £70m benefit in risk weighted assets approximately.

In the top right I set out our MREL requirements. We expect to have a binding MREL requirement of TCR plus £400m from January 2021, ahead of full end-state requirements of two times TCR from January 2022. We are actively pursuing an MREL transaction in the fourth quarter to meet these requirements.

Turning to **Page 10.** Our liquidity coverage ratio has stayed fairly stable at 176%. The reduction in the quarter is driven by our covered bond liability management exercise, through which we completed a repurchase of circa £117m outstanding bonds. We continue to explore potential options to utilise surplus liquidity.

Also in the third quarter, we have completed an initial TFSME drawing of £1bn. We've repaid our original TFS drawing and we are exploring options to deploy the remaining initial allowance, as well as the additional allowance that has increased in line with SME lending growth.

Growth in deposits in the year has reduced the loan to deposit ratio to 91% and the funding mix remains heavily weighted to customer deposits. There is significant headroom to encumbrance limits should any further wholesale funding be required in future.

On the final three slides I'll cover in some more detail the risk profile of the Bank's lending book.

Starting on **Page 11**, we provide an update including more detail on our SME and corporate lending.

You can see in the top left of the page that 92% of our customer loans are secured mortgages, with minimal exposure to unsecured and corporate lending. As the average loan-to-value 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 over 17,000 mortgage payment holiday requests, of which 98% were up to date with payments prior to COVID, and were at a blended LTV of approximately 60%.

Approximately 19% of customers that requested a deferral in phase 1 have requested a second payment deferral, and as at 29 October just 0.5% of mortgage customers, or £105m remains on a payment deferral. I will talk more about our mortgage book on the next slide.

Moving to unsecured, you can see that this comprises only 2% of our customer assets at approximately £300m. We have now received approximately 3,100 payment deferral requests, representing circa 10% of loan accounts and 1% of our credit cards. As at 29 October, just 1.4% of loans and 0.1% of credit cards; which totals £2.2m, remain on payment deferral.

SME and corporate exposures are 6% of our customer balances, or £1.2bn. These are shown in the bottom left chart, split by portfolio showing legacy and core SME. 87% of these balances relate to low risk segments, including social housing and private finance initiatives, and CBILS and BBLS, which are 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 £100m of which circa 75% is at an LTV below 60%. A review has been completed on the loans in this portfolio, and whilst there is some exposure to sectors more impacted by the pandemic, the low LTV nature of the book minimises this risk.

In the remainder of our portfolio, we also have some limited exposure to at-risk sectors, including hospitality and retail, charities, education and care, but in total our at-risk exposure amounts to circa £150m, or 13% of the total SME and corporate book.

Turning to **Page 12**, and as previously mentioned you can see that we continue to run a low risk, high quality mortgage book with an average retail LTV of 57.1%, which is flat in the quarter. Completion LTV is up marginally to 71.7% in the quarter.

In the bottom left, the chart shows that our exposure to London and South East maintains it's position, with the lowest LTV of our geographic segments at 54.1%. Approximately half of the book is less than 60% LTV, and in the top right you can see that only 12% of the book has an LTV greater than 80%. There has been no change in the loan-to-value mix in the quarter.

In the bottom right, credit card arrears have fallen to less than 0.1% of the book, as a result of the re-commencement of debt sale activity which was paused earlier in the year.

[Page 13] Turning the page 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 in total are just 0.4% of the book. Coverage of these loans has remained broadly flat in the year because of limited movement overall. As a reminder, customers that have had payment deferrals are not classed as non-performing.

If we look at exposure by IFRS 9 stage, i.e. in the bottom left chart, there has been movement in the year; an increase in the proportion of stage 2 loans, which has been driven by mortgages and SME. In mortgages, this reflects the impact of payment deferrals, however, the vast majority; approximately 95%; have now resumed payments. For SME, we have moved loans for some 'at risk' sectors, such as commercial real estate, retail and hospitality to stage 2.

The net impairment charge for the year of £16.7m includes £12.3m in relation to the impact of the COVID-19 pandemic, of which £5.8m relates to an update made in the second quarter for economics, which remains unchanged. The increase in the 'other COVID-19' component of the charge is driven by the impact of payment deferral risk. The movement in the underlying charge is driven by an increase in overdraft coverage. Activity is now underway to assess the impact of the second lockdown on economics and also on impairment.

With that I will hand back to Nick to conclude before opening up for questions.

Nick Slape, CEO

[Page 14] Thanks Louise, so to wrap up, clearly macroeconomic uncertainty and the current evolving situation with the pandemic remains at the forefront of our considerations. At present conditions remain relatively stable and we've seen positive moves in HPI in the third quarter, but looking forward we recognise early indicators of long-term recession and rising unemployment. As Louise mentioned, with the reinstatement of lockdown measures this week, we are reviewing the impact on our economic assumptions and impairment.

One way in which we will offset this challenge is through challenging our cost base which remains structurally high for a bank of our size. We continue to aim to address this through digitisation and simplification.

We have leveraged the opportunity presented by government-backed schemes to expand our SME franchise, and in the Retail segment we are taking advantage of current mortgage market conditions to write safe but higher margin loans.

Underpinning this growth we have great confidence around the strength of the franchise. As I mentioned earlier one of the most pleasing outcomes of the quarter has been the improvement in net promotor score despite all the challenges that are being faced by our customers and colleagues and this is a great indicator of the deepening brand affinity that our customers have for the Co-operative Bank.

Finally, the measures that we've taken in the last few years to de-risk the balance sheet is now paying dividends, and we entered and continue to manage through the pandemic from a foundation of very strong asset quality and strong capital and liquidity. The guidance we issued at the first half remains unchanged, and I was see us largely at the better end of the ranges that we talked about for 2020, with an anticipated review of that guidance on the full year results.

That's all from us today, I'll now hand back to Gary to open up for questions if there are any…

Q&A

[No questions were asked during the call]

Nick Slape, CEO

Well thank you everyone for your time today. We look forward to seeing you again in February for the full year results.