Metro Bank H1 Results 2020

5 August 2020

Daniel Frumkin (CEO) and David Arden (CFO)

Presentation

Daniel Frumkin

Good morning everyone and thank you for joining us today. I'm sorry that we're not able to do this in person and for our US shareholder base, I apologise for the early start. Inevitably, without meeting in person and having to pre-record the presentations, it'll seem a bit flatter than normal.

We obviously need to start by saying the first half of the year has been extremely challenging given the pandemic. And while it's unusual, I wanted to start with a video this morning so that you can all see some of the great work our colleagues are doing in the community.

Video spoken by Metro Bank colleagues

During the pandemic our commitment to our community banking and to our FANS has been steadfast. People are facing tough times, so were doing everything we can to help. Every single one of our stores and call centres stayed open, and for longer than other banks. We've opened new stores safely too, including our fifth drive through here in Cardiff. Everyone's situation is different, so we've worked with our customers one on one. From cycling to an elderly customers doorstep to help with their banking, to hopping in the car to set up 9 same day bank accounts for essential new recruits working down the road. For people worried about their finances, we've been a patient creditor and protected customers from fraudsters who used the pandemic to try and scam people. We're helping our business customers plan for a more uncertain future. SMEs are at the heart of our economic recovery and we are behind them every step of the way. We built a brand new SME lending platform from scratch in weeks and have lent more than £1 billion through government loan schemes. In challenging times being a community bank is what really matters. Our Orpington store has been a local donation point for NHS contributions. We've been making scrubs for key health workers. [In Welsh] "We've picked up the phone to say 'hello' to those in isolation across Wales". We completed 26 marathons in 26 days to raise money for our local hospice. We moved 2,000 colleagues to work from home almost overnight and proved our resilience. We've done everything we can to look after our people, from extending our sickness policy and launching our wellbeing hub, to setting aside £2 million to thank our key workers. While the world around feels different, we are just focused on being a bit more Metro. Looking after our FANS and creating new FANS is what sets us apart. We're the people, behind the bank.

Daniel Frumkin

That video simply makes me proud. Our colleagues have been more Metro and really stepped up to make us a great community bank during these unprecedented times. We said we would prioritise our customers, communities and colleagues and that video encapsulates a small sample of our efforts. I said in February, I took the job and I believed that Metro would be successful over the medium term because of our colleagues. Nothing has changed. I genuinely believe our colleagues are our secret sauce and they're the part of Metro that will make us successful. Now let's crack on with the agenda.

You'll see we provided a bit more detail here on what we've done to support our customers, our communities, and our colleagues. I'm not going to spend a lot of time on this slide, but I do want to just highlight a few bits.

We processed over 9,000 payment deferrals, in a normal year we process 15. We've processed over 25,000 BBLS loans and we extended over £1 billion of government backed lending. We kept every single store open, we're the only high street retail bank to be able to say that. We've answered calls and processed payments, we've done everything we had to do to run the bank. For our colleagues, we provided additional support including extended sickness leave, creating additional days to amaze and creating a £2m million thank you fund, amongst many other initiatives. I don't think this slide will be revolutionary for anybody, but I thought it was worth recapping before we get into the financials.

Every bank, anywhere in the world being affected by COVID, is affected directly in four areas of their operation.

Operational resilience. Our ability to respond to the largest humanitarian and economic crisis to face London in my lifetime. We've done extremely well in the face of the pandemic. Our colleagues have truly stepped up.

Fee income. Obviously our fee income is generated by macroeconomic activity, it's what being a bank is. Clearly lower economic activity, be it reduced cash usage, less travel or creating less FX income, has really been impacted through the crisis.

Credit provisioning. While we haven't seen an increase in actual defaults or actually even an increase in non-accruals, our credit provisions are mainly driven off the economic forecasts that Moody's analytics have built. Those forecasts show a meaningful drop in house prices and a significant rise in unemployment. Those factors led us to use judgmental overlays to make sure our provision expense was prudent for the period.

And clearly, margin compression. Given the historically low rate environment creates challenges for the bank. I don't think any of this should be a surprise to anybody.

I want to be really clear, our strategy stays the same. There is nothing that's occurred in the pandemic that changes the path forward for Metro. It's still a J curve turn around, it may be a deeper J but it is still the path forward that we believe in, we will execute against and we will deliver. The drivers to make this happen as outlined in February are cost, infrastructure, revenue, balance sheet management and internal and external communications. Again, those are the right drivers for a Community Bank and they're the right drivers for Metro. The good bit, and the bit that you may find surprising, is we've made really good progress since February at delivering across those vectors. But I'll come back to that later.

Right now, let's get into the financials. David over to you.

David Arden

Thank you Dan and good morning everybody.

First up our KPIs for the first half. Clearly overall financial performance has been severely impacted by COVID, although we've seen strong customer account growth and good momentum on deposits. Our underlying loss before tax of £183 million principally reflects the impact of the pandemic. We estimate the direct impact of COVID to be £109 million in the first half. That's £97 million of incremental ECL expense and we've also seen pressure on fee and other income as a result of the lockdown. The statutory loss of £241 million was further impacted by a number of items, most notably further remediation expenses and a one off charge associated with exiting our Old Bailey office in London. You can see on the slide that capital and liquidity remain robust and above requirements. Overall, and I appreciate that these are a challenging set of financials, the core franchise continues to progress and we have delivered in line with our expectations while also absorbing the operational challenges presented by COVID.

Turning to revenue. NIM reduced 25 bps to 115 bps principally because of the timing lag on asset and liability pricing where base rates fell 65 bps in March, combined with the decrease in the loan to deposit ratio to 95%. We would expect NIM to increase in the second half as cost of deposits continue to reduce. The exit rate on COD was 60 bps vs 82 bps for the half overall.

On fees, the impact of lockdown measures were keenly felt. We saw lower income from FX and reduced transaction volumes overall. It's difficult to guide for the second half on fees, suffice to say we are seeing volumes steadily increase, although consistent with the broader market, they remain materially below pre-COVID levels.

On costs, we've been very disciplined on run the bank costs with growth contained at 2%. This is after opening 6 new stores, delivering our first above the line brand campaign and absorbing the incremental cost of COVID such as PPE in stores, colleague kit for working from home and the thank you fund for our frontline colleagues, without whom we wouldn't have been able to maintain our strong customer focus and keep all our stores open. We've also taken actions to maintain continued cost discipline going forward and for half two cost trajectory we would expect a low to mid-single digit growth again over the half one outturn.

On 'Change the Bank', we're right on track where we said we'd be, albeit it the capitalisation rate is higher than you might expect. We expect this to be a timing difference. The total investment spend parameters that we guided in February remain appropriate, though we may choose to flex the rate of 'Change the Bank' spend in half two. There's an accelerator and brake. The rate of spend in half two will depend on operational capacity and the business's readiness to deliver and accept change.

Now turning to credit risk and starting with our methodology and our assumptions. Our macroeconomic scenarios have been provided by Moody's Analytics and we've used three scenarios with the weightings; 40% base case, 30% upside and 30% downside. The COVID-19 ECL expense is principally a combination of modelled overlays and expert judgements which are used where the underlying risk is masked through payment deferrals and our models, quite understandably, have not been able to fully capture the impact. In applying these scenarios, which are at the more severe end of the range particularly for HPI and unemployment, combined with the resulting overlays and judgments, we believe we have appropriately captured the impact of the pandemic. However, as you all know there remains considerable uncertainty as we move forward. ECL expense is broken down as £15 million underlying, the underlying book is performing as expected, albeit a limited number of single name concentrations have elevated the commercial charge. There's also £97 million of COVID related ECL expense; £15 million of single name exposures, and £82 million of macro-overlay and judgments. Assuming the economic outturn follows our scenarios, or is better, then we would expect the half two ECL expense to be materially lower than half one. As defaults begin to emerge, and we've seen very little to date, then we would expect to release the overlay to offset defaults as they come through. Key risks going forward are clearly a further lockdown, leading to a worsening of the economic outlook, and any unexpected single name defaults on the commercial book.

In terms of asset quality, we have seen no material change in lending mix, underwriting standards or underlying credit quality and we have maintained our disciplined and prudent attitude to lending throughout the period. On the slide we've broken out more detail than usual as we think it's appropriate given the backdrop. You can see cost of risk split underlying and COVID related as well as ECL coverage ratios and stage migration, of which there is little to date.

Residential mortgages remain the largest components of the lending book at 68% of gross lending. The book continues to be highly collateralised with an average debt to value of 59%. We initially granted repayment deferrals to around 25% of our mortgage portfolio, with 99% of those customers being up to date prior to deferral. As at the end of June, active deferrals represented 16% of the portfolio and since that time they have fallen further, by over 45%. As you know, payment deferrals do not automatically trigger a significant increase in credit risk and therefore we've not seen any material stage migration at this point. We will be following PRA guidance on our decision tree analysis regarding stage migration post deferral.

Commercial lending increased in the period, predominantly reflecting the government backed lending we have provided, representing around 20,000 customers and approaching £800 million of lending at the half year. Debt to value ratios remain broadly low across the portfolio. In terms of COVID and its potential impacts, we have reviewed every single name with loans of £3 million and above. We know all these customers individually and we have enhanced diligence in place to ensure the appropriate monitoring and support is provided to customers.

Here's the P&L for the half. I've covered most of the items on this page but it's worth dwelling on exceptional items. A total of £31 million of charges relating to the exit of one of our central London offices at Old Bailey is included within the impairments and the transformation cost lines. There's also £18 million of remediation cost which is largely associated with the ongoing work on the bank's previously disclosed sanctions procedures. We recognise that the work on sanctions is a significant figure. We are being very thorough in this work and are engaging a number of expert third parties. We also believe the programme is consistent with other programmes of a similar nature that have happened elsewhere in the market. For half two, we would expect these remediation costs to be broadly consistent with half one.

Turning now to the balance sheet, which remains relatively simple and very liquid. Our liquidity coverage ratio at 226% remained strong and we remain comfortable at this level for now, given the uncertain macro-economic outlook. I also wanted to flag the additional funding available to us as a result of TFSME. It provides additional flexibility to our funding plans, including the repayments of TFS.

Turning now to deposits, we're really pleased with the growth in retail and small business deposits which are up 13% in the first half and 32% year on year. These deposits now make up 73% of the book which is a marked improvement in stability given the events of last year. Two factors at play here, one is the growth in retail deposits reflects lower transaction volumes during lockdown, with customers spending less, a perfectly understandable dynamic. We've also experienced some SME customers retaining BBLS drawings in their current accounts rather than deploying cashing immediately. Which again, is an understandable customer behaviour. It's also worth flagging the favourable mix shift we're seeing in deposit types, 34% in current accounts up from 30% at the full year, with a corresponding reduction in fixed term deposits. This is a positive driver for CoD.

Given the various dynamics and the uncertain backdrop, it is difficult to provide guidance on the trajectory of deposit growth, but we're pleased to have already achieved our objective for the year, at the half year. Indicatively, we would expect continued mix shift towards retail and SME and we would be comfortable with total deposit balances being broadly flat in the second half. Cost of deposits were 82 bps in the period. This is reflective of initial higher mix of high cost fixed rate accounts, which are now rolling off. You'll recall that we took in a lot of FTDs across May to July last year, as these are now rolling off, it will provide further momentum on CoD into half two.

The base rate cuts in March move the exit rate significantly lower to 60 bps and we would expect the second half to outturn below this level, and to re-iterate, this should be a positive driver for NIM in the second half.

Finally from me on capital, our capital position remains above requirements. Total capital ratio was 17.3% and our total capital ratio plus MREL was 21.3%. The capital position has benefited from the CRR quick fixes firstly from the IFRS 9 transitional agreement, which has largely offset the ECL expense impact. Secondly, the changes to the SME supporting factor added 60 bps in the half. As we look to half two, RateSetter will have a limited impact on our capital position as we are not taking the back book.

And just a couple of comments on MREL if I may. The Bank of England's MREL framework review is due by the end of 2020, so timing on any MREL raise will be subject to the outcome of that review. Pending the outcome, we may consider raising MREL in H1 2021. In the intervening period, we will assess the most appropriate route to market, recognising our experience in October 2019. Additionally, during that intervening period, it is reasonable to assume that our MREL resources may fall below the sum of the MREL requirement plus buffers, which is 20.5%.

So before I pass on to Dan, a few concluding remarks from me. Despite everything this half, we are operationally on track and we continue to have momentum across the franchise. We've shown good cost discipline. Our approach and response to COVID has been appropriate. Capital and liquidity remained well above requirements while recognising and acknowledging MREL continues to be the binding constraint on the bank. All that said, we do not underestimate the current and the future challenges, and in response we have adapted and accelerated our plans as evidenced by RateSetter and we remain entirely focused on executing our strategy as set out in February.

And with that, I'll pass back to Dan. Thank you.

Daniel Frumkin

Thanks David. As seen from the financials, it's been a difficult six months. There's little doubt the organisation has been significantly impacted by COVID. But we shouldn't lose sight that the core operation be it deposit growth or controlling costs, has delivered in line with the expectations we would have had when we laid out the strategy in February. Our colleagues and the business have responded well.

From an operational perspective, we saw an increase in absences which have now dropped back down. Completely to be expected given the pandemic. We did manage to keep all our stores open during the pandemic, however, we did have to modify opening hours, and while we're now back to being open seven days a week, a true differentiator for Metro, our opening hours are not quite back to normal. We have decided to accelerate the rationalisation of our Amaze Central property portfolio. Our central London real estate portfolio was quite expensive and needed to be rationalised for us to deliver against the plan. We mentioned it in February, we were very clear the Old Bailey building was very expensive and didn't seem to make sense from a strategic point of view. We've now decided to exit the building and no colleagues will be returning to Old Bailey.

This is possible by the success we've had, as have many companies, in being productive working remotely. Our remote workforce has been at least as productive and maybe more so than when in the office. And when we asked our colleagues, most didn't want to go back to work five days a week. We did a survey and only 4% of our colleagues currently working at home said they would like to go back into the office five days a week. So between a combination of remote working and using all that extra space we have in stores, be it below, above or around the stores that were part of the leases that were negotiated, we can successfully exit Old Bailey and stay as productive.

I do worry about talent development and holding the unique Metro culture with a peripatetic workforce, but our return to the office plans really do address those concerns and we'll find that as we bring the people together in London, we'll make sure that a big chunk of that is for cultural building events.

We've launched BBLS and CBILS. We provided forbearance. We've done all the other measures the government has rolled out to try and support the economy. As a community bank we thought it appropriate, although it was operationally difficult, lots of colleagues worked seven days a week and extended hours to make it all happen. In addition, the operational impact from BBLS in 13 months' time when borrowers need to make the first payment should not be underestimated. Fee income is directly tied to economic activity and we've been impacted like every other bank. In the next slide I will provide a little bit more detail on economic activity as we've seen a bit of an uptick.

Credit provisions are driven by Moody's economic forecasts. We believe the assumptions we've used are appropriate given the current economic contraction. To be clear, this is the most severe and rapid economic contraction I have ever seen, and our provisions are prudent in light of that. We're also preparing for the road ahead. This is the start of the journey, not the end. So we're actively building out our customer support infrastructure to help customers during this difficult period. As people roll off of furlough and are made redundant and as individuals find it challenging to find a new role, we need to be ready to help them, in a Metro manner. We will be a patient creditor and will work in the communities we operate. Metro can only be as good as the macro-environment we operate in and only as good as the communities in which we're involved.

Margins are compressed and are likely to stay that way for some time given historically low base rates. While David highlighted the transitory nature of some of the NIM decline in half one and we expect that to return in half two, it still doesn't get us to acceptable margins going forward. So Metro needs to take actions to reposition its asset mix to drive higher margin. The acquisition of RateSetter and the further investment in specialist mortgages will help accelerate the asset mix shift. It's hard to believe that the strategic plan was launched just five months ago but the good bit is, it is still the right strategic plan for Metro going forward.

So we said we would provide you some data on economic activity. The interesting bit of this slide is it really shows a precipitous drop at the start of the lockdown and since easing has begun a real build back up in activity. To be honest, I've never seen a drop in activity anything near what was caused by the lockdown. And while it doesn't quite look like a V, probably looks a little bit more like a cheque mark or a tick or a Nike swoosh, there's little doubt the trend in activity levels is positive since lockdown was eased. And I do want to highlight and it should be mentioned that we continued to open new accounts for new FANS throughout the pandemic. So this slide hasn't really changed since February. We've added some bits in terms of response to COVID but the strategy stays absolutely the same and it is absolutely the right path forward for Metro.

There's little doubt that our service led model with extended hours, dog-friendly, lollipops, creating FANS not customers, allowing customers to choose channels, investing in digital and telephone as well as our store estate, gives us the foundation on which to build. The opportunity to meet more customer needs be it unsecured personal lending, overdrafts, credit cards, small business lending, business credit cards, insurance, are all still available to us even with the pandemic. We have an amazing group of colleagues who stand ready to help our FANS and as we introduce more products, I have complete faith they will be able to meet more and more customer needs.

I was clear in February that Metro had room for improvement in meeting those customer needs and when compared to a normal community bank, we still struggle to do the basics well. RateSetter and its unsecured lending platform is a step to addressing some of these deficiencies. As stated in February this isn't a cost out plan, there's no way to turn Metro around by simply shrinking to success. We absolutely need to grow. Our fixed cost base is too high, too much capital was invested into the stores and it puts us in a position where the path forward is about growth. And as I said in February the good bit is there's lots of things that we're not very good at and as we get better at them, unsecured lending, small business lending, etc., we meet more customer needs, we generate more revenue and we begin to leverage up the fixed cost base. And as Metro grows into its skin and gets to scale, we can generate increasing returns for shareholders.

Now, given the historically low interest rates, there is clearly more urgency to change the shape of the asset book. There's little doubt that the plan was always predicated on entering the specialist mortgage market, in building an unsecured lending portfolio, in offering better credit card products, in building out overdrafts, all of that was clearly part of the plan but we need to do it quicker and we need to move with more urgency than the original plan laid out.

So, these help recap where we are four months into the strategy and we've done a fair amount on cost in a very short period of time, choosing to exit Old Bailey 12 to 18 months before it was in the original plan, exploring all lease options with our landlords across every store to see if our current liquidity might be of interest to them in exchange for revised lease terms. We will continue to push and be disciplined about store openings. We're only going to open one store in the next 12 months and two stores in next 24 months. So I promised in February we were putting our foot on the ball in terms of slowing store expansion, and we are. This gives us a chance to enhance the model and get the growth necessary to leverage up the fixed cost base.

In terms of our infrastructure we've done a lot. Between delivering across all of the government initiatives, we've also invested in new products and the plumbing of the business. Things like financial crime, financial controls, regulatory projects and cyber have seen significant investment in the first half of the year. We also signed a contract with Wipro to outsource certain IT functions which provides us some flexibility and anchors us to a lower cost structure that should provide benefits as we move forward.

The revenue story was definitely superseded by helping the government enact all of the various initiatives. BBLS, CIBLS, processing forbearances, etc., absolutely distracted us from some of the core revenue generating initiatives. However, even with that we've managed to launch business account opening online for friends and family, with a full launch expected shortly. Again, this digital service, while Metro's stores get talked about a lot, our core digital offerings don't get the mention they deserve. The business account opening service is as good as any of the current providers in the market, we're quite excited to get it launched. We also managed to begin and complete discussions with RateSetter while laying out a new strategic imperative in specialist mortgages. And again, the one place that clearly was slowed by COVID-19 was balance sheet optimisation. We continue to stay fully committed to driving risk adjusted returns on regulatory capital. We talk about it all the time, we view every decision we make through that lens. However, COVID-19 has limited our optionality around some of the actions we may take over the medium term.

Now let's talk about the RateSetter acquisition. We've been clearly signalling our ambition to grow unsecured lending. Purchasing RateSetter for £2.5 million upfront with a half million deferred for a year and £9 million payable in three years depending on volume and other triggers, is a pretty low cost acquisition for Metro to make, especially when compared against the costs to build a similar platform. Purchasing RateSetter for £2.5 million upfront with a half million deferred for a year and 9 million payable in three years depending on volume and other triggers, is a pretty low- cost acquisition for Metro to make, especially when compared against the costs to build a similar platform. At some level it's a very straightforward buy vs build decision. Another strength of the RateSetter acquisition, given the uncertain macro environment, is we're not acquiring the existing lending relationships. Those relationships are funded by the existing investors in RateSetter. Those investors have benefited from interest they received on those loans over time, and we see no reason to disrupt those relationships. And those investors will see out those investments which will run down over time. So the acquisition doesn't create incremental credit risk for Metro Bank there is no back book. It is one of the structural pieces of the transaction we worked hard to achieve. The logic of the acquisition is, I think, relatively self-evident, I'm clearly biased, but I think it's relatively self-evident.

RateSetter was struggling to find funding, the reality is, is that we have plenty of funding. We continue to generate low-cost sticky deposits. So we have the ability to really leverage up RateSetter's operating model, getting even greater scale in the unsecured lending market. It also provides us a really rapid and cost effective route to market and the ability to embed the processes within our stores to allow us to meet more customer needs. So listen, we're really excited about the acquisition and we're also really excited about the great group of colleagues that will be joining the Metro family. It's a great business, their asset origination model, scorecards, etc. will be additive to Metro. Rhydian, the CEO and founder of RateSetter, sees the logic of the combination with Metro as do we. And for clarity, we're keeping the RateSetter brand, we will continue to use it, especially on platforms where the Metro Bank brand isn't used. And as I said, we will definitely roll out the functionality into our stores.

So this slide, David's covered for the most part, so I don't want to spend a lot of time on it, but there's just a couple of bits I do want to highlight. The first is that if you look at the February guidance, we're not far off on delivering across almost all of those metrics. Considering we're in the middle of the worst economic cycle I've ever lived through, in the middle of a pandemic, the fact that we can stand here today and tell you the second half guidance is not far off of what we said in February gives you an indication of how well the underlying business is doing.

Another thing I think I need to highlight, is expected credit losses. So you saw the provision expense in the first half of the year, it was really driven by IFRS 9 and the Moody's models that were prudent in particular around HPI drops and increases in unemployment. But it would be a mistake to simply annualise the first half charge for the second half. Assuming our economic forecasts hold up and the economy doesn't worsen meaningfully, we don't expect the second half provision expense to match the first half. And I would just like to reiterate what David already said around MREL, we will be below total capital plus MREL thresholds of 20.5% during the second half of the year. We know that, our board knows that and we provided forecasts for the regulator that provides clarity. Given the MREL framework reviews being done, by the regulator, we're more than comfortable operating this way through year end. And if we need to, we will raise £200-300 million of MREL in the first half of next year.

So now on to the 2024 outlook on this slide. And I hate to be following the pack, but I don't think we really have a choice. Every other bank, and almost every other company has withdrawn guidance and we simply cannot provide guidance over the medium term. We have no idea where the pandemic's going. We have no idea if we can successfully reopen the economy and then hold it open without having to go through a second lockdown. You can look at what happened or is happening in the US or Taiwan or other markets around the world and you simply can't predict where it's all headed. So given that uncertainty, it's just too early to establish if our medium term financial targets are going to be impacted.

So in summary, we've been unwavering in our support for our customers, our communities and our colleagues. To be honest, that's what being a community bank is. Inevitably, the financial results have been challenging over the short term, given the effects of COVID. It is amazing to me how quickly COVID has had such a severe impact on the global economy. Metro continues to be a deposit gathering machine. It is the piece of Metro that we told you in February was a critical component for Metro growing into its skin, for achieving the strategy. And with retail and SME deposits up 32% year on year and overall deposit growth of 8% in the first half and 14% year on year being quite strong, we remain very confident that the deposit generating engine of Metro is intact and that is the key plank, along with meeting more customer needs, to deliver the strategy.

And very pleasingly, we've seen a huge shift to more current accounts and a reduction in fixed term deposits. That trend will help margin in the second half of the year and beyond. The strategic plan, as outlined, is absolutely the right path for Metro, I still believe in it, our colleagues still believe in it and I'm confident in its delivery. We clearly need to accelerate our asset mix shift. It was always part of the plan, but given the low rate environment, we have no choice. It's one of the reasons why the RateSetter acquisition made so much sense. Cost discipline remains focused. We spend more time talking about costs as the leadership team than we have since I joined the bank. We're not opening as many stores, we're exiting London office space, we’re outsourcing IT services where appropriate to ensure we contain costs. Lastly, and potentially most importantly, we refreshed the board and management in the last few months. We've attracted talented hires to the executive management team and have attracted a chairman of real quality in Robert Sharpe.

So with that, David and I are happy to turn it over to questions and I want to thank you very much for your time this morning. Thank you. Sandra, over to you.

Q&A

Benjamin Toms

Morning Daniel and David, thank you for taking my questions. Firstly in the presentation you noted the potential for the bank to fall below its MREL requirement before new issuance next year. Could you just provide some colour on any discussions you had with the regulator on this? Secondly, on the CET1 capital ratio, please could you give some guidance on the half two outlook including the benefit from potential software intangibles which I think could be quite material for you guys? Thank you very much.

Daniel Frumkin

Yeah, so Benjamin good questions. It's not surprising given the talk of mine. So I'll talk a little bit about our interactions with the regulator and then I'll turn it over to David and talk about the forward looking one on capital build.

So, we have been providing the regulator financial updates since we started doing the strategic work in September, October. We continued to do that. We've provided them forecasts for the next five years with focus on the first 24 months, that make it clear what we think the financial performance of the organisation will be during the down part of the J curve where it starts to flatten out and where it starts to come back. And as part of that, we've been really clear about what the capital profile looks like. So, I'm not going to recap any of the conversations we specifically had with the regulator, but there is real clarity in the conversations we've had and I think there is an understanding of the financial profile of where Metro goes from here.

I want to be clear that there is an MREL review going on and I know some of the analyst community who have written about and I hope become more vociferous about and become very vocal at the moment because while the review's going on, I think for those who believe the MREL regime should not apply to a bank of the scale of Metro, we need to be really clear because to be honest if we were in France or Germany or Canada or Hong Kong or the US or even Latvia, Metro Bank could be six times larger than it is today, maybe five times larger than it is today, before it would be caught by a loss absorbing capital regime. So we are hopeful that the review concludes, but we've built our plans under the assumption that we will need to raise MREL and MREL will continue to exist, but it would not be prudent for the organisation to raise MREL until the review concludes. So if we need to, we will raise it early next year and we will crack on with that when the review finishes up, and with that I'll turn it over to David on the CET1.

David Arden

Hey Ben, good morning. On CET1 at the half year, CET1 ratio of 14.5%, significant headroom against our minimum, which is 9.6%. What I would say around half two progression is that you shouldn't expect any material RWA inflation in the second half. And regarding the software benefit, it's not in our gift, it very much depends on the EBA and PRA, but if it does come in, it will add depending on the option chosen and we're still looking at that and we will review it when the final thing lands, if it does, it will add between 35 and 70 bps of CET1 in the second half.

Benjamin Toms

Thank you very much.

Joseph Dickerson

Good morning thank you. Just staying on the topic of the regulatory requirements around capital, is there any update on AIRB treatment because that kind of goes hand in hand here with the binding constraints on the business? And if I looked at back of the envelope, a more normal model weighted resi risk weight's at least 400 bps of CET1 for you so, is there any updated talk process on the timing of AIRB certainly as regards the resi mortgages?

Daniel Frumkin

Joe, a really good question and you know we do stay silent on it in the presentation, with the exception we do highlight that in terms of the infrastructure spend, we spent a chunk of money on the AIRB programme. So I think there's a few bits we should just make clear because I know in particular this has been a topic in some notes that have been published. We continue to work on the AIRB, we continue to do all of the parallel running you would expect us to do. We continue to work through all of the models that would need to be in place and all the slotting work that would need to be in place before we would make a submission. So, I know we pulled it off the table at the year end and I think I may have confused a few people. We didn't stop work for a second, we've also just had an external third party come in because I thought it was prudent to get an independent review to see how we stacked up against others who have been through the process. And that review concluded in early July and was broadly favourable. We have work to do but we're in line with where you would expect us to be for somebody who is contemplating making an application. Now all that said, Joe, I'm not going to comment about timing, I'm not going to comment about where we are in the submission process and all that, because that's really within the regulator's gift and I can't tell you whether we'll get it or not get it because it's completely up to the Bank. So all I can tell you is the work is ongoing, we're completely committed to doing the work to a high standard and what comes after that is outside of my control.

Joseph Dickerson

Understood. Thanks.

John Cronin

Morning all, thanks for the call. Just if I can come back to provisioning first. I'm trying to understand, I guess, how much of the-- it's very clear in terms of the split in favour of overlay versus evidence based impairment charges in H1, but I'm trying to ascertain how much of that is structural in the sense that your coverage ratios at end FY19 were quite light particularly on residential mortgages, but also relative to peers albeit it's an apples and oranges comparison, but light as well on the commercial book arguably at that point. So at one level, I guess I can see the scenarios that you paint, particularly in unemployment and HPI context which looked materially worse than peer banks beyond FY20 but what I'm trying to, I guess, understand is A, the sensitivity around some of those assumptions, so any kind of information you could give us in relation to how your mortgage provisions and commercial provisions particularly would move in response to bringing your assumptions closer in line with peers? But also how we should think about coverage levels going forward?

That’s my first question, then my second one is on the RateSetter acquisition and your comments this morning around moving with more urgency. You still have some tail winds coming from a capital perspective as you've called out in response to previous questions. Could you do some more keenly priced deals, maybe in other lending channels, for example SME, to create a platform for further expansion in a post IRB context? And then thirdly, a point of detail just on the RateSetter deal again, could you give us some colour or walk us through maybe how you get to the 30 basis points of CET1 capital ratio depletion owing to that transaction, please? They’re all my questions. Thank you.

Daniel Frumkin

Thanks John, I really appreciate it and thoughtful as always. So listen, I’ll do bits of it and then I'm going to turn you over to David who will do the chunk of it. So I'm going to reorder your question slightly as we go through it. So, on provisioning, John, you have lived through a few cycles like I have, the reality is that, I think for Metro Bank, given its history and given the way I was raised at other organisations, I think early in the cycle is a time to be prudent. Yeah? So I think provisioning overall early in the cycle is not a time to be trying to figure out a way to under egg or justify lower numbers, it is time to be conservative in your assumptions and be prudent. I think it's the right way to attack a crisis, so I think that's what you've seen come through on our numbers and I know that we have other competitors who didn't take such a view. Some of the larger banks were more aligned with us but I accept some of the banks that are closer in size to us did not, but that's fine. We think being prudent is the right thing to do.

In terms of RateSetter and moving with more urgency and trying to attack markets, listen, we're always happy to have conversations if there are opportunities that makes sense, that will accelerate our entry into SME lending or specialist mortgages or anything along those lines, we’re happy to have those conversations. Again, obviously John, I'm not going to tell you whether anything is imminent or anything like that, but we're always happy to have those conversations. But just as importantly, you will see that our BBLS lending platform we did with ezbob, which is a fintech and we created a partnership with them to launch BBLS lending and that they were always our chosen partner for our small business lending platform. So regardless of whether we make an acquisition in that space or not, we have invested a lot of money and capital, some of which was thankfully matched by BCR and contributed by them, to build out both a very slick business account opening online, which will be attractive to SMEs. And we are a few months away, because it had to be delayed to do BBLS, from launching a relatively slick automated small business lending platform which again, both of those, both being able to open a business current account online and the SME lending, will be pretty close to best in class when they're launched.

We’re completely committed to the SME market, we think our seven day week banking, extended hours, all of that appeals to that market place. We still win a larger share of switchers in the London market than our current market share, so we believe it's a place where we can continue to dominate. So yes, we're still open to having those conversations. Again, I think everybody understands the urgency and you've been very clear in your notes about the need to shift the asset mix of the balance sheet to generate more yield. I agree with you and we're on that path and either organically or inorganically we will make it happen. And with that I'll turn it over to David to talk about the structural bits and what we're thinking about coverage going forward on provisions and then the 30 basis points in CET1 deterioration caused by RateSetter. I'll let David take both those. David?

David Arden

Hey John, how you doing? I think you hit the nail on the head on ECL, comparing across banks is to a large extent apples and pears. We have used scenarios that are at the more severe end of the range, particularly on unemployment and HPI, and that does drive sensitivity particularly for mortgages. When you look at the stats on our mortgage book with regard to deferrals we're broadly in line with everybody else, but the level of provision we've taken at the first half, assuming the economics play through the way we're expecting them to or we're forecasting them to, we would expect a materially lower charge in the second half and we will monitor that very closely. On the commercial book, we're also providing significant support to our customers and we believe that's the right response and should increase their chances of surviving the pandemic. It's the right thing to do. We've been very diligent in distinguishing at individual level the difference between temporary COVID support and long term financial difficulty. And as I said in the script, we know many of these customers by name and we're monitoring and supporting our customers throughout. There remains considerable uncertainty, but we believe in the scenarios as we've used, that as you rightly point out, that they're at the more severe end of the range. And therefore we should be in in good stead for the second half depending whatever COVID throws at us. Regarding the 30bps we're not buying the back book, 30 bps is just the acquisition accounting because we are buying the business with all the associated assets and liabilities that come with the business, excluding the lending book which resides and will continue to reside with the investors in RateSetter.

John Cronin

Very clear, thank you.

Christopher Cant

Good morning, thanks for taking my questions. I just like to ask about your store network. Firstly you mentioned during your remarks that you're looking at trying to renegotiate some leases, I just wondered if you could comment a little bit more on what you think is achievable there. I assume that as a bank, you can't actually go through anything like a CVA process. The second question, on the full year '19 call, you said you'd assessed the store network aspects and you felt the stores were broadly of fair value, that was the phrase you used. Presumably the fair value of those store assets has fallen quite a bit given COVID and I presume if you weren't already, you're now quite reliant on value in use modelling to avoid needing to take a right down from carrying values. So is my supposition correct on that? And if so could you talk a bit about the value in use modelling assumptions that you are making? Dan, you commented on the full year call that you were hoping for rates to rise as the bank would be significantly more comfortable, so presumably, given that rates have gone sharply against you, relative to expectations you had when you thought the stores were broadly of overvalued, that's now significantly significantly worse, and I would have thought that rate outlook would make the value in use assessment for the stores materially worse. So what would need to happen before you take a write down on those store assets? Thank you.

Daniel Frumkin

So Chris thanks, I'm going to give some of that in terms of the value in use to David, but let's talk about the lease conversations we're having. So I want to be really clear that we've made all rent payments when due, we think part of being a community bank and financial organisation is that we honour our commitments. We've made all lease payments when due, so we're not withholding lease payments to try to gain leverage against our landlords. However, we think there, and we may be wrong, but we think there may be opportunities where our liquidity may be attractive to certain landlords in exchange for modified lease terms. So we are in a position where we could prepay significant portions of the leases, we could potentially buy out leases and purchase properties, we could exchange for stores we really like, we could potentially sign small extensions, it would be really attractive to them to lock in a tenant, in exchange for modified terms. So I think Chris, we're trying everything we can to work through creative solutions that may or may not bear fruit on a property by property basis across the whole store estate. And I think it is our responsibility to try to see if there's anything we can do across every store. I mean I think we have a responsibility to our shareholders to try to see what we can do so, we're away doing that.

The one thing about lower rates and the analysis at year end, which I thought I highlighted but maybe got missed and maybe I didn't highlight it, is the store analysis that was done, again, was done for a purpose about whether you open or close the store so a slightly different sort of marginal cost, marginal contribution, kind of analysis. But that's not the point, the point is, we did it off the existing product set that existed within the store estate. So as we deliver better products into the store so that they can meet more customer needs, the underlying value of each store improves because they will be doing some unsecured personal lending, more overdrafts, more credit cards, they will become one of the channels to access our FANS, to meet more needs and generate more revenue. So I think you need to keep that in mind actually, that actually the analysis that was done was really just based off the products that exist today and we're actively working quickly to expand that product set to meet more customer needs, which makes the stores more valuable.

And then I know there is a growing drum beat about the value of stores and I saw some comments from some other CEOs yesterday about they've seen drops in activity in their store levels, and they're not sure what they're going to do with their store estate. I think there was an article in The Mail yesterday online, there was a bit of commentary in the FT today. The reality is I hear all that, I don't necessarily believe it, so there's a slide in the deck where we talked about an uptick in activity levels. Our stores are now 70 to 75% as busy as they were pre-COVID. We do not yet know whether there's some form of permanent impairment in activity levels in store. We have no reason to believe there might be. I don't know why people think-- actually you can make the counter argument that actually COVID and being locked inside for as long as people have been locked inside has created a deep need for some level of personal interaction and therefore the tactile experience of going to a bookstore or going to a bank will have more value as we go forward so I don't buy it. I get why the narrative is there, I fully understand that if I had a store estate of 600 or 700 I would be talking about how the stores are less valuable so that I could justify closing a large chunk of them. We have 77 stores, all of which are less than 10 years old, so they're in locations that we've chosen after the demographic shifts that occurred, so we're comfortable with our store estate, we're comfortable with the decisions we made around the store estate and as we build out a broader product set and meet more customer needs, the stores only become more valuable. And as a channel for customers, we fully expect that stores have a huge role to play in the economy as we go forward, but David, I'll let you talk about the value in use and some of those bits if you choose.

David Arden

Hey Chris, how you doing. And the other thing I would just close out and Dan's bit around the analysis we did in February was that it was very much the point in time and we've shown in the past that all our stores are maturing every day and they continue, and the analysis showed that the younger stores on a point in time basis looked really the worst performing but that's just because they are young, right? And you're right, Chris, that impairment is based on value in use rather than market value. A temporary reduction in market value does not necessarily drive an impairment charge. IAS 36 requires that the value in use is compared with the carrying amount of the CGU and our stores, as we've demonstrated many times in the past, are integral to the wider brand and operation of the business. And as we grow the product set to meet more customer needs coming through our stores then the operation of the business and the value of the business grows. That's kind of where we're at, our impairment tests are regularly reviewed through appropriate governance, and now we're really comfortable with the carrying value that we've got.

Christopher Cant

And so on the rate versus product piece, essentially the argument is that because you've done things like buy RateSetter, which will accelerate plans you already have at the full year '19 stage, so you're going to have a bit more consumer credit growth earlier on than you were planning, that offset the impact of minus 65 bps, which we can see in the first half results, it's done pretty brutal things to your top line. Just coming back to what you said at the full year '19 stage, rate rises would have been significant upside to your view, so surely there's significant downside to your view now that rates are lower or are you now in your value in use, assuming base rate rises, which is the only way I can think about squaring the circle here? I understand the branches are an important channel, I understand they are important for the brand but when I look at your freehold property based on previously disclosed store sizes, you've capitalised freehold property assets at about £2,700 per square foot, which is an incredibly high number versus where [inaudible] would imply values are today, so I'm really struggling a bit with this idea that because you found something like buying RateSetter that offsets lower rates. I would have thought that the lower rates piece was pretty bad for what is a liability-led model and I would have thought that that would make your value in use calculations materially worse.

Daniel Frumkin

So listen, sorry, I'll come in and then David, I'll let you sweep up a bit. So listen Chris, maybe we can pick it up tomorrow when we have the breakout session and drill into it a bit but for the avoidance of doubt, the forecast we built and that we have showed the board show flat rates from this point forward. We don't have rate increases built into the forecast and we think that would be inappropriate looking at how we need to reposition the business going forward. But yes, the ability of the stores to be able to do more stuff with customers enhances the value of the stores. Just like if it was a retailer and it sold more sweaters it would be more valuable, so at the end of the day we're comfortable that there is real value in that store footprint, but I don't know David if there's anything you want to add?

David Arden

No, the only thing I would add is that we've been very clear today that the low rate environment accelerates the need to shift the asset side of the balance sheet more rapidly and RateSetter does that. So the plan we outlined in February might imagine that we get to 5% consumer by the end of the plan, with RateSetter that's going to happen a lot sooner. And once we get there a lot sooner then we can determine how much we want to drive consumer lending.

Christopher Cant

Okay, thank you.

Daniel Frumkin

Thanks Chris.

Nicholas Herman

Yes, good morning. Thank you for taking my question. Three questions if I may and apologies if I'm going back on stuff that you've already touched on, I was a bit late on joining the call due to another results call. But the three questions are one on LDR, one on 'Change the Bank' cost and one on RateSetter. So on LDR, have I understood you correctly that you're expecting loan to deposit ratio to pick up in the near to medium term but for 2024 you still expect to operate at a similar LDR versus your original plan?

Secondly, in terms of investment spend, so back in February, I think you indicated front loading of investment costs will be the overall change the bank spend of £250 to £300 million. So I guess you-- well, I guess so, now you're indicating more flexibility in that change to the bank spend. So I guess, firstly what will determine in your approach that flexibility in the second half '20 and '21 versus the more front loading approach that I think that you previously indicated? And are you deferring programmes? Which programmes are you deferring and what effect do you see from that? And then finally in terms of RateSetter and consumer lending, so you've indicated in the presentation that the consumer loan yield on RateSetter loans is 8%, now that seems to be for me a fair bit higher than Metro Bank's consumer current consumer lending book so, your business plan with RateSetter, does that factor in new consumer loans at 8% or more at Metro Bank's consumer existing consumer loan rates? Thank you.

Daniel Frumkin

Good questions, I'll take the RateSetter one and then I'll let David do the LDR and the ‘Change the Bank’ investment spend in the guidance we provided and as part of that I'm sure David will weave in the C&I bit.

Current rates if you walked into one of our stores to get an unsecured personal loan, I think the current rate in store is 7.99%, so it's not meaningfully different. And when we looked at the risk profile of RateSetter’s customer base, it wasn’t miles off of our small consumer base, but remember we have £180 million of consumer lending or something. The square root of bugger all. So the reality is, is that we're not anticipating a meaningful shift in RateSetter’s risk appetite and or risk based pricing model that they currently use. So I think the 8% we put in the deck is a reasonable yield to use. Now the question then becomes the trade-off between volume and price. And we may choose to go to a higher quality, lower price unsecured lending product but again, all those decisions will be made once we own the business. It's a bit too early for us to tell. Again, we've just announced it, we’re working to close and we’re working through all the financial modelling now, but we think 8% is not far off to use and then David, do you want to talk about loan to deposit ratio and then the ‘Change the Bank’ investment?

David Arden

So sorry, I was on mute, apologies. Hi Nicholas. On loans deposit ratio, you’re right. It may go up in the short term and may run at a slightly elevated level through the life of the plan. The mix shift we’ve seen to more stable funding over last 12 months and the introduction of TFSME gives us much more flexibility on funding as we move forward.

On the ‘Change the Bank’, the only thing that will change the rate of expenditure is the business's operational capacity and readiness to accept change. So far this year we have not deferred any programmes, and not that we don’t intend to but I'm just conscious-- we need to be conscious of the capacity and capability in the business given the incredible effort all our colleagues have made so far this year in not only meeting all our expectations in terms of fitting the change programme but absorbing the incremental change presented by COVID. So we will assess that as a management team and as a board over the next few weeks.

Nicholas Herman

Got it, thank you very much.

Daniel Frumkin

I just want to thank everybody for taking the time this morning. I know that the financials were dense, I know that the effects of COVID were more severe than some people had modelled but I don't want to lose sight of the fact that the core business performed in line with what we would have expected pre-COVID. That we saw strong deposit growth which we said repeatedly is an underpinning of the turnaround strategy. So there is a lot in the financial statements to like. It just turns out that COVID has created a scenario that that makes the overall financial performance look pretty difficult in the first half, so I appreciate everyone taking the time this morning and we look forward to catching up when we present year end numbers, at which point we will continue to deliver against the strategy as outlined, and will have further updates on where we're taking RateSetter and how we're continuing to shift the asset mix. Again, thank you very much for your time this morning and everybody stay safe. Thank you