The co-operative bank

2020 INTERIM RESULTS CALL

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Speakers:

Andrew Bester, Chief Executive Officer

Gareth Jones, Chief Risk Officer Designate

Nick Slape, Chief Financial Officer

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

[Introduction]

Andrew Bester, CEO

Good afternoon everyone and welcome everyone to our interim results call. We have Gareth Jones joining us, our CRO Designate to run through where we are in terms of our credit portfolio and then Nick will run through the numbers in the usual way.

[Page 3] I thought I'd quickly run through some of the strategic highlights for us in the first half and I think the thing that I would say is that we have been resilient and the teams have moved with real pace to be able to adjust to what has been an extraordinary last four or five months.

The good news is, as we alluded to in Q1, the book is highly secured at 92% and our AQR at a low 12bps, we'll get to that in a little more detail later. We're happy to report that we've completed all our PPI enquiries and complaints that we received up until last August; the only part outstanding is our negotiations and discussions with the Official Receiver.

In terms of the franchise, the agility we saw in the business, good growth in the deposit base both in our Retail and SME business and very strong growth as we supported Bounce-back loans in our SME business. We enjoyed a 16% share of the Incentivised Switching Scheme in the first half, and what has been really encouraging is seeing us grow our customer base both in SME and in Retail in the year. I'm also happy to report that we have sustained our customer service metrics and held our strong 3rd positon for net promoter scores on current accounts.

Clearly it's been a very different environment and colleagues have got used to working in agile and different ways and remotely and we've spent as a team a lot of time on BlueJeans over the last four months. Clearly this environment is an environment that does pose challenges. NIM reductions follow low interest rates and whilst we feel good about the fact we have low loan impairments we continue to look at ways that we need to drive cost efficiency in the business and we have reigned back our investment plans in response to the environment.

[Page 4] If I turn to specifically what we've done for customers, and I've shared a number of highlights on this page. I don't intend to talk to all of them but I think the things that I would draw out in terms of the way the organisation pivoted to support customers through the COVID crisis has been remarkable and I'm very happy to report that the investment that we put in in transforming our digital infrastructure, completing our separation from the Co-op Group and investing in our digital capability, gave us a platform to be able to respond to customers in a way that would not have been possible 18 months or 2 years ago.

In terms of payment holidays we've provided over 18,000 payment holidays to our mortgage and SME customers. Gareth will run through a little bit later what we've seen as the first wave of mortgage holidays have come to an end.

It's been very important to us to create a safe environment for our colleagues and look at their wellbeing and we've been surveying our colleagues to understand how they're feeling and what's been positive is that 83% of our colleagues working from home have felt that their wellbeing is positive and that's in the teeth of this pandemic.

What's also been very encouraging to see is that the core culture of our organisation, and the care that our colleagues have demonstrated in the community, and we've been flooded with donations from colleagues and care packages provided to local hospitals in the North West, providing headsets to GP's, and a huge amount of community spirit as we've supported the NHS staff through the crisis, but also a number of our customers are also in the NHS.

[Page 5] Happy to report on the next page that we've continued to stay clearly number 1 for an ethical perception in the UK; we were 9 points clear of the second rated bank and we're now 11% clear in terms of non-customer ethical perception, and it's testament to the very strong values and ethics underpinning that the Bank has had over multiple years.

We continue to support charities through this time and we're very happy to be able to facilitate a £650,000 pledge to our major charity partners. It's been an important time to provide support to those charities, for example Refuge one of our deep partners who support domestic violence and that's been an issue that has been unfortunately prevalent through the lock down, and we continue our work and support with Amnesty International.

From a sustainability point of view, again just to reinforce we've been beyond carbon neutral since 2007 and we continue to be on track for our zero-waste-to-landfill commitment for 2020. So very much in the heart of what our business is.

[Page 6] If I turn to customer satisfaction, what's been particularly encouraging is you can think in a crisis like this that you may drop your service levels and that customers would potentially see issues with what you are delivering, but what I am hugely encouraged by is continuing to be recognised across our current account propositions, the work we do in the communities and I'm also very proud of the fact that we got voted Branch Network of the Year by Moneyfacts in the height of the crisis. To bring that to life we were able to keep all of our branches open through the pandemic and that is a real credit to the culture of our people.

[Page 7] If I turn to the businesses and what's happened from a franchise point of view, and I'll start with our Retail business. 8% growth in franchise deposits and what we've seen is customers being conservative and prudent with their money. Obviously they've been paying out less but they've been saving money too and they've trusted us with their funds through the half. I think what has been interesting is we've also seen customers pay down their credit cards through the second quarter.

In terms of lending we sustained continued mortgage growth. It was an interesting quarter as for the half of it the housing market was all but closed, but as the market has re-opened what we've seen is opportunities to both continue to drive good retention levels for our existing mortgage business, but also some interesting opportunities as the housing market opens for some good, attractive margin business. Again good, solid growth in terms of our current account base and really encouraged to see that.

[Page 8] In terms of our SME business, this has been a real highlight of the half year, and I think it builds of the franchise that we have been underinvesting in for a number of years. One of the things I was keen to do when I arrived was to reinvigorate that franchise. We managed to get £50m of investment from BCR and what's been particularly encouraging is seeing the growth in that franchise; 25% growth in our SME deposit base in the first half and a 74% increase in lending, which is primarily driven by the support that we've been able to provide our existing customers with Bounce-back Loans and CBILS.

We achieved 16% share of the Incentivised Switching market against our own internal target of 6% and that has really created a momentum for our franchise that we want to build on. We are looking at seeking additional BCR funding in 'pool E'.

[Page 9] If I turn to the next slide around our digital enablement; the digital investment we've made in the last couple of years is really starting to bear fruit, and it was a crucial enabler in being able to respond to the changes that we saw through the COVID crisis. Just to bring that to life with a few statistics; our online saver sales have doubled year-on-year and 70% of our sales are done through digital channels. We saw a 2% increase in digitally active customers in the half year. Huge changes in the amount of releases we've been able to provide for our mobile apps but also increased straight through processing.

[Page 10] In terms of responding to the crisis, I eluded to what we needed to do was given the pace of change that was being driven for our SME and Retail business, be that through mortgage holidays, credit card holidays, responding to overdraft changes; what was critical was being able to deliver automated, digitised capability for our customers and I'm very proud of the fact that our colleagues were able to make that happen in the teeth of this crisis.

But as we look forward, what we have done is dialled-down our investment portfolio and continued to rotate that to work out how we can continue to drive evermore simplification in our organisation. And that takes lots of forms; whether it's digitising our credit card applications, automating how our customers can upgrade their mortgages, mobile statements, simplifiying the number of suppliers that we operate with… for example we did have 16 foreign payment correspondent banks, we're now down to 2… reducing faster payment times, rationalising our infrastructure. To bring that to life 25% of our telephony infrastructure has been rationalised, and 15% of our legacy applications across the business; a focus on how we make sure we simplify and streamline the organisation. In the first half, I'm happy to report that we've reduced our number of third party suppliers by 23% to really focus in on how we simplify the Bank.

Back to the investment portfolio that we had, we have decided to pause some of our pace and speed of our investment portfolio and effectively half the amount that we expected to invest, from what was c.£80m to between £40-45m. The major area we've paused on is the transformation of our mortgage and savings platform

[Page 11] So if I pull that all together in terms of where we are as a franchise, clearly the low-rate environment does provide some challenge with our structurally higher cost base, and that does mean as we think about profitability, that that does move out and we continue to target profitability in 2022. We will continue to pull the various levers that we need to, be that income, be that driving cost efficiency. In addition to that we're very focused on our MREL requirements through the second half and through 2022. We have taken the opportunity to revise our guidance in light of COVID and Nick will share that in his session.

In terms of opportunities, it's slightly ironic because as we've been through this crisis we see opportunity for our franchise. Why is that? We don't see a major impairment challenge for our business, and therefore we think about how we can support our customers; we're very much open for business and there to support our customers. The SME momentum that you've seen gives us great hope and optimism that we will continue to drive that franchise. We are operationally much more resilient that we were; we're able to respond to the COVID crisis but that also creates a platform for greater efficiencies in future.

The fact is the franchise is a strong franchise, and it very much resonates through the crisis and the focus on community and the focus on co-operation and working together, which is very much at the heart of what the Co-operative Bank is. Yes, we look at challenge ahead, but we have a high quality loan book, very committed colleagues, a phenomenal customer base and huge amounts of liquidity as customers trust us with their deposits.

So with that I'll pass to Gareth who's going to give an update on the Risk portfolio.

Gareth Jones, CRO Designate

[Page 13] Thanks Andrew, on the overall portfolio Andrew's eluded to some of the low-risk elements, so I wanted to take you through some of the key attributes of the portfolio in terms of where we are today. The portfolio is mainly a secured asset base; 92% of our assets are mortgage lending. In that population to date we've seen around 12% take a payment deferral, of that around we've seen around three quarters mature. Where we project is that we expect that around 20% of that base to take a further payment deferral. Of that 20%, what gives us some comfort is that we're only seeing around 5% or less than 5% of the portfolio where the LTV is greater than 85%. In terms of those customers that have matured and have reached their first payment date, we've seen around 97% of customers making their first payment. So we have some encouraging signs in that payment deferral cohort which gives us some comfort around provisioning expectations.

Unsecured lending represents a very small part of our portfolio, mainly credit cards, and of that there's a certain age demographic there which means they are relatively insulated against potential impacts around unemployment. So we are comfortable that we are provisioned comfortably there. There's only around 0.5% of that population that have taken a payment deferral at this point.

We do have a small SME corporate portfolio as well, predominately low-risk in nature; PFI which consists of schools and NHS, where we see relatively little risk within that portfolio; housing associations; some non-retail CRE with very low LTV's and therefore limited risk; and some renewables with strong cash flow covenants, so again we don't see anything there.

We have identified some elements of the portfolio which are at-risk segments, but we've done a line by line review of any exposure above £1m. We've looked into those and made sure we're comfortable with where they're set today. Predominately three areas. CRE retail, where we do see some exposure and risk, we'll be managing that over the next 12 months making sure that that portfolio is evolving as we'd expect. We have some exposure to hospitality and retail, and a small element to charities, education and care.Where we are today our estimation is that we're not exposed to material losses from that portfolio.

[Page 14] Moving on to the next slide, as I've said the main exposure for the organisation is to mortgages. We have a well-diversified portfolio. We've had a strong credit strategy in terms of origination, which has given us a well balanced portfolio. So as you can see in terms of looking across both LTV and geographic distribution, we are not outliers in the industry. We're not outliers in terms of our key credit criteria either, so we are writing high-quality business and that is being evidenced in how we are managing stock and flow.

You can see in the arrears position, the profile is actually reducing at the moment. Now some of that is due to the government support measures; the furlough scheme and also payment deferrals; so we do expect those to start to trend upwards in the second half of the year, but as it stands they're under control. In terms of the current portfolio of arrears and defaults, they are also quite low LTV, so we don't see any exposure in terms of our current defaulted population, which has to a certain extent delivered a lower ECL than you might have evidenced across the industry. Even the arrears and defaults population is quite high quality.

[Page 15] Moving on to the next slide, how we flow through the macroeconomics in terms of driving our ECL through IFRS 9 models. We thought it would be helpful to provide some context. Some of the terminology might be slightly misleading; mild upside is how I would describe a mild stress, so we are still seeing some deterioration in HPI and a level of increase in terms of unemployment. The Bank has aligned it's base case to a sharp, 'V-shaped' recovery. We expect around 8% year on year drop in HPI, unemployment climbing to around 9% by the end of this year, then recovering to around 6% late in 2021. We do have a more severe downside with around 16% year on year reduction in HPI, and then a very severe downside in terms of a 33% HPI drop.

Now, we think we are appropriately placed within the industry; we've done some benchmarking against recent results. There have been some exercises conducted by the PRA where we feel that, in terms of the projections that are driving our models, we're in the middle in terms of projections against the industry. So we feel that's diving out a representative ECL in terms of the portfolio.

[Page 16] If we turn to the next slide and the context of that. We have a small exposure in terms of the balance sheet; where we do have exposure we've seen very encouraging signs in relation to that payment deferral population, and that's fed through to our provisioning for H1.

We have seen a material increase, we saw an £11.2m charge in the period, but actually if you look at the asset quality ratio, as Andrew eluded to earlier, it's still very low at 12bps. If you actually look through that to the non-COVID elements, so the underlying asset quality, that's sat at around 3bps, which predominantly relates to that mortgage portfolio.

In terms of where we are from an exposure stage, we have moved an element of that payment deferral cohort into stage 2, because we do believe there is an indication of some form of credit risk. We will be monitoring that over the second half of the year and moving those customers as we see them.

As it stands the signs are encouraging, the portfolio is acting in the way we would expect it to based on that low-risk profile. The other element that we've seen in the first half is one single exposure in a corporate legacy case. Where we are at the moment, we probably ranker lower in the industry in terms of the level of ECL that you've seen compared to other institutions, but I think really that talks to the quality of the portfolio at this stage.

We're not complacent. In HPI we did start to see a deterioration. We know that that will drive both risk weight inflation and further provisioning in the second half, so we do remain watchful and we will continue to monitor the market as we move into the second half of the year we'll hopefully be able to control that, but we will be playing close attention to the payment deferrals and if we start to see any further stress in the portfolio as well. But as it stands today we've seen a really encouraging trend in customer behaviours.

With that I'll hand over to Nick Slape.

Nick Slape, CFO

Thanks Gareth. So if we turn to the income statement on **Page 18** , the first thing to say is that whilst we are reporting an overall loss before tax of £44.6m this is in line with where we expected to be at this point in the turnaround. Income is down 22%; this is a function of a 24% reduction in net interest income at £127.4m, and a 9% reduction in other operating income at £21.0m.

Net interest income has reduced by £40.5m 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 the impacts following the reduction in the Bank of England base rate. 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 following the reduction in the Bank of England base rate to 0.1%. Although customer NIM has reduced by 48bps year on year, vs. H2 19 the reduction is 17bps.

Whilst other operating income is down 9% at £21m, core other operating income is broadly flat.

I am pleased that we have been able to offset part of the income reduction through tight cost management, with operating expenditure down 11% year-on-year to £171.1m, with efficiencies in both staff and non-staff costs.

We have reported a net impairment charge of £11.2m, the majority of which is the result of adjustments made in light of COVID-19. 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 £8.5m. The remainder of the charge is driven primarily by a one-off legacy corporate case unrelated to COVID-19.

The difference between our underlying loss of £33.9m and statutory loss before tax of £44.6m is driven by strategic project costs and non-operating income. Following the conclusion of the 'fix the basics' stage of the strategic plan in 2019 the levels of strategic spend have reduced in 2020, and are 72% lower year-on-year.

The gains in non-operating expenses are a result of an increase in the value of our holding in Visa preference shares, which recovered through Q2, and now have a higher value than they did at the end of 2019. 2019 also included adjustments to the surrendered loss debtor and other one-off gains, which have not been repeated in 2020.

We maintain a strong CET1 ratio of 18.2%, down 1.4 percentage points since full year, but only 0.1% in the quarter, as losses reduced and RWAs remained broadly stable.

Turning to **Page 19**, and net interest income, where core interest income is down 23% to £129.1m.

Whilst you will recall that we reported a full year customer NIM of 175bps in 2019, which was in line with guidance, we saw underlying customer NIM adjusted for EIR reduce by 22bps in the second half of the year. We have seen this trend continue into 2020 with an underlying customer NIM of 146bps in the first half of 2020, primarily due to impacts in treasury.

I have highlighted in the chart the £8.5m EIR adjustment in December 2019, reflecting changing customer behaviour on SVR. We booked a further £4.8m adjustment in H1 following the reduction in the base rate and expectations that rates will be lower for longer due to the COVID-19 pandemic. The EIR asset relating to SVR is now £17.4m, 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 across 2020.

A number of factors cause the variance in treasury, Firstly, returns on assets have been lower due to the reduction in the base rate and the mix of assets, with cash balances now representing a higher proportion of the total. Interest expense has increased following the Silk Road 6 issuance in Q4 in 2019. Finally net interest income arising from pensions is £1.9m lower.

There has been a smaller impact in Retail in 2020, which is driven by reducing yields on mortgages and the timing lag between pricing actions taken on retail deposits following the base rate reduction. You can see in the bottom left chart that I am expecting the cost of deposits to reduce much further in Q3 from pricing decisions already taken on our variable deposits. As asset pricing is primarily fixed this rate will remain broadly stable across the rest of the year, but variable deposits are a large proportion of our customer funding, so repricing has a more profound impact on the cost of deposits, which causes the widening in the customer corridor. This change will help to stabilise NIM at the 140-145 bps level across the rest of the year.

[Page 20] Turning to other operating income, which is broadly flat in our core business. Core customer fee income is up 18% at £18.3m, with retail £3.3m higher. Personal current accounts have benefitted from the renewal of strategic partnerships. This included a one-off benefit, but also an enduring saving on expenses associated with our current accounts.

The extended lockdown period has had an impact on fee income, with lower transactional volumes impacting credit cards, current accounts and SME. As lockdown measures have eased, there has been evidence of some recovery through June, which is likely to continue into Q3.

Treasury is down £3.5m, or 55%, driven by the impact of Gilt and MBS sales in 2019. 2020 includes £1.9m gains on gilt sales, compared to £5.7m in the same period last year.

[Page 21] The next three slides give details of our core Retail and SME segments followed by treasury.

First on Retail; Retail assets have increased by £287m, or 2%, which is driven from growth of £360m in our mortgage portfolio. You will recall in Q1 that we reported new business volumes of £1.1bn, which is the key driver in the growth so far this year, as market disruption due to COVID-19 had significant impact on new business applications in Q2. Applications started to increase in June and that has been maintained in July as lockdown restrictions have eased.

New business completion margins have increased and are up 27bps year on year. This is promising, as we are starting to see the maturity of some of the low margin business originated in 2018 reverting to higher margin deals today. This will not provide an immediate observable benefit due to the size of the portfolio, but I am expecting to see some recovery of mortgage yields through the rest of 2020 and into 2021 if current application margins are sustained.

Credit card and overdraft balances have dropped in the year, which is a trend seen across the market, as customers have reduced spending through COVID-19 and have paid off debt where they can. There has been some signs of balance growth in June and into July and we continue to monitor this situation.

On the deposit side of the balance sheet, we have seen a net 3% growth. Retail current account balances have increased by 12.9%, and franchise savings have increased by 5.6%; overall this is a £1.1bn or 8% increase in Retail franchise deposits. A primary factor behind this growth is lower levels of spend through COVID-19 and average balances have increased, so I am not expecting this level of growth to continue into Q3 as lockdown measures are eased. We will benefit from further pricing actions we have already taken on our variable deposits in Q3, which will reduce our cost of funds further. Term deposits continue to reduce and are 13% down in the year so far as we continue to actively manage our cost of funds.

[Page 22] We move onto SME. Where previously we have touched on our liability led SME strategy, we have seen this shift in the last quarter as COVID-19 has driven demand for SME lending through Bounce-back loans and CBILS. Asset balances have increased by 74%, with drawdowns of £140m BBLS and £10m CBILS and we expect to continue lending in H2, with a further £35m lending so far in July, supporting 6,000 businesses in total. Other SME asset balances have reduced, as there is limited new business originated in this portfolio.

Deposit balances have increased by 25% which is particularly pleasing. The majority of this growth has been through current accounts, which have grown 24%. The majority of *this* balance growth occurred through the period of lockdown, so we may expect to see some of these balances reduce in the coming months as businesses start to return to a more normalised working pattern. Some of the growth in deposits is from the Incentivised Switching Scheme, where we have attracted 16% of those switching customers this year.

SME savings balances have increased by 31% to £473m, and remain some of the lowest cost deposits in the Bank. The income generated in our SME business is heavily weighted towards these low cost deposits, as the SME business supports the overall funding position for the bank.

Having been through the two core customer segments, I now turn to Treasury on **Page 23**. The top left chart shows the composition of our wholesale funding, which totals £2.5bn. This represents only 11% of our funding with the remaining 89% being customer deposits. The cost of our wholesale funding is around 200bps, which includes more expensive Tier 2 debt and lower cost TFS liquidity. A large proportion of our wholesale funding is due to mature within the next 18 months, and there is an opportunity for us to refinance this at lower rates. There has been a modest reduction in the cost of wholesale funding, primarily linked to the lower interest rate environment.

Treasury assets have increased this year, as seen in the top right chart, due to an inflow of cash balances. The mix is weighted towards lower risk, highly-liquid assets, which have seen a compression on returns due to the reduction in the bank of England base rate.

As mentioned previously income in treasury has reduced considerably compared to 2019 due to the issues I have just mentioned, but we have also seen a lower amount of gains from the sale of gilts. Returns are also lower on our NIBBs portfolio, and although the structural hedge has provided considerable revenue protection in the low rate environment for a number of years, the continued reduction in rates reduces the returns made on these balances.

The primary opportunity remains how we can reduce the expense attached to our wholesale funding whilst deploying some of the additional cash balances we have received to support NIM in the coming periods. A further headwind from an income perspective will be the upcoming MREL debt issuance, which we are targeting later this year.

Turning to **Page 24**, given I have just been through our Treasury segment detail, I thought it would be sensible to explain liquidity at the same time. Our Liquidity Coverage Ratio has increased to 182% following an increase in customer deposits. This growth in deposits has also reduced the loan to deposit ratio to 91%. We have c.£1.6bn of excess liquidity at the end June. This does not include any of the c.£1.76bn initial TFSME liquidity that the Bank has access to, or the estimated further £1bn available from TFSME for anticipated balance sheet growth this year.

As the funding base is weighted heavily towards customer funding, there is significant headroom to encumbrance limits should any further wholesale funding be required in the future.

[Page 25] On the next slide I have combined 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, which are down 11% and 72% respectively, and £60m in total.

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 reward for 2020 in light of the pandemic. This decision remains under review and will be revisited later in 2020 when we understand more about the impacts of COVID-19.

Non-staff costs have benefited from a number of efficiencies, including benefits from the renegotiation of key strategic partner contracts and benefits relating to the completion of IT separation. We are now focussing on doing more with fewer suppliers, and have rationalised our supplier estate down 23% in the year from 645 to 494. There has also been a reduction in discretionary spend such as marketing as we have looked to preserve capital during the pandemic.

Turning to strategic project costs, we had already planned to reduce strategic spend in 2020 as we concluded the 'Fix the Basic's' phase of our strategy with the completion of Desktop Transformation and IT separation from the Co-operative Group in January 2020. Of the £15m strategic investment expensed this year, c.£4m relates to non-recurring IT separation costs.

Due to the change in the economic climate and the associated impacts on projections and investment benefits, we have re-profiled our investment portfolio, primarily through the deferral of our mortgage and savings re-platforming. I now expect cash spend to reduce significantly vs our original guidance of around £80m and to be between £40-45m. We remain committed to delivering on our BCR programme for SME and will prioritise mandatory projects to keep the bank safe.

Turning to capital on **Page 26** and 27. We have a strong CET1 ratio of 18.2%, with a 5% surplus to minimum plus CRD IV. Including Tier 2, our total capital ratio at the end of June is 22.4%.

Following the 1.3% drop in the CET1 ratio in the first quarter, the ratio has been stable through Q2 due to tight cost management and stable RWAs.

CET1 resources have reduced by £31m in the year, driven by the losses incurred; we have reported a loss before tax of £44.6m, which is offset by £7m due to a lower deduction from the excess of regulatory expected loss amounts over credit provisions following the increase in ECL, and a £7m lower intangibles deduction as the asset amortises.

Our RWAs have increased by 4%, but as I previously mentioned have been stable in Q2. Balance sheet growth in the quarter has been in the SME book through BBLS and CBILS, both of which have very low risk weight density given that they are largely government protected. RWAs have increased due to the 2% mortgage book growth, partially offset by reducing unsecured lending exposures. There has been a 13% increase in non-customer RWAs, primarily in other assets due to market volatility on interest rates and new industrywide rules on securitisations.

I am anticipating a c.£67m reduction in RWAs from SME supporting factor changes, which on a pro-forma basis would improve the CET1 ratio by 20bps. There is also a potential opportunity from software intangible policy changes in H2, which we estimate to be worth about 40bps.

[Page 27] Turning to MREL and leverage. I told you on both our full year results and Q1 call that I expected to make considerable progress towards required MREL issuances in 2020 subject to market conditions. With COVID-19 and the challenging primary markets we put these plans on hold in H1 but remain fully prepared to issue MREL-qualifying debt when the market is more supportive. With a total capital ratio of 22.4%, we have a surplus of £206m to our MREL requirements excluding the CRD IV buffer.

The chart on the top left shows the reduction we have seen in our ICR in recent years. There has been a reduction in June 2020 as a result of the regulatory introduced static ICR, which fixes the requirement using 2019 RWAs and remains in force to the end of next year. This provides a benefit of c.£13m against our TCR. We continue to explore options to be more efficient with our ICR and still have two ICAAP cycles to conclude before end-state MREL requirements come into effect.

I am expecting that the Bank needs to issue c.£550m in order to meet end-state MREL requirements by the end of 2021, and the chart at the top right of the page demonstrates this. I am expecting the CET1 ratio to drop to 13.5-14.5% in 2021, which would result in a total capital ratio of 17-18%. Based on RWA's today, £550m of MREL issuance would equate to a further c.11% capital to meet the requirement. The actual quantum of MREL issued will be impacted by losses incurred before the end of 2021, any RWA inflation due to COVID-19 and any change to capital requirements.

The removal of the countercyclical buffer is a welcome benefit to our capital position and reduces our overall capital requirements by around £50m, which is in addition to the static ICR benefit I previously mentioned.

The leverage ratio on an EBA basis has reduced in line with expectations to 3.7%, although this requirement is not binding for the Bank until June 2021.

Finally, I said at Q1 that I would provide an update to our guidance once we better understood the emerging impact of COVID-19 and some of the challenges that we would face as a result, and this revised guidance is provided on **Page 28**.

As I mentioned at the start of my section, although the unforeseen impact of COVID-19 is clearly a set-back, I am pleased that we are broadly where we expected to be at this stage in our turnaround. I am, however, alert to the fact that margin pressures in a low rate environment will persist, credit impairment risk will remain heightened for a period of time, and the window to issue MREL qualifying debt ahead of the end-state requirements is narrowing. As such, I have provided a set of new guidance to reflect the challenging outlook that we face, which replaces any previously issued guidance.

The low rate environment will push customer net interest margin to be c.140-145bps in 2020, with the full year impact of the lower base rate environment and MREL debt expense reducing margins further in 2021 to a low point of 135-140bps before recovering, reaching 170-180% at the end of the plan.

An underlying cost:income ratio of 110-115% in 2020. In subsequent years, the ratio will see the results of our ongoing simplification activities - targeting 100-105%, in 2021 and, as income recovers post COVID-19, improving the long-term target to 65-75% at the end of the plan

We expect to return to sustainable profitability in 2022 and in the meantime, our CET1 ratio reduces reflecting ongoing losses to c.16-17% in 2020, and 13.5-14.5% in 2021 which is still well above regulatory minimum levels. As profitability returns in 2022, the CET1 ratio builds to 19-20% at the end of the plan.

With that I will hand back to Andrew.

Andrew Bester, CEO

Thank you Nick. So if I just summarise briefly and then we'll throw it open to questions. As we've run through, there are a number of challenges that we're dealing with, but what we're doing is flexing the various levers; find pockets for growth in our franchise going forward, continue to prioritise our investment spend and look to drive cost efficiencies, and continue to build our MREL stack in the second half this year and next year. But certainly we feel encouraged by the opportunities that we see, be that in continuing the momentum in our SME business, opportunities for some targeted growth in our mortgages and retail business, and in particular, we start from a strong platform; we have a very strong customer base, we have good liquidity and we are well capitalised and continue to build our stack. So we feel that we have a good base to continue to the transformation of the Co-operative Bank albeit in challenging circumstances.

Q&A

[No questions were asked during the call]