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Metro Bank Investor Call Hosted by Jefferies

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David Arden (Metro Bank CFO) and Joseph Dickerson (Jefferies)

Joseph Dickerson

Welcome to the call. It is our pleasure to host a call today with Metro Bank's Chief Financial Officer, David Arden. David, thank you for being so generous with your time today. We agreed to a limit of 45 minutes, so let me kick off the discussion before we open it up to general Q&A from those that are dialled in.

I guess to kick it off could you summarise your views on the third quarter results and also the performance of the bank year-to-date?

David Arden

Of course, Joe, and welcome everybody. Listen, we are really pleased with our results and we are very proud of the business that we are building. Our customers are pleased too, as evidenced by the recent CMA survey results. It has been a really strong nine months for us. We trebled PBT compared to a year ago. We have maintained robust capital ratios, and our asset quality remains very strong.

And most importantly of all, we continue to create FANS every day. We have welcomed 300,000 new customer accounts so far this year, and we have now got over 1.5 million in total. The results are demonstrable evidence that the model is working.

Joseph Dickerson

A couple of areas attracted investor attention following your Q3 results, namely, on your net interest margin and your capital position, also capital planning around so-called MREL requirements. So, just a first question on margin. Further bank results announcements after yours have confirmed that most are feeling the pressure in pricing in the mortgage market, and it is expected to continue for some time. How is this impacting Metro Bank and is there anything you are actively doing to try to offset this?

David Arden

I think pricing pressure has been a common theme across Q3 results season. It is obviously unusual for base rates to rise and mortgage yields to fall. I do not think anybody predicted that. However, rates have started to stabilise, and we are starting to see some banks put their rates up over the past few days.

What we are doing, though, is working hard and focusing on other levers. We talked extensively on the call last week about the actions we are taking, but in summary, as we widen our service offering it will create FANS and open up additional revenue opportunities for us.

Joseph Dickerson

Great, thanks. One area where you are very strong is on your cost of deposits, and we have mentioned many times that they are below 12-month LIBOR and, indeed, even the base rate. How does your low cost of deposits provide some NIM defence in the face of this industry asset pressure?

Also, your cost of deposits were up to two basis points Q3 and Q2. Is this the start of a trend, or how do you expect this cost of deposits to evolve? And does the rise in deposit betas put further pressure on your net interest margin going into 2019?

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David Arden

I have already said the model is working, and the model is all about creating FANS, which, in turn, generates low-cost sticky deposits. We have the highest deposit growth rate in the UK with one of the lowest cost of deposits. And we attract customers every day on service and convenience, not rates.

We have got pretty strong structural advantages. 30% of our deposit base is non-interest bearing, i.e., current accounts, and we have got a split between both at 50/50 business and commercial/retail, and the benefit that we get from low-cost sticky deposits gives us a long-term, enduring competitive advantage.

You are right; deposit costs did rise 2 bps in Q3. That was all due to the base rate rise you saw in August. In Q3, we had one month of that base rate rise. As we look through to Q4, we can expect the full quarter to play through. The model is working, though, and that 61 bps cost of deposits, as you said Joe, that is below base rate today, and we continue to look at opportunities to manage that cost.

Joseph Dickerson

Moving on to the matter of capital. Your fast loan growth and subsequent capital consumption saw your CET1 ratio decrease to 15.7% in Q3. It was a pro forma 17% after the equity raise at the half-year. As a fast-growing bank, how do you capital plan in the face of challenging regulatory requirements, and is another equity raise a potential scenario in the next 12 to 18 months?

David Arden

We are a bank, right, so as you would expect, we have planned for multiple scenarios. Our capital position today is strong; total capital ratio is 19.1%, CET1 ratio 15.7%, and our leverage ratio is 5.7%. All those are very robust and with material headroom for growth.

As we look forward, our application for AIRB is with the PRA, and our expectation remains that that will be an H2 '19 event; that provides significant upside to capital efficiency, and on that path, we see no need for an equity raise until 2021. Looking forward again, we will look to continue to diversify our capital base. We have already issued this year 250 million Tier 2; AT1 is likely the next logical step for us, and we will look to that at some point in the future as we continue to diversify the capital stack.

Joseph Dickerson

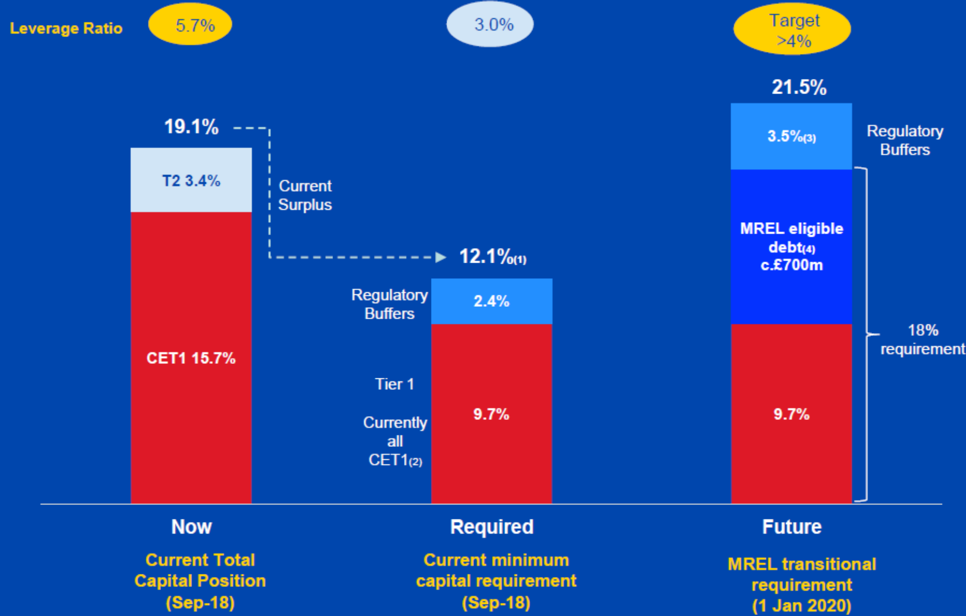
Still on the capital stack, but a more technical topic. It is a topic that does feed into your capital planning and margin trends, and that is MREL. For those who are non-EU or non-UK investors, they may be less familiar with this concept of MREL. Could you briefly explain the concept and how it applies to your bank?

David Arden

Of course. As a concept, MREL is similar to TLAC in the US, and MREL in the UK will apply to Metro Bank because we are now viewed as a systemic bank in the UK. And that is good, right? It means that we are a relevant and significant part of the UK banking system, which is exactly what we want to be, and it is what our customers want us to be.

We will meet our interim MREL requirement by 1 January 2020, and for Metro Bank, our interim MREL requirement is 21.5% of RWA. To meet the requirement we will raise MREL debt, which includes non-preferred senior debt, and that is all baked into our capital plan as we look forward. There was a really good slide in our Investor Roadshow in the US, which investors can refer to.

The presentation can be accessed by clicking the following link:
https://www.metrobankonline.co.uk/globalassets/documents/investor_documents/us-roadshow-presentation-october-2018.pdf



Joseph Dickerson

You mentioned the likely future requirement issue of subordinated debt. I suppose one question that has cropped up is the potential for the regulator to require you to set up a holding company and issue a holding company debt to achieve the regulator's preferred structural subordination, rather than a contractually subordinated debt from your operating company. Can you share some thoughts on this?

David Arden

The Bank of England issued a policy statement in June this year, so relatively recently. In it, they said that in the context of banking groups, banking groups are required to issue MREL out of a HoldCo. We are not a banking group; Metro Bank is a simple bank with a simple operating structure, and it is our ambition to remain as simple as we can going forward. We, therefore, do not believe that a HoldCo is necessary to achieve that.

Joseph Dickerson

What would a HoldCo mean for your existing Tier 2 if you created one? Questions have been asked about the potential HoldCo requirement being treated as a capital disqualification event where the Tier 2 could lose regulatory capital credit and you could choose to call the instruments. Is that something you would agree with?

David Arden

No, we disagree, and it is clearly something that we considered at the time we issued the Tier 2 bond in June this year. If we put in place a HoldCo – and just to reiterate, at this point we are not expecting to do so – but if we decided to put a HoldCo in place, the notes will continue to count as regulatory capital.

Joseph Dickerson

Continuing on with just one more question on this front before we go to Q&A. You have referred to issuing around £700 million of MREL qualifying debt in the past. In what time frame in the format do you expect this, and does your MREL requirement change as you grow?

David Arden

The 700 million of MREL qualifying debt is to meet our interim requirement by 1 January 2020. As you recall, our interim requirement is 21.5% of our RWA. Our full MREL requirement, which is due by 2022, is 22.9%. So, that is an increase of 1.4% of RWA over two years. We think that is a manageable amount, particularly as our P&L will continue to strengthen and the balance sheet grows.

Joseph Dickerson

Excellent. Megan, can we open up the call for Q&A from investors, please?

Operator

Thank you, Joseph. Ladies and gentlemen, if you would like to ask a question, please press star followed by one on your telephone keypad. If you change your mind, please press star followed by two. When preparing to ask your question, please ensure that your phone is unmuted locally. As a reminder, ladies and gentlemen, that is star followed by one.
We have a question from Connor Fusselman of StackLine Partners. Connor, your line is now open. Please go ahead.

Joseph Dickerson

Hey, Connor.

David Arden

Hey, Connor.

Connor Fusselman

Hey, David, thanks for making time and thanks for organising the call, guys. A couple of quick questions on MREL. Firstly, does the Tier 2 issuance you already did this year count towards the 700 million, or is that 700 million incremental?

David Arden

The 700 million is incremental, Connor, so that is 700 million of MREL debt in 2019. As you know, when you look at the capital stack, AT1 is the most equity-type subordinated capital available, so that is the highest price. Our Tier 2 bond was priced at 5.5%; MREL is senior to that in the capital stack, and from a price perspective, I would imagine that would be in the range of 2% to 4%.

Connor Fusselman

Got it, okay. What about the relative mix? If you can give us a ballpark of the 2% to 4% stuff versus more Tier 2 at 5.5% versus AT1, how are you thinking, again in broad strokes, about that mix?

David Arden

Yes, as you know, capital plans are fluid, and we are managing our growth prudently. The MREL is 700 million. As I mentioned, we will look to diversify our capital base at the appropriate time, and that may include AT1 at the right time for us. So, I would be loathe at this stage to give you the exact mix, but the 700 million MREL is MREL debt for ’19.

Connor Fusselman

So, that 700 million of debt has got a 2% to 4% range?

David Arden

Yes.

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Connor Fusselman

One more. You alluded to this, but it was the point that one of the analysts asked on a call about why there is such a small difference between your interim MREL target in 2020 and your final 2022 numbers. I think you mentioned that had to do with your Pillar 2A being very small. Can you just talk about what exactly that means, why is it small, and why was there such a divergence between your internal capital planning model and the math that that analyst was doing? That is all I have got. Thank you.

David Arden

Thank you, Connor. Great question. So, the exact maths for final MREL is 2x Pillar 1 plus Pillar 2A, plus buffers, and our Pillar 2A is 1.7%, which is relatively low. When you play that math through, you get to a full MREL of 22.9% after an interim MREL of 21.5%. I think the fact that our Pillar 2A is low indicates that we are a low-risk bank, which is exactly what we want to maintain, both next year and going forth long-term because we believe that low-risk will stand us in good stead over the long-term.

In terms of why analysts were predicting a higher Pillar 2A for us, I think if you look at the Bank of England website they provide an average of MREL for the mid-sized banks, which we are in there, and that average is much higher than 22.9%.

Connor Fusselman

As a follow-up, are you planning on more clearly delineating that difference that you have outlined here publicly? Looking at the average number, I understand why you would take that 29.5 number as opposed to the 22.9 that you mentioned.

David Arden

Yes, well, I think today is the first part of us providing more clarity on our long-term MREL. We disclosed our Pillar 2A, which closed at the half-year, and we will continue to disclose that, but hopefully, the call today provides a bit of clarity on the long-term MREL for Metro Bank.

Connor Fusselman

Got it. Thank you, guys.

David Arden

Thank you, Connor.

Joseph Dickerson

Thank you. Megan?

Operator

There is a further question from Matthew Williams of Carmignac. Matthew, your line is now open. Please go ahead.

David Arden

Hey, Matthew.

Matthew Williams

Hi, David. Hi, Joe. Can I just clarify on the structure of your non-subordinated part of the MREL? Because you are not a HoldCo, does that mean you will issue contractually-subordinated senior, i.e., a non-preferred senior-type instrument?

David Arden

That is what we are anticipating as we sit here today, Matthew.

Matthew Williams

And the PRA are signed off on that?

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David Arden
We are putting our plan together as we speak.

Matthew Williams
Okay. Given the subsequent market performance, does your Tier 2 issue… how would you explain that right now?

David Arden
Sorry, Matthew. The line was bad there. My apologies. Would you mind repeating that? I am sorry.

Matthew Williams
Sure. You referenced that you issued a Tier 2 instrument at 5.5%, but then subsequently the yield on that was obviously considerably higher. What is your interpretation of what has happened there, and how does that impact your planning for further issuance?

David Arden
Yes, you are right. The market for bank debt in the UK has been somewhat volatile over the past few weeks. I think in the main, the pricing of our Tier 2 bond has followed the market. Whilst we cannot dictate that and we clearly watch it, we're focusing on stuff that we can control. In terms of going forward, the market volatility is something that I think all banks will have to face into as we get into 2019, but clearly, we will tap into that market when the time is both right for ourselves and market participants.

Matthew Williams
Just two more questions, if I may. The first one is in terms of the 700 million issuance, does that include any optimisation of your Pillar 2A buffer insofar as taking some CET1 out of that and replacing it with debt-like or debt instruments?

David Arden
We are working through the plans at the moment, Matthew. The 700 million is the straight MREL. Clearly, as we get into the time of issuance, then we can look to optimise as best we can because, clearly, that is the mix that makes sense for Metro Bank.

Matthew Williams
Okay. Final question is as you said that you capital plan on a scenario basis, in a scenario of a delay in receiving approval for your IRB model, how would you then respond in balance sheet management? Do you slow growth or is that the scenario where a CET1 issuance becomes a possibility?

David Arden
We are confident of AIRB doing an H2 '19 event. There are options available to us, so we can look at other capital instruments. We can also look at the growth in the balance sheet. But just to be clear, we are confident that H2 '19 will be the right timing for AIRB.

Matthew Williams
Thank you.

Joseph Dickerson
Thanks, Matthew. Megan?

Operator
Our next question comes from Robert McLaughlin of Hound Partners. Robert, your line is now open. Please go ahead.

David Arden
Hey, Robert.

Robert McLaughlin

Hi, David. Thanks for taking the questions. First for me is just on the NIM and the NIM plus fees have a little over 30 bps to bridge between now and 2020. Could you give us the latest on how precisely you plan to bridge that 30 basis points?

David Arden

Yes. As we spoke about on the call last week, we are focusing really heavily on the non-interest side of our business, so fee revenue. One particular element of that is how we drive deeper relationships with our commercial customers. We believe business customers are the most underserved segment in the UK.

We are winning business customers consistently. We are bringing new customers on at a rate of just under a thousand a week. Indeed, we are winning 17% of switchers for small business customers in the market we operate, which I think is an incredible statistic. We are strong in current accounts, which helps to build and deepen relationships, which in turn helps to generate additional revenue streams for Metro Bank.

I spoke last week around what we are doing to optimise our fee structure and some husbandry inside, but there are lots of other things in terms of delivering new services, using our API gateways, driving banking transactions, deepening our penetration in terms of FX revenue streams. Our clean technology stack allows us to provide services that we just introduced, like Insights, that fulfill customer needs, and, again, drives greater opportunities for us to drive other revenue streams.

Robert McLaughlin

Is there a number you can just call out on how much you expect in basis points from the fee income versus any improvement on the lending side?

David Arden

No, our target is very clear, which is c.3.0% Customer NIM plus fees. I would also draw your attention to the fact that our cost of risk remains very low, and substantially below our 2020 target of c.20 bps. So, that is today and will continue to flow through to the bottom line. But rest assured, that Customer NIM plus fees target of c.3.0% is something that management are focused on day in and day out.

Robert McLaughlin

Do you know for the 3.0% NIM plus fees, should we expect that to be the average across 2020, or is that by 2020 we hope that is the run rate?

David Arden

That is an average not run-rate.

Robert McLaughlin

Okay. The second question, if I can, is on the operating costs ramp. To get to the 2020 cost-to-income I think the operating costs need to slow down their growth. Do you have a sense of over the next four half-years between now and the end of 2020, what we should expect the pace of the profit leverage to be?

David Arden

I have articulated in the past that I do not expect the progression of the operating leverage to be a linear path; it will be non-linear, and therefore, it should accelerate as we go into the back end of ’19 and ’20. Again, we are doing lots of stuff internally in terms of driving scale efficiency through our operations, which should start to bear fruit as we progress over the next four halves.

Robert McLaughlin

Thanks.

Joseph Dickerson

Thanks. Megan, next question?

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Operator
Our next question comes from Georgina Aspden of Goldman Sachs. Georgina, your line is now open. Please go ahead.

David Arden
Hey, Georgina.

Georgina Aspden
Hi there. Thanks for doing the call. I just had a quick question regarding what you are seeing on the ground. Of all of your peers, I think you are probably closest to the customer and the customer experience, and I wondered, with all of the headlines we are seeing on a weekly basis at the moment about Brexit negotiations, how do your corporate clients respond to that? We are getting closer and closer to the deadline. And then, in turn, how do you respond to that, given the uncertainty we face?

David Arden
In the SME space, we play in the S and middle part of M, so we have not got large corporate clients with cross-border concerns. For our customers, in the main, what we are seeing today is very much business as usual. We are very focused on managing our credit risk, as you know, and you would expect. But for us and for our customer base, it is very much business as usual today.

Georgina Aspden
Great, thank you.

Joseph Dickerson
Thanks. Megan, next question?

Operator
Our next question is from Nishil Patel of Basswood Capital Management. Nishil, your line is now open. Please go ahead.

Nishil Patel
Hi, David.

David Arden
Hey, Nishil.

Joseph Dickerson
Hey, Nishil.

Nishil Patel
Just one question. Do you mind repeating the maths behind that final MREL requirement?

David Arden
It is Pillar 1 plus Pillar 2A times 2, plus regulatory buffers.

Nishil Patel
Got it. Okay. And then, the risk weight on the commercial real estate portfolio, if my math is right, it is 60.4%, which just seems low, given where those standardised risk weights should be. Do you mind just helping me understand the disparity there?

David Arden
I have not got the details to hand, so I will probably get back to you. But just rest assured, we continuously look at all the risk weightings we have, and we are constantly reviewing that. I am afraid I have not got the math to hand.

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Nishil Patel
Okay. And then, just on IFRS 16, does this change the buy versus lease decisions? How does the dynamic or the structure of new leases change, given that regulation?

David Arden
For people on the call, IFRS 16 is a new accounting standard that comes into play in the UK on 1st January 2019. It effectively means that leaseholds that are currently off the balance sheet and we just take the rental charge to the P&L come onto the balance sheet on both the asset and the liability side.

You are right, given the fact that some of those leases are coming onto the balance sheet, it makes it more attractive for us to go for freeholds going forward as opposed to leaseholds. About 10% of our estate today is freehold. Now, we would typically want the freeholds. The question is you cannot always get them, but you are absolutely right, in the context of IFRS 16 it makes freeholds much more attractive.

Nishil Patel
And then, just a final question. When I look at your 2023 efficiency ratio target, one, it implies between 2020 and 2023 a pretty meaningful pick-up in expense growth, and also, to bookend it, I look at Clydesdale; they're targeting a sub-55% efficiency ratio with a significantly less efficient branch network than you will have. So, I just cannot reconcile why there is not a ton of operating leverage between '20 and 2023. Could you just help me understand that?

David Arden
Our 2023 target is for a cost-to-income ratio of between 55% and 58%. I would hope there is opportunity there, as we look at 2023, but given our high customer service model and our high touch through our store network, I doubt we will ever get to something below 50% is the reality. And so, some of our targets are more pressured than others, and I would hope there is a bit of wiggle room in that cost-to-income ratio after 2023.

Nishil Patel
Okay, thank you.

Joseph Dickerson
Next question?

Operator
There are no further questions on the line, so I will hand back to you, Joseph.

Joseph Dickerson
Great. Well, thank you all for joining us on this call. I think it was quite useful as a follow-up. David, is there anything you would like to say in closing?

David Arden
The only thing I would like to say is thank you very much, everybody, for joining. We are very pleased with the performance of the business. The business goes from strength to strength, and we look forward to updating you on our full year in due course. Thank you all very much.

Joseph Dickerson
Thanks, David, for your time.