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OneSavings Bank & Charter Court

Recommended all-share combination of OSB and Charter Court

2018 Full Year Results Presentation

14th March 2019

OneSavings Bank

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Sebastien Maloney, CFO, Charter Court

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Introduction & Highlights

April Talintyre, Chief Financial Officer
Good morning, everyone, and thank you for coming. It's great to see such a good turnout this morning.

I'll start by outlining the order of events for this morning. I'm going to kick off with a run-through of OneSavings Bank's 2018 results, and then Seb will do the same for Charter Court before we move onto the proposed combination.

I'm going to start with a few highlights which, consistent with previous sets of results, demonstrate a story of strong performance, with continued growth, underpinned by strong and disciplined risk management.

Gross organic lending was up 15% to £3bn, demonstrating the strength of our proposition in our core markets, with the net loan book growing by 23% to £9bn.

Our core Buy-to-Let business continued to grow as professional landlords recognised the strength of our proposition.

And our InterBay commercial business had another record year with the commercial and semi-commercial loan book growing 48%.

Our net interest margin was 304 basis points, slightly ahead of expectation. And our cost to income ratio was well-controlled at 28%. The loan loss ratio remains strong at 10 basis points for the year.

So, strong growth, an attractive net interest margin and low loan losses contributed to a 15% increase in underlying profit before tax of £194m. And we continue to return excellent shareholder results with underlying EPS up 14% to 58.5 pence, and a strong return on equity of 26%.

Capital remains strong with the CET1 ratio at 13.3%, and we're pleased to recommend a final dividend of 10.3 pence per share. Together with the interim dividend of 4.3 pence, this represents 25% of underlying profit after tax, attributable to ordinary shareholders in line with our dividend policy.

I'll now look at the results in a little bit more detail.

I'd like to start by summarising the key drivers of our strong underlying profit before tax and return on equity. Net interest income rose by 17% to £287m, whilst the net interest margin reduced to 304 basis points.

The lower NIM, despite broadly stable asset pricing, continues to reflect the changing mix of our loan book with new originations forming a growing proportion of the total book, diluting the impact of loans originated, or acquired several years, at exceptionally high yields.

This changing mix, and the impact of wider average five year swap spreads, was partially offset by relatively favourable cost of retail funds and additional benefit from the Term Funding Scheme. The favourable cost of retail funds was due to the retail savings market not pricing in fully the two Bank of England base rate rises.

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The bottom left-hand chart shows our efficiency metrics.

As planned, we invested significantly in 2018 on important regulatory projects - primarily, GDPR, PSD2 and our ongoing IRB project.

We also started planned upgrades to our IT infrastructure, including customer platforms.

Despite this investment, we were able to deliver a strong cost to income ratio and lower the man-ex ratio to 84 basis points as we continue to focus on finding efficiencies in the cost of running the bank on a business as usual basis.

The bottom right-hand chart shows the loan loss ratio of 10 basis points for 2018. The increase versus the prior year is primarily due to the prudent inclusion of an additional macroeconomic downside scenario in relation to a disorderly No-Deal Brexit in our IFRS 9 modelling.

Removing the impact of this additional scenario, the loan loss ratio would have been around six basis points.

Turning to our segments, the Buy-to-Let/SME segment experienced strong growth with the gross loan book increasing by 31% to £7.4bn in the year. This growth was driven by £2.8bn of new organic origination, up 15% year-on-year as well as targeted strong retention.

Year-on-year growth in the loan book helped drive the increase in net interest income to £220m, up 24%.

The small reduction in gross asset yields reflects the impact of the changing mix of the book, partially offset by the benefit of the base rate increases on variable mortgages.

This segment made a contribution to profit of £213m, up 22% versus the prior year, due to this growth in net interest income, partially offset by higher loan loss provisions. And, once again, the increased loan loss provisions were due to the addition of that No-Deal Brexit scenario.

Average loan to values remained low at 70% at the end of the year.

Turning to the gross Residential loan book, this decreased by 3% in 2018, with new organic lending more than offset by redemptions in the back book and the acquired mortgages which were in run-off.

Net interest income of £67m was down 1%, primarily reflecting the lower average loan book and the impact of the changing mix of the loan book, partially offset by the relatively favourable cost of funds.

Gross asset yields increased in this segment to 5.5%, from 5.2%, due, primarily, to the base rate rises partially offset by the continued run-off of the higher yielding acquired portfolios.

Contribution to profit was up 3%, reflecting the slightly lower net interest income being more than offset by lower third party servicing fees, lower amortisation of the fair value adjustment on hedged assets and lower loan losses.

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The decrease in the loan loss ratio in this segment was due, primarily, to the strong performance of both our acquired and organically originated portfolios, partially offset by the addition of that No-Deal Brexit scenario.

Average loan to values in this segment remained low at 56% at the end of the year.

Turning to our strong balance sheet, the net loan book growth of 23% was supported by the strong origination as well as continued strong retention through our broker-led Choices programme.

The loan book growth was, in part, supported by a final drawing of £250m of TFS funds, with the balance provided by retail savings, which increased by 21% in the year.

We also took the opportunity to raise an additional £80m via the Bank of England's Indexed Long-Term Repo Scheme.

Our liquidity ratio was 14.5% at the end of the year, and the liquidity coverage ratio stood at 224%, significantly in excess of the regulatory minimum.

Moving to the strong credit quality of our balance sheet, our weighted average total loan book LTV of 66%, a new origination loan to value of 69%, remained broadly flat to the prior year. These sensible loan to values are complemented by a low arrears rate of 1.5%.

Turning to capital, you can see the Bank's capital's position remains strong, with a fully-loaded CET1 ratio of 13.3%, total capital ratio of 15.8% and leverage ratio of 5.9% at the end of December 2018, despite that very strong net loan book growth.

In summary, we had a very good year with continued attractive growth and originations, low arrears and strong risk management metrics. Our customer focus vision is serving us well with an excellent customer net promotor score of plus 63, and very strong savings bonds and ISA retention rates of 95%.

Our commercial business is flourishing, and we are very pleased that we launched InterBay Asset Finance in the year, funding our first deals in October.

In 2019, we have the opportunity to acquire our joint venture partner's interest in the heritable residential development finance business for a one-off cost of £9.8m, which we reported as an exceptional item in 2018. I've previously mentioned that we held capital against this opportunity.

I'm particularly pleased that we were able to retain the key individuals in the business going forward, and continue to offer them the opportunity to lend alongside the Bank.

Trading conditions in our core markets remain highly attractive, and application levels this year to date are very strong.

I will now hand over to Seb to go through the Charter Court results.

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Charter Court Financial Service - Highlights

Sebastien Maloney, CFO, Charter Court
Thank you, April, and also welcome to Charter Court Financial Services plc's 2018 results.

We've had a very strong year on most measures. So, if we start with gross originations, we were up 4% relative to last year to £2.85bn, and we'll turn to our markets in a little while.

Our loan book continued to accumulate with net growth of 24% to £6.7bn as a reminder on an underlying basis, removing the structured sales, that would have been 34% and the loan book would have been £7.2bn.

As expected, and as we signposted at half year, our NIM stabilised at 308, in line with the half year outcome.

Underlying operating expenses grew by £12m, mostly driven by staff expenses relating to control functions, IT and expanded operational capacity.

Cost to income ratio continued its downward trajectory to 29%, as balance sheets and income growth outstripped costs, and was particularly helped by the £36.4m of income from the sale of the economic interest into our securitisations.

Cost of risk continued to be exceptional at four basis points. The four basis points includes a management overlay for Brexit-related uncertainty. The underlying costs of risk with other management overlay would be/have been two basis points.

Underlying PBT has grown by 35% year-on-year to £158m at an ROE of 30.8%.

In light of our robust performance in 2018, we are announcing a final dividend of 9.9p per share, bringing the total dividend to 12.7p per share, representing a 25% dividend pay-out ratio.

So, let's look briefly at segmental performance, starting with Buy-to-Let on Slide 8. Originations in Buy-to-Let grew by 3% year-on-year to £1.64bn, while the Buy-to-Let book grew at a much faster pace of 39% to £4.5bn.

The Buy-to-Let book yield improved to 4.2%, underpinned by higher interbank rates during the year relative to 2017.

Credit performance remains strong with a cost of risk at two basis points on an IFRS 9 basis.

The contribution of this segment increased from 49% in '17 to 58% in 2018, reflecting strong loan book growth in this segment.

Moving onto Slide 9, with a brief overview of Specialist Residential, we've had a very good year in Specialist Residential, increasing flow by 7% year-on-year to £825m. While the loan book was pretty much flat over the period due to the structured sales. The underlying book growth, removing the structured sales, would have been 31%.

Book yield was relatively stable throughout the period, while both average loan sizes and average LTVs were slightly higher than the overall book.

Segmental costs of risk increased to eight basis points on an IFRS 9 basis. I just need to caveat, that's six basis points of the eight are related to the Brexit top-up.

Specialist Residential contribution decreased from 35% in '17 to 30% in 2018. With that, again, is due to the impact of the structured sales in the period.

So, if we now move onto the funding side. I think you know that the first half was particularly strong on the wholesale funding side. We executed three securitisations in the first half and two structured sales, taking advantage of strong demand for IBS and equity tranches throughout the period.

We sold two equity positions in CMF2017-1, and CMF2018-1 on very attractive terms. We also topped up our TFS drawdowns by £150m in '18, bringing our overall TFS drawings to £1.15bn.

The second year has seen a bit more of an emphasis on our retail channel where we were a lot more active in the second half, drawing in, or growing our book by £0.7bn to £5.1bn outstanding by year end.

We also diversified our sources on the retail funding side through partnerships with Hargreaves Lansdown, Flagstone and Insignis.

Real briefly, on capital and liquid - in the interests of time, I'll keep it very brief, suffice to say that we continue to enjoy robust levels of capitalisation with a CET1 ratio of 15.7%, and retain access to vast pools of off and on balance sheet liquidity.

So, in summary, our strategy has resulted in continuous growth over the last three years. I think we've continued to deliver, or exceed, the targets that we're promised at IPO. We're going from strength to strength in our chosen markets, which we still believe are underserved and have growth opportunities.

The full year '18 has proved that our resilient diversified funding model can achieve differentiated results and can be very supportive of NIM. We've formed new partnerships to enhance our retail savings platform. And we believe, by and large, that we have headroom for growth and can continue to be an employer of choice.

Before I hand it over to Andy, I, at the half year, we spoke to many investors who asked us - What's next for Charter Court? And I think we've been fairly consistent in saying that one thing we're not going to do is look at small incremental opportunities to engineer growth.

If we're going to do something in the consumer management bandwidth, we were going to do something big, something bold, and something transformational. And, here we are. And I think Andy's going to introduce you to what the concept is.

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Andy Golding, Chief Executive Officer, OneSavings Bank
Thank you, Seb.

I've done a number of journalist calls this morning, and it was very disappointing that none of them actually wanted to talk about the 2018 results, they all wanted to dive

straight into Q&A on the transaction. So, let's get to the meat of the sandwich. Why now I hear you cry from the floor?

So, look, we are in a marketplace that has its challenges. People have been talking about consolidation in our sector for some time. It's a competitive marketplace, and it's continually evolving.

And I think it's fair to say that both the Boards of OSB and Charter Court want to be a bigger, better, stronger lender in that market context. We want to build a platform for growth.

We see the industrial logic of bringing two great businesses together to create scale, resilience and to absolutely maximise those opportunities for growth.

These businesses are similar enough to make the integration achievable and low risk, but they're different enough to be bring complementary skillsets to create opportunities across operations, distribution and funding, which we'll touch on later.

This is about creating a really leading specialist lender in the UK. On a pro forma basis, this would be a £6bn a year new lending origination platform.

We are absolutely wedded to leaving the brands intact. We think the things that take place in the OSB brands and the things that take place in the Charter Court brands are the special source that makes both of these organisations successful, and we absolutely don't want to mess with that, and we want to leave that frontend proposition intact whilst, though, sharing the individual skillsets and best practises across both organisations, to make both origination platforms better.

Let me give you an example of what I mean by that. If you come to OSB with a complex 100 property portfolio, we can achieve that for you and we can look at that deal because of the way that we run bespoke and manual underwriting. However, if you want a rapid answer on a residential mortgage loan, you can go to the Charter Court brand, or the Precise brand, and get yourself a decision in principle online in eight minutes through your mortgage broker.

Those different and complementary skillsets are going to enable us to engender and bleed those skills across a wider group and absolutely deliver that additional growth.

We are wedded to having key operational centres, centres of excellence and strength in all of our key sites, maintaining Wolverhampton as a centre of excellence, Chatham, our sites in Fareham and Bushey and, of course, leveraging OSB India to provide operational flexibility and really help us cement that platform for growth.

Clearly, we need to talk to you about the Board line-up, and I'll describe that for you now.

Sir Malcolm Williamson will take the role of the Chair of the combined group, and David Weymouth will remain on the Board as the Deputy Chairman and will also chair our Integration Committee.

April and I, as you've heard, will become the CEO and the CFO of the business, and then we have a good balance of NEDs coming from both boards to form the wider Board for the consolidated group.

However, for us, it was absolutely key to make sure that we have Ian and Seb on board for sensible periods of time - Ian to come on as the Integration Director and lead that integration project, arms around Charter Court, making sure we're doing everything properly as we look to maximise the opportunities from that integration. And it's key that Seb, with the skillset he brings around liability management, balance sheet optimisation, we want Seb to transfer those skills into the combined group so that we can all benefit from those mutual things that come to the table.

We will also seek to have a good balance across the rest of the Executive Team moving forward.

The transaction terms are pretty straightforward, and obviously we've put them in an RNS, but it is an all-share deal, of course. The pie is divided at 55% for OSB shareholders, 45% for Charter Court shareholders, and I'm very pleased to say that the two major shareholders, so Elliot in terms of Charter Court, and then Merian, who are actually a large holder in both of us, have both given us their support through irrevocables or letters of intent, which we're delighted with.

In terms of the financial effects, there are opportunities here to deliver real meaningful cost synergies. This isn't a cost play, this is a strategic scale resilience from growth play, but there are meaningful cost synergies on a backward looking basis, of course. And those savings, obviously, mean more as we move forward with the cost base.

They're more than enough to cover any anticipated future cost of MREL, and this transaction, on an underlying basis, is earning accretive for all shareholders.

I'll now hand over to Ian.

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Ian Lonergan, CEO, Charter Court
Great. So, if we maybe start to dip into the operating model somewhat, and start on the asset side, and then I'll pass it over to Seb who will pick up on the liabilities.

So, the combined entity, as we've also already said, will originate around £6bn of specialist mortgages annually, forming a balance sheet of greater than £15bn, and with net loan book growth in both businesses of 20% plus. These are two businesses, therefore, which are combining from a position of strength.

The combination will make us better as, whilst the brands will remain separate, the product sets are complementary, giving greater reach in the intermedium market and a wider product set enabling to compete more effectively.

CCFS brings highly efficient controlled automated underwriting, offering mortgage brokers speed and certainly of deal execution.

OSB, on the other hand, brings bespoke manual underwriting processes, suitable for complex cases, and specialising, in particular, in the Buy-to-Let market.

CCFS also brings a very sophisticated data analytics capability, focused on providing product insights and value maximising analysis.

The combination enhances the capabilities and the presence in some of our key areas.

OSB should be able to expand more quickly into the residential and lending markets, leveraging CCFS's extensive experience here.

CCFS's Buy-to-Let proposition would benefit by considering adding manual underwriting capability where suited for particular customers.

Both businesses increase their capacity for new product development, and that will be at the heart of what we look forward to in the coming years.

From a brand perspective, and a broker distribution perspective, as we've said already, the two businesses will continue to go to market with their current brands, distribution capabilities and unique broker propositions. We see little value in mixing these operations.

The combined business has improved asset classed scope. We span buy-to-let, residential, new builds, shared ownership, commercial, bridging, development, finance and second charges. And the business has greater breath of intermediary channels through which it can take those products to market.

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Sebastien Maloney, CFO, Charter Court
Thanks, Ian.

So, similar to the asset side of the balance sheet, we're looking to leverage the strengths of our respective organisations on the liability side. So, on the one hand, we have a strong combined retail proposition with a 150-year-old brand in the form of Kent Reliance, with £8.1bn of deposits as at the end of the '18, and another £5.1bn coming from Charter Savings Bank, which we launched in 2015. So, on a pro forma basis, a total retail book of £13.2bn at the end of '18.

Over time, we'll seek to migrate CSB's operations to OSB's highly efficient India-based savings platform and achieve significant cost synergies, which will be detailed a little bit later in the presentation.

We will initially operate with two banking licences, and anticipate that retail deposits will continue to be the bedrock of the Group's combined funding strategy.

That said, of course, Charter Court is well-known for its capital markets capabilities. We are a programmatic issuer of our MBS across three different series. We're told this was in excess of £3bn. We've also executed in excess of £1.5bn of structured sales.

I think our shareholders will understand how we use our wholesale funding capabilities to better manage funding risks while optimising our cost of funds, and we'll be looking to deploy those same capabilities in the combined group.

In that regard, I think that OSB's high quality loan book will present us with sizable opportunities to execute not only funding but also capital transactions, obviously subject to market conditions, that could unlock significant value for shareholders and optimise the use of capital.

Moving onto the financial benefits of the transaction, Andy's already referred to the qualified financial benefits statement of £22m of cost synergies. I think you know on what basis those assessments are done. There's been a lot of detailed work due to quantify this and I think it's quite a conservative assumption on a backward looking basis.

Obviously, we're two fast-growing banks with cost bases that are evolving through time, and some of those cost synergies unwind alongside the Group's trajectory.

The one-off cost to deliver those cost synergies are estimated at roughly £39m.

Moving onto the loan book and the funding platform, the combined entity will have high quality loan book on a pro forma basis of £15.6bn with very low impairment rates.

As previously discussed, we'll have a resilient and diversified funding base with roughly 75% of that funding base coming from retail deposits, but we see significant opportunity to deliver value by deploying Charter Court's capital market expertise.

So, with regard to capitalisation inbound, we're two very well capitalised banks, so we expect to be, as a combined entity, also very well capitalised. We think that scale will bring some benefits in terms of future debt issuance, but we will also become an MREL bank by virtue of our trajectory as of the point of culmination and, certainly through the next few years, going into the £15bn to £25bn MREL zone.

Now, I'm sure we'll discuss this in further detail, but there's an important concept with regard to MREL, and that, as individual banks, given our relatively robust growth in the banking sector, eventually we were probably going to reach that MREL zone as solo entities and, for those of you familiar with how you get captured by MREL, what happens is that, as of the £15bn mark, you incur a one-off virtual fixed cost that you need to amortise through the incremental balance sheet beyond £15bn.

So, when you're on your own, this is largely just a cost, and, if you cannot get through that £15bn zone quickly enough, the marginal cost of funds that you incur is pretty brutal.

Through the combination, two things happen; one, we transcend that no-man's-land in the £15bn to £20bn zone pretty quickly and are able to amortise that extra cost over a much larger balance sheet, but, on top of it, we can absorb the blow through the cost synergies that we can achieve.

And we've done a lot of work in trying to quantify what that could look like. Of course, this is subject to market conditions, but we believe that the cost synergies will outweigh the incremental cost as an MREL.

So, in summary, we think that this transaction will be accretive to both shareholders, both OSB and Charter Court shareholders, by 2021, and that we have the correct strategy to be able to have a game-changer in terms of the scale and capabilities of the combined organisation versus the two solo banks on their own.

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April Talintyre, Chief Financial Officer
Okay. Thank you, Seb.

So, the combination is expected to generate meaningful cost synergies. And, as Seb has just mentioned, the two businesses collaborated to seize the opportunity on a bottom-up basis based on a lower risk integration plan that Ian will outline in a bit more detail in a moment.

We've split the opportunity into four main buckets. The largest component is deduplication of roles, weighted, as you would expect, towards senior management.

Further synergies were identified through a review of the lending lifecycle in both businesses.

As you've also heard, Charter Court currently outsource their savings operation, so the third significant synergy bucket relates to bringing this in-house within our very efficient Indian operation.

And, the fourth, and smallest bucket, comprises other operational efficiencies.

We're not assuming any large IT integration or savings here as, actually, we already use the same lending platforms.

This slide also provides the phasing of those synergies, with around 30% expected to be delivered by the first anniversary post-completion, 75% by the end of the second year and achieving full run-rate by the third anniversary.

A conservative assessment of total one-off costs is £39m. And, as you've already heard, but I did want to stress again, this synergy number of £22m is on a backward-looking basis, assuming full run-rate was achieved in 2018. And, as our business continues to grow, the synergy opportunity also grows, and there would be further costs that we believe could be avoided.

Turning to our capital position. Individually, you've already heard that each of us has a strong CET1 ratio on a standalone basis and, as such, of course, this would also be the case on a combined basis.

We will continue to work with the PRA through the change of control process to confirm the total capital requirement for the combined group. We will, of course, continue to maintain appropriate buffers over this minimum requirement.

The increased scale of the combined business should facilitate capital optimisation and diversification potential. As an example, this includes the ability to issue larger ticket sizes to optimise liquidity and pricing.

Both banks have initiated IRB projects. This combination allows us to share data and best practises to optimise the application process, and should also create some cost synergies too in respect of external advice.

We will work with the PRA again during the change of control process to optimise our approach to the IRB application process post-combination.

We believe that achieving IRB will be create the platform to explore strategic diversification in a capital efficient way. For example, further opportunities in residential lending.

Over to you, Ian.

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Ian Lonergan, CEO, Charter Court
Excellent. So, post-deal completion, I've been asked to lead the planning in delivery of integration.

So far, we've conservatively assessed the opportunities and plan to deliver over a sensible timeframe.

In designing the programme, we'll establish some key principles; keeping the funding and lending brands separate, establishing centres of excellence to maximise the excellent underlying businesses and where best capability already exists. Identifying low risk and high value opportunities is an obvious thing to do and, equally, avoiding large IT integrations is a sensible thing to do where possible.

Integration planning will also be helped because these businesses are actually surprisingly similar to each other. We operate on similar software platforms and in similar markets. And, actually, the businesses know each other pretty well. We've worked together over the years on a number of projects, and there's quite a lot of meeting of minds that goes on quite quickly.

Integration oversight will be delivered by from an Integration Committee, reporting to the combined Board. David Weymouth, from OneSavings Bank will lead that, and myself, Seb Maloney and Phil Jenks from our current Board will also help on that Board.

Okay, so, finally, just turning to some matters of timing on the transactions. As you will know, transactions such as this are subject to court and various regulatory processes. During Q2, a scheme document and prospectus will be developed and published with an aim of holding shareholder votes at the end of the quarter.

Of course, we've been in close dialogue with the PRA, FCA and CMA, and the transaction is subject to satisfying the needs and requirements of our regulators and those of the scheme.

We, therefore, believe that completion can be achieved by the end of Q3 of this year.

Okay, so, finally, handing back to Andy.

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Andy Golding, Chief Executive Officer
Thanks, Ian.

So, in summary, and I'll keep the summary short because I know you'll be really keen to get into Q&A, but this really does create a lender of scale with the best in class proposition that we can blend across the two entities with resilience increased and genuine firepower in our competitive market position.

The financials stack up. We hope shareholders will agree and support us in terms of building this future platform for growth.

So, I think we're now going to disconnect the webcast, because the Q&A is only going to be for the room as far as I'm aware. Thank you for the thumbs up at the back. And we can happily go into Q&A.

Yes. The first hand here.

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Questions and Answers

Ian Gordon, Investec
Morning. Congratulations on two great sets of numbers. Can I have three questions, please?

Firstly, and, again, apologies if I've missed it, Seb, have you quantified the pro forma benefit of the January disposal gain? From memory, I thought it was the best part of 200 basis points on CCFS standalone.

Secondly, April, you referenced the impairment charge for full year, ex the Project Fear charge is about six basis points versus 10. Does that mean you - I don't know if I've got the maths right - but your ex Project Fear charge in the second half, it would be only one to two basis points, i.e. comparable with the CCFS level. Is that right?

And then, thirdly, could you talk a bit more on the look forwards cost benefits? You mentioned, AIRB. One of your peers described the costs as eye-watering. Have you offered any quantification of your standalone AIRB costs and the amount which might be stripped out, and could I also trouble you for an update on expected timing?

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Andy Golding, Chief Executive Officer
Okay. Thanks, Ian. So, I think we've a Seb, we've got an April and then we've got probably a combination of Seb and April.

Seb, do you want to pick off that first one?

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Sebastien Maloney, CFO, Charter Court
Yeah.

So, just to clarify, you're asking about the 2019 disposals?

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Ian Gordon, Investec
Yeah, the January one.

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Sebastien Maloney, CFO, Charter Court
So, yes, we are disclosing this was £30m gain. Two transactions.

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Ian Gordon, Investec
And it's just converting that into basis points on the CET1. I thought it was best part of 200. Is that…?

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Sebastien Maloney, CFO, Charter Court
Pro forma.

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Ian Gordon, Investec
Yeah.

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April Talintyre, Chief Financial Officer
Okay. Shall I pick up the question on loan losses?

Yes, you're absolutely right. I mean, we've had sort of a stable performance from the loan book and, therefore, in the absence of that change, to put more weighting on sort of downside economic scenarios, that is correct, it would have been broadly flat, and we end up at stripping out the impact of that extra scenario. We end up with a slightly lower loan loss charge than we had in the prior year.

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Ian Lonergan, CEO, Charter Court
Integration benefits going forwards - we're not giving any guidance to forward-looking benefits. It's just not part of the process. So, what you're looking at here are 2018 costs and a review there.

We are, of course, saying that when you find a design item that you can deal within your business, it will replicated as the business grows, and we're pointing you to the fact that the business is growing at 20% on a balance sheet basis.

I think we both think that our IRB teams are some of the best people we have in our businesses, and, certainly, having more of those guys together to solve the problem of IRB, I think, is a huge benefit to the business, to be honest with you, both in terms of control and analysis of the key questions that a bank has to answer.

So, it's not an area we're looking at a cost saving other than maybe some of the external expense that we can deliver, but we do expect to see a better overall project at the end of it.

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Andy Golding, Chief Executive Officer
Thanks, Ian.

We had a hand here at the front, just second up.

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Robert Sage, Macquarie
Yes. Just a couple of questions if I could, please.

First of all, just possibly, sort of, further to Ian's question, I was wondering, in terms of whether - I know you're both making separate AIRB applications, and whether, sort of, the change of control, effectively, might affect the likely timetable on that, as in could there be a delay as the sort of Bank of England sort of thinks through the implications of that?

I guess the second allied question to that would be - I think you're talking about maintaining two separate bank licences. Is that the long-term sort of end game for you or would you actually expect to go to one over time?

And the other question was, really, have you - I know it's early days, but have you had any sort of feedback from the IFAs yet in terms of how they see this deal? I know there's a bit of talk around sort of might you lose some market share because they might not want to concentrate too much business in any sort of one hand as it were.

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Andy Golding, Chief Executive Officer
Okay. I mean, I'll touch on the IRB change of control impact, or, you know, potential for impact, I guess, and then if colleagues want to add that's absolutely fine.

Clearly, we have discussed with the regulator, as part of the transaction, where we see things. Both businesses are fairly advanced in their project and their use test, and we're both in that sort of cusp of, you know, towards the end of this year we'll be looking to put in formal applications for IRB.

We've done a couple of things with the regulator through this transaction that's causing them to exercise their mind; you know, the first one is this the first time two organisations have come together and busted through an MREL threshold. So, those detailed discussions, and part of change of control with the Resolvability Team at the Bank of England, is absolutely on our agenda and key to moving forward in a sensible way with that. And this is the first time they've had two organisations come together that are as advanced as we are in the IRB application process.

So, the initial response was a little bit of head scratching and then it's - Well, okay, we've got to think about it and work it through.

We've maintained optionality, I think, in the way that we've initially planned to structure the organisation.

We're both very clear about how our models and our data are operating, and we will try and work hard with the regulator to converge that journey, if you like, as quickly as we can.

The two banking licences' piece, you know, again, it's part of the structuring debate around some of those key questions, like resolvability and IRB.

I think the end game is, clearly, that we arrive at a single banking licence, point of exit. Certainly, in the early days, it's useful to have the double FSCS protection for any deposit crossover, and, clearly, as you'd expect, we've sized any of that deposit crossover and feel it's very tolerable.

And then I'll just comment briefly on the broker feedback. We sent out a Q&A after the very kind press leak at the weekend to the broker community, and we haven't picked up that sense of - We won't use you because it's concentration risk.

I mean, I think I'm allowed to say this because to use to run the salesforce at one of the UK's biggest independent mortgage brokers, I think, you know, the keys for a broker are, do I like your product, do I like your criteria, and do I like the process you deploy to get me what I want? And what they want is a response and an answer for their customers so that they can get the deal secured.

Now, the net promoter score from brokers for the Precise mortgage brand is very strong, as is the net promoter score for brokers from ours. We have slightly different distribution channels. We operate through, clearly, some common distribution chains, but we have differences in the way that we approach that. And, actually, the key for us about leaving the brands, the product development and the offering intact is what makes sure we think we can keep those brokers wanting to come back to us.

I really don't think concentration risk in a lender is a problem for them. When Lloyds Banking Group had, you know, Birmingham Midshires out in the specialist space, no one said - Well, I won't use Birmingham Midshires because we do loads of business with Lloyds - If the product's right, the service is right, and you work with the broker in the right, I think that's okay.

Ian, do you want add anything on that one?

. . . .

Ian Lonergan, CEO, Charter Court
No, I'd support everything you just said.

As Andy says, two operations, separate, go to market the same tomorrow's they did today. I don't see any difference in the broker channel.

On the IRB application point, I'd say it's where you end, not where you start that's important. Obviously, when you put two businesses together you have to think about what you're doing with that programme, and we may take some time to do that.

It certainly won't be any quicker because of that on an entry point, but the question is not really when you enter, it's when you exit. And, when you exit an IRB programme, it's about the quality that you're deliver in the programme.

And the two bests sets of minds in our business coming together to take on those challenges, I think we'll come up with better answers for the business overall. So, we'll be stronger in that application process.

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Andy Golding, Chief Executive Officer
Okay. Yes.

. . . .

John Cronin, Goodbody
Thank you, and well done on the announcement, guys. Just a few questions.

First of all, look, on MREL, what can you say about the expected timeframe in terms of the actual introduction of those issuance requirements, noting the £15bn to £25bn guidance leaves you in a grey area somewhat?

The second question in interrelated vein I guess is the - look, how big a point is that around the cost amortisation pertaining to the one-off initial impact from an MREL perspective, and could it influence your strategy in terms of attitude towards potential further de-recognition of assets given your proven capabilities in that respect?

Then, secondly, look, just curious to understand better how the underwriting will be integrated? You know, a little bit in the dark in terms of, I guess, how that actually works out at a ground level, but is there either a substantive gains perhaps over time that could accrue from the integration of both underwriting systems?

And then, finally, just in terms of the scale opportunity - look, I appreciate you're not going to call out explicit opportunities, but have you identified further potential in organic avenues for expansion over the medium to longer term given your increased scale as a consequence of this transaction, or how should we think about that? I mean, clearly, the transaction presents benefits in and of itself. Thank you.

. . . .

Andy Golding, Chief Executive Officer
Thank you. Some good questions there. I'm going to tackle them in slightly reverse order because I'm going to talk about that sort of scale play and then organic first and then, on the complex questions on MREL, I'm probably going to get Seb to tackle though, and I think Ian's going to want to talk about the underwriting integration because I think, you know, that's a good question as well.

But, look, you know, you can only eat one elephant at a time, right, and you have to break that into bite-sized chunks, so we will do that as part of the integration project and make sure that we've absolutely crossed all Ts, dotted all the Is and got this thing firing on all cylinders as a V8 rather than two V4s operating in isolation. You can tell I like cars, right.

Once we've done that, you know, clearly, the market continues to present opportunities, and I think, you know, what I tried to say in the introduction right at the beginning is both of our Boards don't want to be, you know, the smaller guy hoping that, you know, someone doesn't rock up over the shelf and take us out and lose the personality of the business and homogenise us, and all those things bigger players do when they buy smaller players.

You know, we were very keen in OSB, and I think we've had similar discussions with Charter Court. Let's be that specialist of scale and, if those opportunities present

themselves, and there is further in organic growth opportunity, let's get ourselves in a state of fitness and readiness to take those opportunities.

So, I can't say, yes, that's in the strap plan right now, because we've got to eat the elephant, right, but, once that's done, you know, strategies evolve and this is a platform for growth, as we've said.

. . . .

April Talintyre, Chief Financial Officer
Both organic as well as inorganic.

. . . .

Andy Golding, Chief Executive Officer
Yeah.

Seb, do you want to tackle the MREL?

. . . .

Sebastien Maloney, CFO, Charter Court
Nobody's every called me an elephant, by the way, but [Laughter] point taken.

So, on the MREL question, there's been a, obviously, you know, the product of a lot of thinking with regard to MREL. So, with regard to your last question, I think that's a strategy that makes sense if you're in a kind of a little bit of different situation.

Had we continued our trajectory or, indeed, the OneSavings Bank, their trajectory as a solo, you have been dealing with entity that's doing £2.5bn to £3bn a year in terms of flow. Let's call it at a five year average asset duration for argument's sake. And you can see how that takes you straight into the MREL zone.

Now, the problem with that, and the problem that a lot of different banks have reached that scale will have, is the marginal cost of the next billion, right.

So, if you do some just quick maths to make it nice and round, you'll say we'll get £15bn. What's actually happening here, of a risk weight density of 40% let's say, so that's £6bn, you're going to have to issue MREL to the extent of your Pillar 1 and Pillar 2A. If you make it 10% that means that, right off the bound, at that £1 after £15bn - it's not quite that clinical - you have to issue £600m.

That £600m, let's say that the net spread just to put a round calculation our there relative to retail, it's 200 basis points. Right there, that next £1bn in costs and incremental, 12. If you do £2bn above the £15bn, you're now in £17bn, it's 6. So, if you do £3bn, it's 4, and so on and so forth. It increases a little because there is a marginal issuance, it's a component.

So, the point is that the burst through, where the falling into it, means that the marginal economies keep on improving as you grow the balance sheets. And I think one the rationales for the combination here is that if we're going to burst through that thing, and reignite growth and the growth theory, let's just make sure that we do it decisively, and that we absorb that cost as quickly as possible.

Now, the other side of the equation, of course, is as a solo. There are no such things as cost synergies. So we have the double whammy. We have the burst through in terms of scale, and the absorption through, you know, for two very cost efficient businesses having roughly 15% of our combined cost base as a target for synergies, while they're low risk and high value, they are still a meaningful number.

So, we believe that the combination of those two things really address the MREL problem head-on and in a thoughtful manner.

. . . .

Ian Lonergan, CEO, Charter Court
Underwriting, as your middle one, I think it's question two - Don't think about it as integrating underwriting operations. That would be a big bank disaster. You don't take something that's black and white and make something nice and grey in the middle. You keep black and white different because they go to the market differently and offer a broker a different outcome. And, as Andy absolutely said, this is about delivering to the broker what they want.

Some brokers want an eight minute underwriting process, give me your case, pack it out to the automated system, I'm done. Other ones know that their customer needs are a more bespoke operation. We have both. Mixing the two would be a disaster.

That's not to say, however, that there aren't great practice odds on both sides that one does and one doesn't. They have a great Indian operation cost centre. There's nothing to say that parts of my operation can't be done in a lower cost jurisdiction. It's not say that parts of what Andy's business does can't benefit from the analysis and automated techniques that we use.

But that's not to make black and white grey. That's just to enhance the clarity of the black and white.

. . . .

John Cronin, Goodbody
Thank you. And can I have one follow-up on funding costs. Look, you know, it's obviously very topical - deposit funding costs for both of you - anything to call out in relation to, you know, any developments in recent weeks or months? I mean, we keep track of your pricing, but just keen to understand if you see any signs of emerging pressures. Thank you.

. . . .

April Talintyre, Chief Financial Officer
I'm happy to start with that and that, and say you know, we have raised quite considerable retail funds in recent months at slightly below our sort of cost of funds assumption, but there's no doubt that, you know, depending on how things turn out with the macroeconomics and potential competition for retail funds, should wholesale markets remain illiquid, that's clearly a consideration that we take into account when we do our, you know, stress testing. But, right now, we've been raising deposits at what we think is reasonable levels.

. . . .

Sebastien Maloney, CFO, Charter Court
If I follow up on that by saying a couple of things, especially looking in the rear view mirror.

2018 was supposed to that year where the end of TFS in February would have led to a blow-out in retail spreads, a blow-out in wholesale funding. Having closed out the year, I can tell you that none of these things are true. Actually, wholesale funding in the first half was actually the best in 10 years.

The second half, when we had to switch to retail, we didn't find that our retail spreads were any wider than they had been previously. In anything, quite the contrary.

From our perspective, that continues to be the case. I mean, the markets are pretty healthy, the flows were pretty easy to obtain, and the pricing is pretty stable.

So, you know, of course it can be disruptive further down the line, but that's not the situation on the ground right now.

. . . .

Andy Golding, Chief Executive Officer
Other questions from the floor. Yeah, so there was a hand immediately over the back. I can't see who that is.

. . . .

Edward Firth, KBW
Thanks. Hi. I guess just a couple of questions.

Firstly, could I just ask you just to give us some indication of the quantum of MREL that we should be thinking about? I know there's quite a big range when I look at your peers about the total loss absorbing capital requirements, so some sort of sense of what that level might be based your discussions with the Bank of England.

And then, I guess, related to that, you've talked a lot in sort of general terms about revenue synergies and about sharing, you know, best practise etc and securitisation, but it was very little in terms of numbers that I can think of. So, if I look at your combined group over the next two or three years, then it seems to me that, with the MREL in, the combined revenue's going to be lower than we might have expected if we'd been looking at the two of you on a standalone basis.

And I accept all the points you make about longer term we've had to address it anyway, but, just looking at the next, say, two to three years, which is I guess where the prime focus is, could I just sort of ask you just to sort of give us, or just invite you really just to talk about those quantum of those synergies might be? Should we actually be expecting the combined revenue to be lower in the next two or three years? Is that a reasonable assumption? So, I guess that's the first area.

And then the second area is about the timing of the deal. Obviously, Charter Court came to the market, what, 18 months ago. You must have had plenty of opportunity to look at it then at a reasonably lower price. So, I just wondered what, you know - all the

points I see in terms of the strategy all make good sense, but they would have all made good sense 18 months ago, so I'm just trying to see, well, why now, not 18 months ago? Thanks very much.

. . . .

Andy Golding, Chief Executive Officer
Okay. Thank you.

I mean, let's just touch on the revenue synergy piece before, because you will appreciate that we're kind of bound by the UK Takeover Code in what we can and can't say, and there is a very structured process for arriving at cost synergies, and not trying to artificially inflate things with revenue synergies.

You know, clearly, if we complete the transaction, and then we start to build out a plan and give guidance to the market, that will give the market the idea of, you know, how we're moving in that journey, but, right now, we haven't got, and wouldn't be permitted to give you a kind of quantification around what thoughts we have around potential revenue synergies going forward.

I'm going to touch on the MREL quantum point, but I'm going to ask Seb to put the detail on it, if he wants to, but one of the questions that was asked here at the front as well was around does it influence de-recognition strategy, for example, and I'm sure we answered that.

Resolution is the key here. MREL's not the key, it's resolution. The bigger the bank you are the bigger deposit taker you are. Clearly, the Bank of England want to ensure that, you know, you're not going to be too big for the FSCS to deal with in the event of a failure, and there are a raft of different ways in which you approach that.

One of them is balance sheet optimisation, or management of the balance sheet, which could be around deconsolidation trades, and there are times in the market where you're an acquirer and there are times in the market where you're a disposer of assets because the quantum is right. So that will find its way into our thinking. You know, there's transfer. The deposit book will not be so huge that you couldn't think about that as an option.

You know, there are a raft of ways in which we can tackle that resolvability discussion, and that’s the discussion, as part of the change of control, that we will get into in depth with the regulator.

But, of course, you have to, when you're putting these things together, you have to take the uber approach conservative approach, which is to say we'll drop into MREL fairly quickly, we'll issue an instrument, you know, we'll get ourselves a rating, which has other potential benefits, and that's what it'll be.

I'll ask Seb in a minute to come back on quantum if we can, although I'm not sure we put that out.

Timing of the deal, I mean, I won't comment about whether we did or didn't discuss with Charter Court, you know, prior to them IPOing, but you've got to remember that, you know, if you're listed entity, trading with paper is one thing, trading with cash is a very different scenario.

These are two businesses with very similar PE multiples. It makes the ability, in terms of our scale, to be able to make a nil-premier merger look attractive. You know, you could question the timing around Brexit. Well, you know, we lean into Brexit, whatever that may be, as a standalone organisation. Charter Court leans into Brexit as a standalone organisation.

We genuinely think we are stronger and better together, and, therefore, whatever the headwinds are of that economic dynamic, we think a combined business leans into that headwind more strongly if that headwind presents itself. Although, I have to say, right now, the UK plc economy, all the indicators are reasonably good. It's just the political ones that are not so hot.

So, I can't comment any further around prior discussions, but the timing of the deal, for us, is similar business, similar scale, opportunity to create that platform for growth, you know, strategic discussions and decisions of this scale and businesses take a long time.

Seb, I'm not sure we can add too much more on MREL quantum really, can we?

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Sebastien Maloney, CFO, Charter Court
Well, clearly, we haven't disclosed what we believe the MREL quantum is going to be, nor are we at this stage with the journey with the Bank of England, to actually size what the level of the issuance will be, or, formulaically, it's well-known how this things are sized down. Essentially, it's just two times your Pillar 1 and Pillar 2A, so you can quickly, based on your balance sheet projections, get to a number that should be all your MREL requirements effectively.

I think, on your question of revenue synergies and the implication of MREL, I think we cannot, as Andy's said, we cannot quantify what those might be, but, of course, there is a spectrum of sustainability of revenues all the way to synergies. While we can't quantify it, we will, of course, try to deploy our skillset across the combined group to make sure that we achieve within that spectrum whatever can be had, subject to market conditions within that timeframe.

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Andy Golding, Chief Executive Officer
Okay. Thanks, Seb. I think we've got time for one, possibly two more questions. We definitely had a hand up at the front here, so I don't want you to get lost. Just here.

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Anthony Da Costa, Peel Hunt
Morning. So, in both sets of results, you both mentioned that the pipelines are strong. So, I'd like to know are they any sort of indicators, is there any reduction in economic activity, and do we see any signs of credit stress?

And, the second question is for April. An IFRS 9 provision for a no-deal. If there's a deal and whatever happens happens, does that reverse into the P&L?

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April Talintyre, Chief Financial Officer
I can take that first perhaps.

We, in common with other banks, under IFRS 9, we run our calculations under multiple scenarios.

When we implemented IFRS 9 we had three; an upside, a base case and a downside. What we did was add a fourth, more severe, downside.

So, as the economic outlook changes, and the probability of those various - and the quantum impact of those various scenarios change, yes, we would update. And, if there's a general improvement, then that would result in a reversal. It's how IFRS 9 works. So you're correct.

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Anthony Da Costa, Peel Hunt
Thank you.

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Andy Golding, Chief Executive Officer
I'll touch on the pipeline and credit stress from OSB perspective, and then I'm sure Ian will do the same for Charter Court.

I mean, look, we came out of 2018 into this year with a really super healthy pipeline across both our Kent Reliance brand and our InterBay brand, which is really kind of on fire at the moment.

Are we seeing changes in economic behaviour amongst the borrower base? You know, the purchase market is soft. You've got to go to UK Finance and get the data on that. There are less purchase property transactions going on there have certainly in the peak periods. But there is still purchase activity going on. There are still landlords who are taking opportunities to buy up half a dozen under one freehold or something like because they can get a good deal on it and the rental yields are strong.

There's a phenomenal amount of refinancing activity going on. You know, there continues to be heaps of business that comes up for renewal. You know, people want to change the shape of their portfolio, or even morph into a limited company, or whatever it might be. They need a lender who can facilitate that.

So, you know, I think April said when we did the quick scoot through the 2018 results, current application levels are very strong, so we have no issues there.

From a credit stress perspective, I mean, we run a bucket load of credit data on all of our borrower base, including changes on their consumer indebtedness position, whether they're a corporate borrower or a personal one, and changes in their sort of AAM scorecard and, you know, is their profile getting better or worse? It's a low indebted, high credit score portfolio, and we still have kind of micro numbers of arrears in our front book versus the number of loans originated. So, the answer is, no, the movement, for us tend to be around accounting treatment, and not around underlying drivers.

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Ian, do you want to comment on the CS?

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Ian Lonergan, CEO, Charter Court
Exactly the same [Laughter].

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Andy Golding, Chief Executive Officer
Okay. We will take one final question.

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Shailesh Raikundlia, Panmure Gordon & Co
Morning. Just one question, actually.

I was just trying to understand the competitive landscape following, obviously, the merger. From what I can see, especially in the Buy-to-Let and Specialist Buy-to-Let, you, basically, have two major players, and then there's a huge concentration risk going forward. So, I was just wondering, you know, if you could sort of explain to me what the competitive landscape is post this deal and whether it could bring about sort of scrutiny from the regulators at some point in the future.

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Andy Golding, Chief Executive Officer
Yeah. I mean, it's a good question.

We have done our thesis around the Competition and Markets Authority, and we will go through a formal process with them as part of our change of control and all the regulatory procedures. You know, we've done a market analysis. We don't think we will puncture a threshold where there will be CMA concerns about the deal, but we will go through a formal discussion with them to make sure that that's okay.

I mean, yeah, we're both big players in some of the, you know, the core markets in which we operate, and there are one or two other players of our scale in the specialist end of the market. There are a lot of very small players in that specialist end.

You know, lots of the building societies are still very active in the Specialist Buy-to-Let and Specialist Residential territory, and there are a number of non-bank lenders who compete in that space, although I sense, from some of the news of late, that non-bank lenders are finding life a little bit more tricky than from those with a deposit and RNBS franchise.

So, we'll work through the process with the CMA. We've done our analysis. We think we're okay, but, clearly, we have to go through that piece.

Okay, I am going to say thank you very much all for coming, and allow you to get back to your day jobs, and thank you for your time.

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END

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