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Simple, straightforward banking

Project Manager,
Retail banking market investigation,
Competition and Markets Authority.

Non-confidential version

Dear Sir,

As promised, I set out below some thoughts following the release of the Retail Banking Market Investigation Updated issues statement on 21 May 2015.

Secure Trust Bank PLC is a longstanding bank having been established in 1952. It currently serves Consumer and SME banking markets in the UK only. Customer numbers are approaching 500,000 and these are served by over 700 staff. The bank has historically provided a basic bank account for consumers who have been unable to obtain a current account from a High St bank. For economic reasons we have recently ceased to write new basic bank account business.

In common with many of the CEOs of the so called Challenger Banks I have held senior executive roles within the systemic banks. In my case my last role with RBS was as MD of the RBS and NatWest SME Banking business across the UK. As such I benefit from a deep understanding from both the systemic bank and small bank perspectives.

Whilst I appreciate the CMA's focus is on the PCA & BCA markets I firmly believe it is important to take a holistic view of the whole market in order to understand why the current position prevails and the potential actions that could be taken to foster greater competition in UK banking, in line with the stated political agenda.

Market Context

Listed below are just some of what were independent, standalone, UK banking competitors present on the UK High Street on 1/1/2000. They have since been subsumed within the x largest banks and the x largest Building Societies. This is why the 'too big to fail' position exists. I would note that many of the firms below provided the full range of banking services including PCA and BCA products. I would contend that in 2000 the UK Government could have allowed say Bank of Scotland to fail without destroying the UK Banking system. 7 years later in 2007 it had no option but to support saving it.

Abbey National	Alliance and Leicester	Bank of Scotland
Birmingham Midshires	Barnsley BS	Bradford and Bingley
Bristol and West	Britannia	Chelsea BS
Cheltenham and Gloucester	Chesham BS	Cheshire BS
Clydesdale	Derbyshire BS	Dunfermline BS
Egg	Halifax	ING Direct
NatWest	Norwich and Peterborough BS	Scarborough BS
Stroud and Swindon BS	Woolwich	Yorkshire Bank

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Speaking as a long standing (and qualified) banker I believe that recent years have seen the greatest ever period of UK Banking consolidation. Factors behind this include the desire by the larger players to increase scale and market share and profits by acquisition and the introduction of the Basel II capital methodology.

Under the Basel I regime introduced in 1992 broadly speaking all banks used the same risk weighting methodology against their lending assets to determine the amount of capital they required to hold to cover credit risks. For example the weighting for mortgage lending was 50%. Under this regime small banks could compete effectively with larger ones hence the UK had a much more diverse banking sector.

Basel II sought to introduce more risk sensitivity into the Basel I regime. This created a two tiered approach to the risk weighting. The Advanced (or IRB) approach and the Standardised approach. In theory all firms could use either approach but in practice only the largest firms could commit the resources necessary to meet the criteria required to qualify to use the Advanced approach. It will therefore be apparent that Basel II gave larger firms an immediate capital advantage of huge proportion.

This made it easier for them to acquire smaller firms whilst simultaneously growing their own balance sheets at considerable pace. To put this in context the ICB report (page 178) noted that Nationwide BS was able to risk weight its mortgage assets at 5%, Barclays and Lloyds risk weighted these assets at 16%. This meant that the banks and building societies on the standardised basis risk weight of 35%, suffered between a 700% and 218% capital disadvantage relative to these systemic firms. It is no surprise therefore that the 'Advanced' firms now dominate the low risk low LTV mortgage market.

This consolidation also created the present scenario whereby the ownership of the payments infrastructure is much more concentrated than it was in 2000. This limits competition and choice for agency banks. Not surprisingly this has also driven the increased concentration of current account market shares (PCA and BCA) since previous competition investigations were conducted.

As a consequence of being deemed too big to fail the systemic firms benefit from an implicit UK Government guarantee which has been estimated by the Bank of England to have been worth hundreds of £billions since 2009. This subsidy and the huge volume of non-interest bearing balances held on their customers current accounts gives the systemic firms very low funding costs.

The combination of enormous capital advantages (especially in mortgages and larger SME and Corporate Banking) and very low funding costs are the key reasons why the systemic banks continue to dominate the UK banking market.

Paragraph 158 of the Updated issue statement highlights that the new entrants are small scale and have focused their approaches in particular market segments. This is more through necessity than choice. The existing and new small banks cannot compete on an economically viable basis in the large scale core prime consumer or SME markets due to their capital and funding disadvantages so must instead concentrate in areas where they have some ability to compete. This implies the market is not functioning effectively.

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HM Government appears committed to the creation of more new banks. In isolation this is laudable. However it could ultimately be sub optimal and counterproductive. Creating a multitude of new banks that have exactly the same funding, capital, payment infrastructure and regulatory burden disadvantages relative to the big banks is a flawed strategy, unless it is also aligned to a broader strategy to address the disadvantages noted above. It's a bit like thinking CASS (and now ANP) would lead to a surge in switching without simultaneously addressing the root causes of the fact that there are very few current account providers.

Without a far reaching holistic approach the small banks will remain restricted to a narrow part of the market which is underserved by the larger banks. In consequence the small banks will not be able to scale to be genuine challengers and will generally have riskier lending portfolios than average (because they cannot economically write lower risk lending due to funding and capital disadvantages). Inevitably if the limited pool of opportunity available to the smaller banks becomes too crowded the challengers will become the challenged. Which would be somewhat ironic? Ultimately too many fish in too small a pool leads to asphyxiation. The too big to fail banks (few in number but absolutely huge) will continue to dominant the open ocean. The largest banks would of course prefer to see the small banks compete with each other instead of with them.

Knowledge is power

- The clearing banks by virtue of being a customer's current account provider have much greater knowledge and insight into a customer's behaviour than the non-clearers. This gives them considerable advantages when it comes to cross selling and credit decisions.
- I would expect any analysis to show the number of products held and services used per customer to be considerably higher for the current account providers than those banks which cannot offer free if in credit current accounts. This highlights the ability of the larger banks to use their dominance to cross subsidise their various activities.
- I would also expect analysis to show that the average impairment as a percentage of consumer and SME lending to be lower for larger banks than for the smaller lenders. This highlights their ability to use their unique insights to select the best credit risks leaving non-clearers and alternative lenders to write the risker lending.
- The apparent asymmetry of knowledge is recognised in paragraphs 155-157 of the update issues report. I would note that the data generally available to non-current account providers is much less powerful, is historic and relies on the accuracy of information supplied by lenders under the reciprocal code with the CRAs. I do not believe that the Midata project will fundamentally alter this. The data available to non-current account providers is nothing like as insightful as being able to review the behaviour of a customer's current account in real time. Parallels could be drawn between the knowledge a supermarket has about its club card holders compared to those who don't have a loyalty card. Supermarkets do of course use this data intelligently to focus their marketing efforts. Banks do the same.

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- HM Government is keen to force larger lenders to refer to alternative lenders, especially peer to peer, customers who they refuse to provide with lending facilities. This could create potential future issues unless the alternative lender undertakes deep analysis before agreeing a loan and adequately prices for the risk. If they do not they could suffer increased credit losses if the economic environment deteriorates. In such a scenario the 'alternative lender' sector would suffer disproportionately than the lower risk clearing bank lenders. Thus the dominant would see potential competition weaken.
- Given their unrivalled insight into their customer's behaviour the incumbent clearing banks ought to be able to innovate in a more informed and targeted manner than smaller rivals giving them an ongoing market advantage.
- Deep insights into customer behaviours, customer inertia, clever marketing and a general lack of awareness of alternatives could ultimately mean customers end up with sub optimal solutions.

Control of the payments infrastructure inhibits competition

- At the 2015 BBA Annual Retail Banking Conference Atom Bank revealed that they could find only one clearing bank willing to engage with them to discuss their agency banking requirements. Unless there are idiosyncratic reasons for this, such a revelation hardly suggests a properly functioning competitive market. Paragraph 110 identifies how barriers to entry can reduce competition. I agree with these views.
- Secure Trust Bank PLC has been around since 1952. It traded profitably throughout the financial crisis and enjoys a good reputation with its customers as measured by FEEFO; however we are entirely dependent on our clearing bank to provide our customers with payment capabilities. We have no negotiation power and our clearing bank has repeatedly refused to engage with us to negotiate the charges they levy. For example they charge us xxp per faster payment. We have no choice but to pay this. Other charges are penal.
- Aside from the economics of the relationship, we also have no leverage in respect of service standards. The contractual arrangements with our clearing bank are weak. The service level agreements are not fit for purpose. For example some provide for the clearer to have 12/24 hours to resolve an issue which is completely at odds to the regulatory timeframes required to process faster payments. Invariably if there is a service failing the agency banks rank behind the clearing banks customers in the resolution priority rankings. This means the small banks payments service can be no better (and potentially worse) than the clearing banks.
- This basically ensures that we in common with the other small banks cannot make a viable business case to launch a free if in credit current account product. It is telling that none of the so called Challengers including larger ones like Virgin Money have sought to launch a free if in credit current account.

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Previous attempts to foster competition have not worked

- Current Account Switching Service (CASS) was much trumpeted as being the catalyst to drive a dramatic increase in current account switching. A number of practiconers, myself included, warned that without a significant increase in the number of alternative current account providers CASS would only result in faster movement of current accounts amongst the existing providers. So it is no surprise to note that the levels of switching are 2% and 4% for PCA s and BCAs respectively. The updated issues statement notes that the market shares of the four biggest banks have fallen slightly between 2011-2014. I suspect that if Santander and Nationwide were included alongside the other four large firms, the combined market shares would be unchanged. It is telling that despite having the highest market share of all PCA's providers the market share of Lloyds Banking Group is unchanged. The clearing banks are frantically trying to talk up the benefits of CASS, in part to try to see off the possibility of Account Number Portability (ANP) and in part to reduce the likelihood of significant interventions by the CMA.
- A number of commentators are pushing the case for ANP. Whether this is sufficient to overcome the huge customer inertia remains to be seen. I cannot see this working in isolation due to inertia and general consumer lack of awareness. But even if it does, in the absence of significant numbers of new current account providers, where will customers switch to other than existing banks?
- Paragraph 80 notes the negative advocacy and latent dissatisfaction of SMEs. The question remains in the absence of alternative BCA providers where can these disgruntled SMEs go other than existing banks?
- Since the last two competition reviews of the current account market, the market shares of the dominant incumbents has increased. This begs the obvious question what will the competition authorities recommend this time around that drives a different and more successful outcome?

Capital

- I have detailed examples of the huge capital disadvantages suffered by the smaller banks and building societies already. This remains a massive competitive barrier as recognised in paragraph 121 of the updated issues statement. However I feel obliged to put the comments about counterbalances in context. There are no reductions to the standardised risk weights for new banks. The same methodology for the calculation of the credit risk component of their overall capital requirements applies to new entrants as it does to established banks on the standardised approach. The PRA has relaxed the requirement for new banks to have to prefund the capital required for their medium term business plan but this is not the same as giving them concessions when it comes to credit risk weighting which is typically the largest component of any banks overall capital requirement.

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- It is acknowledged that the systemic firms are subject to additional capital buffers relative to the smaller firms but it is critical to understand that such buffers are based on overall risk weighted assets. So taking Barclays as an example, by 2019 it will be subject to a 2% globally systemic firm buffer. But in context increasing its 16% mortgage risk weights (as revealed by the ICB) to 16.3% is not going to make much of a competitive impact when the small banks are weighting the same assets at 35%. I note here that neither Lloyds nor Nationwide who between them control a material percentage of the UK mortgage market are subject to these GSIF buffers.
- Moreover the imposition of capital add ons across the board serves to further disadvantage those on the standardised model. Capital Conservation Buffer requirements begin to get phased in for all banks from 1/1/16. This is initially 0.625% of risk weighted assets. So for Barclay's mortgage assets (using the ICB data) this moves their effective weight from 16% to 16.1% (+0.1%). The smaller banks see their effective mortgage risk weight move from 35% to 35.2% (+0.2%). So the add on for the smaller bank is twice as great as the systemic firm.
- The proposed changes to the standardised capital model published by the Basel Committee on Banking Supervision 23/12/14, if they were to come to pass, would dramatically increase the competitive disadvantages suffered by the small banks.
- The attached speech by Martin Stewart from the PRA / BoE in March 2015 provides some useful insights.
- The CMA needs to guard against making general assumptions that modest capital add ons for the systemic banks represent, in any way, any real steps to narrowing the huge capital advantages the 'advanced' banks enjoy.

Funding

- I have already highlighted the huge funding advantages enjoyed by the systemic banks as a consequence of their dominance of the PCA / BCA market and the implicit subsidy they enjoy due to being 'too big to fail banks'. The attached paper from the Bank of England serves to quantify the value of this subsidy which rather puts the banking levy in context.
- Just to illustrate the actual impact of this; HSBC have recently marketed a lifetime tracker mortgage for loans up to 60% LTV at 0.99% above base rate. So 1.49% all in. A customer could therefore borrow from HSBC and place the monies borrowed with one of the so called challenger banks and earn credit interest (variable rate on short term notice accounts) at 1.75-1.86%. In other words they would be paid more by having funds deposited with a small bank than they are paying to borrow from a systemic firm. This surely highlights a major competitive advantage / disadvantage depending on one's perspective. It perhaps also gives an insight into why the larger banks are not keen to see a whole bunch of new current account providers.
- Previous liquidity schemes introduced by HM Government have disproportionately benefitted the larger firms enabling them to consolidate and sustain their market shares to the disadvantage of the smaller banks. For example, the Funding for

Lending Scheme initially focused on the larger banks and in order to maximise utilisation of the very cheap funding available banks needed to pledge collateral with the Bank of England, typically in the form of prime UK mortgage assets. As already noted it is economically impossible for smaller banks to compete with the larger ones for the most prime mortgage assets. As such the largest beneficiaries of the scheme were the biggest banks. Because of the quality of their lower risk lending books the larger banks will continue to enjoy greater availability of ongoing BoE liquidity schemes giving them any ongoing funding advantage, over and above simply lower costs.

- The larger firms have well developed behavioural economics capabilities. They deeply understand how their customers are likely to behave relative to a stimulus. For example in early 2015 the FCA published a paper entitled Cash savings market study report. Within this they raised concerns that huge back books of deposit customers of the large banks revealed material disparities between the rates of credit interest paid to long term deposit account customers on legacy products compared to the newer ones. The FCA inferred action might be taken which, to my mind, prompted the larger banks to seek to reduce the gap in these rates. Which they did by largely pulling their credit interest rates down towards the lowest common denominator. They knew that as all of the larger firms would be doing this at broadly the same time (but not in collusion) there would be minimal customer attrition and they would end up with a lower overall cost of funding. I wholly expect to see the systemic banks reveal in their 2015 interim and year end accounts that the costs of customer deposit funding has fallen. It is difficult to see how this is in the best interests of the customers. The smaller banks do not benefit from customer inertia nor do they typically pay different rates to new and existing depositors. As such the funding disadvantages they suffer relative to the larger firms is likely to increase going forward – especially when base rates rise and the value of the huge non-interest bearing balances held by the clearing banks by virtue of their dominance of the current account market grows. This latter aspect represents a major competitive threat to the smaller banks.

Regulation

- I have covered a number of prudential issues already. I expect that all bankers want to enjoy a sound and sustainable banking system and support the FCA & PRA's role in achieving this. It is however important that rules are applied proportionately relative to an individual firms risk to the overall system.
- During 2014 the PRA and FCA between them published nearly 60 Consultation Papers many of which directly applied to UK banks. These ran to nearly 6,000 pages. Substantial volumes of additional papers were published by other regulatory bodies. Small firms by definition have very finite resources and the sheer pace of change in the regulatory environment presents a major challenge. In my estimation the cost of ensuring regulatory compliance for the smaller firms will be a much

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higher percentage of their total revenues than for the larger firms. It is critically important that the cost of regulation does not in itself become a barrier to growth.

Summary

This latest market investigation is welcome. However I fear that unless a holistic view is taken the opportunity to really stimulate UK bank competition and in so doing achieving a better outcome than the last two reviews will be missed.

I believe four key steps could be taken that will foster greater competition across the board offering consumers and businesses more choice and in so doing creating the potential for the too big to fail problem to begin to be addressed as leveling the competitive playing field would allow normal market forces to function much more effectively than is currently the case. These steps are;

1. Creation of a Smaller Bank growth fund which allows established smaller banks to borrow via HM Government at the same effective funding costs as those enjoyed by the systemic banks on the back of the implicit government subsidy.
2. Allow the established smaller banks to risk weight their lending assets at the average of the top ten biggest firms.
3. Require clearing banks to provide access to the payments system at a fair price and not just the highest they can negotiate and agree industry standard service level agreements.
4. Ensure all regulation is proportionate and is targeting relative to the individual firms risk to the safety and soundness of the overall system.

I look forward to discussing matters in more detail in person.

Kind regards,

Yours faithfully

Paul Lynam, ACIB, AMCT, Fifs
Chief Executive Officer
Secure Trust Bank PLC