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

Non-confidential version

20 November 2015

Dear Sir,

CMA Provisional Findings and Possible Remedies

I write to express my significant disappointment that despite the CMA's clear acknowledgement of some of the root causes of the ineffective competition in UK Banking, the provisional findings and possible remedies are largely superficial in nature and will do almost nothing to help create the level competitive playing field that is urgently required in order to foster genuine competition.

I recall a speech given by Mr Osborne 4/2/13, which included the following words;

"One of the prices we're paying for the financial crisis is that our banking sector is now dominated by a few big banks. It verges on an oligopoly. 75% of all personal current accounts are in the hands of just four companies.... I want upstart challengers offering new and better services that shake up the established players...... We're seeing new banks like Metro Bank on our high streets – but I want to make it easier to start a small bank and grow the business."

Given the ongoing pro competition support from politicians and consumer groups, I was expecting to see the provisional findings set out immediate decisive steps that would address the obvious disadvantages faced by existing small banks and in so doing make it easier for them to grow. Instead I regret to opine that the provisional proposals will have no material tangible effect whatsoever thereby ensuring the perpetuation of the 'oligoploy'. The absence of meaningful interventions by the CMA coupled with recent developments such as the bank corporation tax surcharge will only make it harder, not easier, to grow an existing small bank.

I should also note that I find it somewhat ironic that the Bank of England and Prudential Regulation Authority are making a stronger case for a level playing field than the CMA. This feels very odd to me. Please refer to the appendix attached.

My 'Challenger Bank' CEO peers and I met with the Alasdair Smith and his group on 3rd July 2015. We highlighted that the previous competition investigations had been abject failures as evidenced by the fact that the market shares of the five biggest banks and Nationwide BS have grown since and these six firms have become more dominant, not less. An 'oligopoly' some might say. We explained that past reviews had failed to take a holistic perspective. Instead they largely focused on one aspect being current account switching and as a result sought to address symptoms but not the root causes of ineffective competition. Inevitably this meant any hope of fostering real competition was doomed to fail from the start – as history clearly shows. We stressed that the CMA needed to learn from past mistakes and avoid a myopic focus on current account switching. We highlighted that the real inhibitors of effective competition in UK banking are, disproportionate capital requirements, huge funding cost disadvantages, inadequate access to the payments infrastructure and a largely one sizes fits all regulatory regime. Sadly it appears from the CMA announcements to date, that this counsel, from the very banks the Chancellor says he wants to help, has fallen on deaf ears.

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As matter stand, and barring substantial changes, I fear that the 2014-16 investigation will go down as yet another missed opportunity. As a result the CMA is running the very real risk of letting down UK consumers and business – the cohorts the CMA is supposed to safeguard.

Let me explain my thinking. When considering the provisional CMA report it is insightful to look at a different industry like supermarkets. For a long time there were 5 dominant incumbents making cosy profits and enjoying high share prices. Their dominance allowed them to strangle suppliers in respect of prices and payment terms. Along come Aldi and Lidl. The new insurgents created vigorous competition offering more choice and lower prices. Faced with this threat the dominant incumbents have responded by investing in their customer propositions and cutting prices. It was announced on the 17th of November that these new players have taken a combined 10% market share from the incumbents, whose profits and share prices have suffered. The consumer has benefited enormously from this real time example of effective competition in action. Indeed such is the effect of the competition that lower food prices is a major factor behind the ongoing levels of low / no inflation. This in turn is increasing disposable income which households are spending elsewhere thereby helping the broader economy to grow. Save for investors in the dominant supermarkets, it is difficult to see any downside here for the UK or its consumers.

Aldi and Lidl have been able to take a meaningful market share from the incumbents because the supermarket industry has a broadly level competitive playing field. These insurgents do not require disproportionately more capital to grow than their competitors and pay the same price for the goods they buy to on sell as the Tesco's and Asda's. No such level playing field exists in banking and the CMA provisional proposals fail to adequately address the fundamental and very stark inequities in Funding, Capital, Access to Payments and Proportionate Regulation.

It is also worth noting that the UK government could allow one of the large supermarkets to fail without the risk of it doing catastrophic damage to the economy. By contrast unless a level playing field is created in UK banking the ongoing 'Too Big to Fail' (TBTF) banking problem will persist indefinitely. The UK taxpayer will remain exposed to the potential of having to bail out TBTF banks that get into trouble in the future. Even in ring fenced form Lloyds will remain by far the largest bank for consumers in the UK and RBS the largest for businesses. As such there is no chance these would be allowed to fail. The ring-fencing and revised regulations are designed to reduce the risk of such a firm failing but in practice wholesale funders know TBTF banks will not be allowed to fail and therefore they will continue to derive an annual multi £bn funding subsidy on the back of this implicit UK government guarantee. The CMA's observation (page 352) that the TBTF subsidy *'is reducing in magnitude and can be expected to diminish further'* is frankly disingenuous and fails to recognise that this remains an ongoing annual multi £bn benefit which along with their dominance of the current account and inert deposit account markets explains how they can lend profitably at prices lower than smaller banks pay for deposits, as shown on the next page.

It is important that as you consider your final findings you adequately address the major barriers to growth facing the smaller banks and create the conditions called for by the Chancellor in 2013 to make it easier for small banks to grow. This means initiating the steps needed to create the same sort of level playing field that has seen competition flourish in the supermarket industry which has ultimately benefitted the consumer and the UK at large. Current account switching has slowed in the ended 30/9/15 only 1.03% of customers switched compared to 1.2% in the prior year. Such low levels of switching will not be addressed by the token gestures such as the price comparison website proposed. A much more radical plan is required and the CMA still has time to deliver.

I set out below some further comments on the views expressed by the CMA in the key areas of Funding and Capital.

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Funding

Whilst I agree with the provisional finding that the access to Retail Deposit funding is not a barrier to growth, I totally disagree with the view that smaller banks do not suffer disadvantages in respect of the cost of funding. There is overwhelming evidence to support my assertion here.

The section relating to funding appears to be written from an academic rather than a practical perspective. For example the comments in respect of best buy league tables seem to show a lack of understanding of how these things actually operate in the real world.

Detailed below is best buy league data (as at 19 November 2015) for fixed rate mortgages and fixed rate deposits. It is plainly obvious that the best buys for mortgages are the systemic firms. The best buys for deposits are the smaller banks. It is readily apparent that the TBTF lenders are providing loans (which will be profitable for them) at a lower cost that the smaller banks offer for deposits. In simple terms the bigger firms can lend money out for a lot less than the small banks can fund themselves. As the table below shows, a customer can borrow money from a TBTF bank for 2 years and more than double their return by placing this on deposit with a smaller bank and enjoy a risk free return, ultimately insured by the UK taxpayer via the FSCS.

Fixed Rate Mortgages (50% LTV)			Fixed Rate Deposits				
Firm	period	APR	Firm	period	AER	+Ve	+Ve%
HSBC	2 years	1.19%	Shawbrook Bank	2 years	2.45%	1.26%	105%
Co-op	3 years	1.79%	Al Rayan Bank	3 years	2.73%	0.94%	52%
HSBC	5 years	2.19%	Secure Trust Bank	5 years	3.05%	0.86%	33%

This very obvious arbitrage is a clear example of a dysfunctional market and tangible evidence that the systemic firms are enjoying massive funding advantages, which sustains their dominance.

The comments in the CMA report that large banks feature on the best buy league tables for deposits, needs putting into context. The aggregators are obliged to detail <u>all</u> products available. But the vast majority of business will go to those that are genuine 'best buys'. That is why these sites work in the first place and is exactly why firms pay the price comparison websites for 'prominence'. This results in their offering being the first that appears on the landing page of the website and drives business to that provider. It is blindingly obvious that a bank offering a much lower rate of interest for a 2 year deposit than Shawbrook, especially for deposits covered by the FSCS guarantee, will attract a lot less deposit business, in proportionate terms, than Shawbrook. Any inference that by featuring way down the best buy league tables the big banks must be actively competing on price for deposits is misleading.

The comment at 10.130 (page 340) is a fair academic observation. The cost of funding can be considered a combination of three elements being the risk free rate, a credit risk premium and a liquidity risk premium. Again this needs to be considered from a practical perspective and one needs to understand why these factors give the TBTF banks unassailable advantages. The TBTF banks utterly dominate the current account and the inert deposit account market. This gives them very cheap and stable funding which is reflected in their liquidity risk premium. Their credit risk premium is influenced by their dominance of the low risk low loan to value mortgage market and their too big to fail status which generates an annual multi £bn funding subsidy.

A number of the TBTF banks have publicly stated their intention to widen their net interest margins as base rates increase. In simple terms what they mean is that they will not pass on the full benefit of any base rate increases to their depositor customers. They will also see an immediate increase in the value of their non-interest bearing balances dues to their stranglehold on the current account market. As a result their huge funding advantages will grow as base rates increase.

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Small banks do not have huge inert customer bases or large back books of low cost deposit customers. In aggregate have a lending portfolio which is higher risk than average because they cannot compete on a sustainable economic basis for the lower risk mortgage or lower risk SME lending assets. This is a function of their funding and capital disadvantages and represents a vicious and self-perpetuating circle.

The CMA's view that the funding benefits enjoyed by the TBTF banks are to a large extent related to their incumbency advantages and that these will be resolved by the CMA's proposals to increase switching are dangerously naïve and need urgent reconsideration. I believe I have set out above very clear evidence of the extent of the problem.

The CMA needs to recommend measures that will help to equalise the current funding costs differentials between TBTF and small banks which would act as a circuit breaker allowing, over time, the smaller firms to grow broader based and lower risk lending portfolios thereby sustainably reducing their credit risk and liquidity risk premiums.

Capital

It is encouraging to see an acknowledgement that the current capital requirements have *'the potential to distort competition and act as a barrier to entry and expansion for smaller banks in retail banking'*. I am also encouraged that the CMA is to give this matter further consideration and I hope to see genuinely radical proposals emerge.

I would like to counsel the CMA from putting too much store in the assertions by larger concerns that the impacts of add on buffers and leverage ratios effectively counter balance the IRB benefits enjoyed by the TBTF banks. It is of course technically correct that add ons reduce the capital requirement differentials but this is very much at the margin and in practice has no competitive impact whatsoever. The table below shows the impact of the add ons on Globally Systemically Important Firms (GSIF). It is readily apparent that the pre and post add on advantages remain absolutely enormous. It should be noted that only Barclays, HSBC and RBS are subject to a GSIF buffer requirement which ranges from only 1% to 2.5% of risk weighted assets.

	Standard risk weights%	Average IRB weights %	Difference to standard	Post GSIF buffer risk weights %	Difference to standard
Mortgages – Prime					
<50% LTV	35	3.3	- 960%	3.4	- 929%
<60% LTV	35	5.1	- 586%	5.2	- 573%
<80% LTV	35	10.8	- 224%	11.1	- 215%
Mortgages – BTL					
<50% LTV	35	3.5	- 900%	3.6	- 872%
<60% LTV	35	8.2	- 326%	8.4	- 317%
<80% LTV	35	17.5	- 100%	17.9	- 95%
Large Corporate	100	54.1	- 84%	55.5	- 80%
Mid Corporate	100	79.0	- 27%	80.9	- 24%
SME Lending	100	77.1	- 29%	79.0	- 27%

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The CMA should also note that all banks are subject to capital conservation buffers (CCB). This is initially set at 0.625% of RWAs and has a disproportionate impact on banks on the standardised approach due to their higher RWAs to begin with. The CCB actually increases the smaller banks disadvantage. For example, in the table above the standard banks <50% prime mortgage risk weight becomes 35.2% (+0.2%) and the GSIF bank becomes 3.42% (+0.02%).

The various assertions about the counterbalancing impact of the leverage ratio are red herrings and smokescreens. Whilst in theory the 3% leverage ratio implies a 35% risk weight floor on IRB firms, in practice this has no practical impact on their competitive activities. If proof is required simply review the best buy leagues for Personal Loans, Motor Finance, Credit Cards and Mortgages. These are dominated by the TBTF banks. Their very broad range of products and enormous back books means it is very easy for them to optimise the composition of their overall asset portfolio so as to maximise their IRB benefits.

Possible Remedies

I have to express my astonishment at the superficial nature of the 15 possible remedies proposed and the CMA's contention that these are radical. The Oxford dictionary definition of radical reads' *adjective (especially of change or action) relating to or affecting the fundamental nature of something; far-reaching or thorough.*

The possible remedies proposed thus far can in no way be considered far reaching or thorough, not least as there are no meaningful proposals to address the huge disadvantages suffered by small banks in terms of Disproportionate Capital, Expensive Funding, Access to Payments Infrastructure and Excessive Regulation.

Instead some of the proposed remedies absolutely favour the TBTF banks. For example Remedy 15 states *'Loan providers would be required to make available on their websites a tool that would permit SMEs to enter the amount they wished to borrow and over what period, together with either their credit rating or questions which would enable the provider to assess their creditworthiness, and for the provider to give an indication as to whether, and if so on what terms, they would be willing to make the loan.'* Ignoring for a moment the technical difficulties and the fact that almost no SME will have a recognised credit rating; it is worth thinking what might happen here? The TBTF banks have huge capital advantages (see table above) and huge funding advantages (see table above). Therefore starting an online price comparison war for SME lending, in the absence of fundamental proposals to equalise the capital and funding differentials extant, will simple play right into the hands of the TBTF banks. They will be able to use their data, funding and capital advantages to cherry pick the lower risk loans leaving only the higher risk loans available for the smaller lenders. Writing these loans, through economic necessity, would mean that the credit risk premium differentials identified by the CMA would be perpetuated leaving the smaller banks in a vicious circle they would be unable to break out of. This possible remedy is misguided.

I do agree that some of the proposals such as remedy 6, the standardisation of account opening forms, will be helpful. But overall the remedies need to be fundamentally rethought and targeted to drive wholesale changes across the board rather than be almost exclusively limited to measures which, at best, will only result in marginal incremental changes in current account switching.

Summary

Whilst I acknowledge that the provisional findings are by definition 'work in progress' I am extremely concerned that the possible remedies outlined are very narrow and do nothing to address the principal causes of the recognised ineffective competition in UK Banking.

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I believe that in order to foster more effective competition the CMA needs to significantly broaden its horizon and make genuinely radical proposals that serve to create a leveling competitive playing field in all products, not just current accounts. We have seen how effective competition in other industries has benefitted consumers and the UK at large. The CMA needs to foster the same sort of fair and effective competition in UK Banking and this cannot be truly and sustainably achieved without a level playing field. I therefore call upon the CMA to;

1. Make proposals that serve to equalise the current huge funding cost differentials that exists between the TBTF banks and the established smaller banks.
2. Make proposals that allow established smaller banks to compete more effectively for lower risk mortgage and business lending assets by redressing the hugely disproportionate capital requirements imposed upon them. One option could be to allow the established smaller banks to risk weight their lending assets at the average of the TBTF firms.
3. Direct that smaller banks be given access to the payments system at a fair price, without onerous obligations and supported by industry standard service level agreements.
4. Direct that all regulation (including conduct and prudential) is proportionate and is targeted relative to the individual firm's risk to the safety and soundness of the overall system.
5. Call upon HM Government to reconsider the thresholds at which the bank tax surcharge is applied so as to avoid the scenario whereby the increased tax generated from smaller banks is effectively used to pay for a reduced banking levy on the TBTF firms.

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

Yours faithfully

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

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BANK OF ENGLAND

RESPONSE TO THE EUROPEAN COMMISSION'S PUBLIC CONSULTATION ON THE POSSIBLE IMPACT OF THE CRR AND CRD IV ON BANK FINANCING OF THE ECONOMY

ANNEX 2: The case for a more proportionate regulatory regime

Summary

1. Unlike other large jurisdictions, such as the USA, the EU applies the same rules to all its banks in seeking to achieve a level playing field.[1] Consistent standards are key to delivering safety and soundness in the financial system and thus the Single Market. That is particularly the case for large, internationally active banks. But a "one size fits all" approach of common binding rules for all banks, no matter what their size, complexity or level of cross-border activity, can cause distortions given that the costs of regulation tend to bear more heavily on smaller banks. Policy makers need to weigh the desirability of the same rules for all firms with wider objectives, including growth, financial stability and effective competition. More proportionate, differentiated rules are more likely to enable banks of different size and business model to compete on an equal footing across the EU than the same rules applied to all banks.

2. The costs of regulation must be proportionate to the benefits. The benefits and costs vary across banks of different size and business model. Often the benefits of regulation are proportionately bigger for larger or more complex banks, while to the extent that regulation imposes fixed costs those will tend to bear more heavily on smaller banks.

3. The financial stability benefits from regulation of large, internationally-active banks mean these firms should meet the global standards that are designed with such banks in mind. Broadly speaking, EU regulation already reflects the greater benefits from applying tighter requirements to such banks. For example, higher capital buffers are required for large, interconnected banks and recovery and resolution planning is also tighter. But aspects of EU regulation are not fully consistent with those global standards, partly due to the need to apply rules across all banks.

4. A differentiated approach would allow the EU to align regulation of larger banks more closely with global standards, thus supporting financial stability. But it can also recognise the lower benefits, and sometimes higher costs, from regulation of smaller banks. More

[1] The term 'bank' or 'firm' is used throughout this document to refer to credit institutions covered by the CRR/CRD IV.

proportionate rules can help to promote competition and growth. That, in turn, can enhance the resilience of the banking system: lower barriers to entry foster competition, allowing new banks to substitute for any loss in the provision of finance by less resilient firms, while growth improves loan performance, supporting profitability. While there are clearly challenges in putting a more proportionate approach into effect, including defining the boundary between groups of banks to which different rules might be applied, these have been overcome in other jurisdictions, such as the United States which applies a narrower set of regulatory rules to smaller banks, and only applies global standards to large, internationally-active banks. The gains for the EU of adopting a similar approach could be material.

5. A more proportionate approach could be adopted for many aspects of bank regulation. For example, there is a case for ensuring that regulatory reporting requirements do not go beyond what is necessary for effective supervision of smaller banks. Regulation could also be tailored to business models: the benefits from the prospective application of the Net Stable Funding Ratio should be larger for banks that rely more heavily on wholesale funding. Differentiated approaches should be carefully designed to avoid unintended distortions: there is a need to reduce the competitive imbalances that exist between firms using model-based approaches for estimating mortgage risk weights relative to firms on standardised approaches. These imbalances can have unintended effects on the safety and soundness of banks by encouraging banks on standardised approaches to compete for riskier mortgages, where the capital differentials are less marked. Finally, remuneration policy should also be proportionate to the risks the policy is meant to mitigate and the cost it imposes on a firm.

Framework for assessing the proportionality of regulation

The benefits of bank regulation

6. We regulate banks to offset market failures that can surface in the event of their distress or failure. Banks tend not to take sufficient account of the negative effects that their failure can have on creditors and the financial system. The impact of failure on a bank's creditors tends to vary with the size of a bank, suggesting the need for a common basic level of regulation across all banks. But some market failures, such as spillovers to the wider financial system from bank stress or failure, are more apparent for larger banks,

for banks that play a key role in certain markets, and for banks that provide critical services to the wider financial system or economy.

7. While spillovers from the failure of individual small banks may be modest, problems arising in small banks can be systemic in aggregate. For example, if small banks were to face problems simultaneously - as has been seen in some previous financial episodes, such as the US savings and loans crisis - the combined effect could be much more material. This point reinforces the need for minimum standards even for the smallest banks.

8. There are also benefits from regulation in a cross-border context. Regulation can mitigate spillovers across borders arising from bank failure, and can help ensure that jurisdictions do not engage in a 'race to the bottom' by lowering regulatory standards to favour national interests. These benefits tend to be greatest for large, internationally-active banks.

Costs of regulation

9. Regulation entails various private costs for banks – for example, the costs of maintaining capital and liquidity ratios at levels above those that a bank might choose absent regulation and, not least, costs involved in understanding and complying with regulatory requirements. To the extent that these costs are fixed, they tend to bear more heavily on smaller banks. While EU bank regulation already recognises the greater benefits from applying tighter requirements for some banks, it does not adequately reflect the relatively higher costs that regulation imposes on some firms. Parts of CRR/CRDIV do allow some exemptions for certain firms, but in general there is limited tailoring for smaller banks which means the costs of regulation may not always be proportionate to the benefits.

10. It should be noted that even regulation that is designed to reflect differences across banks can lead to unintended secondary distortions. An example is credit risk, where regulation provides for both simple standardised approaches and internal models. However, big differences in capital requirements between the two approaches undermine competition between small and larger banks. Work to reform these approaches is underway in Basel.

Developing a more proportionate regulatory regime

11. This cost-benefit approach has several implications:

(a) it highlights the need for common minimum capital requirements for all banks to mitigate the negative externalities that banks can impose on their creditors;

(b) it supports the higher regulatory standards for larger, systemically important banks, and banks that are systemic in certain markets; and

(c) it points to the need for greater consideration of the private costs of regulation.

12. A more proportionate approach could be adopted for many aspects of bank regulation. Examples include:

- **Regulatory reporting** should require information to be reported to the extent that it is necessary to obtain a comprehensive view of the risk profile of a bank's activities and of the systemic risks posed by banks to the financial sector and the real economy. It is likely that smaller banks are currently reporting more information than is necessary to meet this aim, at disproportionate cost. Reporting should be more tailored to bank size.

- The **Net Stable Funding Ratio** (NSFR) is not part of the current regulatory regime but may be introduced in the future to tackle risks associated with over-reliance on wholesale funding, which has played a major role in many financial crises. Applying a "one-size fits all approach" for the NSFR could mean disproportionate costs relative to benefits for banks whose business models do not involve wholesale funding. In this case, regulation might be tailored by bank business model.

- CRR/CRDIV does provide for differentiated approaches for **credit risk** across different groups of banks, by allowing both standardised and model-based approaches to be used to calculate capital requirements. However, internal models tend to generate significantly lower risk weights on average than the standardised approach for certain exposures. For example, models in the UK deliver risk weights of between 3% and 15% for mortgages with loan-to-value below 80%, compared to 35% under the standardised approach. Although large banks face additional capital buffers and are subject to leverage ratio requirements, this differential creates an uneven playing field between different sized banks. It can have unintended effects on the safety and soundness of banks by encouraging smaller firms to compete for riskier mortgages, where the capital differentials are less marked. This underlines the need to reform standardised

approaches to allow for greater risk sensitivity and ensure that internal models are adding risk sensitivity based on genuinely better and more robust information.

- **Remuneration policy** should also be proportionate to the risks the policy is meant to mitigate and the cost it imposes on a firm.

Conclusions

13. In differentiating rules across banks - by size or business model – it would be important to avoid rules that create 'cliff effects' in regulation that would impede effective competition and inhibit the growth and development of banks. A more proportionate regulatory regime must also account not only for the size and business model of banks but also for the extent of cross-border activity.

14. While there are clearly challenges in putting a more proportionate approach into effect, these have been overcome in other jurisdictions, such as the United States which applies a narrower set of regulatory rules to smaller banks, and only applies global standards to large, internationally-active banks. The gains for the EU of adopting a similar approach could be material. Differentiated regimes could allow both for closer alignment of EU regulation of larger banks with global standards, and more proportionate regulation of smaller banks. That in turn can promote competition, growth and financial stability.