Atom Bank plc

Northumbria House

Durham

5th April 2016

Dear Sir or Madam,

The Capital Requirements Regulatory Regime. Addendum to provisional findings

We welcome this report and concur with its provisional view that the capital adequacy regime puts Standardised Approach (SA) banks at a relative and significant competitive disadvantage when supplying lower risk residential mortgages.

However, we consider that the degree to which these disadvantages hinder non-IRB banks has not been captured fully. This issue fundamentally constrains the ability of SA banks to compete in the lower risk residential lending. Its effect is particularly acute for early stage banks who are competing for capital, and in our view, this has been a major factor in driving new entrant banks to specialise in higher risk lending segments. In the long term, we cannot see how this is desirable from a prudential standpoint.

We see little logic for a discrepancy in capital requirements on this scale. IRB approaches were designed to encourage the development of strong risk management. That objective is uncontroversial, but **all** banks must maintain high standards of risk management regardless of whether they are IRB approved, and if there are differences in standards, we don't see that this can justify a need for so much more capital. The regulators have many less blunt tools to penalise weak risk management. This seems to achieve little except to protect the mainstream market for the large incumbents.

In a well-functioning market, capital will flow towards areas of financial opportunity and this is the fuel for increased competition in those segments. "Challenger" banks have been successful in attracting new capital in recent years but it seems that the business models that have been supported have in the main been quite specialised. This has occurred despite the residential mortgage market as a whole offering more than £200BN of gross new lending p.a., low risk characteristics and attractive returns on *economic c*apital. In our view this has inappropriately skewed the market's allocation of capital.

We also consider that whilst SA banks supply lower LTV mortgages, they do this in order to achieve a balance of risk in their portfolios and to offer a sufficiently broad customer proposition despite unattractive returns on regulatory capital IRB banks do not have this issue. The absence of any major new entrant into the mainstream residential market is telling (and contrasts with SME lending for example). We believe that a major reason for this is that returns are attractive only to the limited set of IRB banks.

SA banks have needed to make progress in improving their cost efficiency and customer service to offset these capital disadvantages. Some of the best cost efficiency ratios and net promotor scores have been reported by the challenger banks. However, it does not serve the customers or shareholders of SA banks well if those improvements are used to compensate for their relative disadvantages in capital requirement.

The CMA should be aware that this is one of several major obstacles that new banks have to overcome and in combination, these pose much more of a barrier to successful entry into the banking market than is conducive to the development of effective competition. For example new banks:

- require considerably more capital (this issue) and start-up/early stage investors require a higher return on it;
- struggle to translate cost leadership into compelling customer propositions due to the loss-leading practises of established banks including 'free' current accounts or zero-rate credit cards (where 'transactors' are heavily subsidised by 'revolvers');
- are restricted in their access to wholesale markets and pay a premium where they can source it relative to large banks supported by an implicit government guarantee;
- cannot easily set up their own clearing capabilities and rely on large banks to provide access – a service they provide reluctantly, if at all.

Unless these barriers are fully dismantled, challenger banks will, despite their best efforts, continue to make progress only in niches or will simply provide another round of consolidation opportunities for the incumbents. This is not what the UK banking sector needs.

We have some more detailed comments on the report which are set out below. We would be very pleased to discuss these matters with you in more detail if it helps in finalising your report

Yours,

Mark

Mark Mullen
Chief Executive, Atom Bank plc

Detailed comments

1. Funding cost disadvantage

We note the provisional findings of the PRA review and that it seeks to isolate the degree to which the introduction of Basel II risk weightings has caused a gap to open up between IRB and SA banks in respect of price point or volume, when applied to low LTV lending. The analysis estimates that a disadvantage of 42bps has arisen between SA and IRB banks in the pricing of these loans.

Our own estimates do not differ significantly from this (at 12% ROE) although we would indicate 50bps as more representative (as set out below).

Table 1 of the report demonstrates the scale of the disadvantage in weighted average cost of funds for SA banks versus IRB banks. Whilst acknowledging that this is an illustration, if modified to allow for the impact of corporation tax and to incorporate a more realistic common equity tier 1 target[1], this would show that SA banks experience, as indicated, a pricing disadvantage at 50% LTV of c. 50 basis points if targeting the same 12% ROE (after tax).

The addendum report explains that such impacts could either be passed on to the customer in higher pricing or be borne by the bank through a reduced ROE (or combinations of the two). To illustrate the point, we have shown both extremes.

a. Impact on price competiveness

It is our view that a 40-50bp pricing disadvantage if passed onto the customer is highly significant.

The Mortgage Market Review (MMR) has resulted in a situation where a large majority of mortgage sales are advised, and it also requires that those advisors must recommend the most suitable product to their clients based on the superiority of at least one of price, customer service or lending criteria.

Our judgment is that a disadvantage of 40-50bps (+50bps would cost a customer[2] with a £150k mortgage an extra c. £700 a year) will generally be too great for a product to be recommended on the basis of price and hence the bank supplying that product is likely to focus on the latter two elements. Whilst a drive for superior service is desirable, a drive to compete on lending criteria is likely to impact upon the bank's risk profile and therefore may not be. In any case it is clearly unfair for specific banks to be hampered in their ability to compete on all three fronts.

SA banks will often feel a need to sell low LTV mortgages despite the low returns they offer. That is because they will generally require a balance of credit risks to achieve a desired risk standard set by the board or regulators. Since the price point must be competitive to sell, this may often be a loss leader with the greater returns from higher LTV lending compensating to achieve a suitable blended return. This leaves them highly exposed should those more limited markets contract or the margins compress.

b. Impact on ROE

This same c. 40-50 bps disadvantage if instead borne in full by the bank is also highly significant. Banks that depend in large part on mortgage business typically report net interest margins of 100-150bps and around 50% of that income will generally be consumed by operating costs and normal credit losses resulting in a pre-tax return on assets of 50-75bps (indicative).

Due to the structure of bank balance sheets, a 40-50bps squeeze in NIM will be leveraged both operationally (due to the fixed costs of running a bank) and in capital terms to result in a highly significant reduction in return on equity. We simply don't think a bank could successfully compete for the capital it needs for growth, if these dilutive effects were not mitigated by other higher yield assets.

The report indicates that SA banks may be generating lower overall ROEs on average. Whilst appreciating that several factors might explain these differences, in our view it is very likely that much of that effect, at least in respect of their mortgage books, will be due to the differences in capital requirement.

One further point on this. The illustration assumes a target ROE of 12%. That is probably in the ball-park for established banks for whom a low double digit return is now the norm. Note that new banks attract capital on the basis of high implied shareholder returns – private equity for example tend to seek c. 25% returns. So new bank cost of equity is higher and therefore this multiplies the disadvantage beyond the indicated 50bps.

2. Impact upon risk profile

The report indicates that the SA banks when compared with the IRB group, have been growing at a slower pace in respect of low LTV lending and at a quicker rate for higher LTV lending (relative to the IRB group). This is a rational and predictable response to the asymmetry in capital requirements set out above since banks will invariably have an ROE measure as a core target.

This is in line with our experience and will have the consequences of skewing the portfolios of SA banks towards higher LTV lending. It is also likely to be one of the main factors that explains the disproportionate focus of SA lenders on buy-to-let lending since the scale of the disadvantage in risk weights tends to be less for those products. Whilst certain banks have developed strong capabilities in these lending segments, it is not, in our view, fair that regulation in itself should drive a need to specialize in certain risks to be competitive.

Furthermore, both the cost of debt and cost of equity are likely to be higher for banks with a riskier and less diversified asset profile than the norm. Such discrepancies are examined carefully by rating agencies and equity investment analysts and with a likely adverse impact on ratings. The logical consequence of a lower rating from either of these sets of opinion-formers, is that such banks will pay more for each unit of both debt and equity, whilst also needing relatively more of the latter element.

This is an important point that is overlooked in the analysis. 12% ROE (using the level set out in your illustration) may be a value adding return for an established bank with a diversified set of assets, but it is unlikely to be acceptable for a bank with a higher risk asset profile.

3. Practicalities of achieving IRB status

The report explains that the availability of historical data is one of the main limiting factors in applying for IRB status and indicates that a minimum of 3 to 5 year's data is required – quite possibly more. It also explains that the cost of both preparing the IRB waiver application and of maintaining that capability it is very high and may weigh more heavily on smaller banks. Again we concur with these views.

The addendum report shows that eleven banks currently apply IRB treatment to their mortgage books. It is very hard for new lenders to achieve IRB status despite aspirations to the same high standards in risk management.

We acknowledge the logic of requiring all banks to prove their risk management credentials before allowing the flexibility in determining the capital requirements that IRB gives. However, the cost of achieving that it is a major barrier. Achieving IRB permissions requires aspirants to invest directly in the capability and even more significantly, to operate sub-optimally in those lending areas for many years until an adequate data set has been built. This is a considerable deterrent for existing lenders and even more so for new ones that have not inherited that history.

This impact is marked for new banks like Atom. New banks seek equity investment to back their business plan and securing such investment depends on there being a compelling case to indicate that it has specific competitive advantages in its chosen sector. The institutions providing such finance typically have have finite and relatively short investment horizons and will look for areas of competitive disadvantage as part of their analysis.

In our experience the risk weighting disadvantage is a matter that has been of significant concern for the investor community and the fact that it will take 3 to 5 (and probably more) years for the disadvantage to unwind is likely to have deterred certain investors from backing new banking initiatives. It is asking a lot of them to accept the certainty of subs-standard returns for that length of time.

4. Other capital requirements

The report makes reference to the other capital requirements that are borne disproportionately by the larger banks and also refers to the the PRA's statement to the effect that they seek to 'level the playing field' where they have discretion to do so. In practise we think they will find it hard to do so since they also need to consider Pillar IIA risk assessments and Pillar IIB stress testing results; perversely, since SA banks are likely to be pursuing higher LTV lending strategies they may well need more Pillar II capital.

We also note that the PRA's discretion is limited by EU law and the Basel Accord and that even where they do have discretion (in setting the ICG) we don't think that this will persuade investors that the playing field has been levelled since those determinations are not transparent.

It is also important to note that the markets in general set an expectation upon banks to report an acceptable core equity tier 1 ratio – probably now 10-12% for new banks. CET1 is a simple ratio of capital to risk weighted assets and so any mitigation of requirement would not be evident in that ratio and therefore capital is probably not 'freed-up'.

We also question whether reference to other capital requirements is relevant at all to this review. These requirements are set for different reasons (indeed if they were not it would be appropriate to should dispense with much of the complexity in the capital regulation regime). For example, the additional capital buffers required by systemically important banks exists for a very specific reason in that they benefit from the implied support of the government and therefore the government needs additional capital protection (relative to a bank that is not in this position). Those banks enjoy cheaper costs of debt than would apply without that implied support and this will be reflected in their NIM. Having benefitted in this way it would be inappropriate to consider that the additional capital costs compensate the SA banks for the risk weighting asymmetry.

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[1] The illustration set out in Table 1, works out the weighted average cost of funding assuming a target ROE for banks of 12%, a cost of debt of 2% and a capital ratio of 8% (being the regulatory minimum). Accepting this is an illustration, it misses practical points that help scale the pricing disadvantage.

Firstly, Banks cannot operate on a minimum 8% capital ratio partly due to Pillar II requirements (resulting in IRR and buffer requirements) and partly due to establish market norms for the reported ratio. The norm has probably settled at at least 10% and perhaps as much as 12% for common equity tier 1 (revised calculation assumes 11%).

Secondly, debt is tax deductible and this considerably increases its attractiveness relative to equity which is not. ROE is a post-tax measure hence its gross equivalent is 15% or to put it another way the net cost of debt costing 2% is 1.6%.

Replacing the inputs in table 2 with these, the cost of funds for SA bank is xx and for SA bank at 50% LTV xx% which indicates that the economic cost of the disadvantage is xx bps.

[2] Calculation is based on an indicative £150,000 loan repaid over 25 years