Secure Trust Bank
One Arleston Way
Solihull
West Midlands
B90 4LH T 0121 693 9100

Secure Trust Bank
Simple, straightforward banking

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

Non-confidential version

6 May 2016

Dear Sir,

**Addendum to Provisional Findings 15 April 2016**

I write in response to the above inviting comments. In overall terms I find the CMA's review of the Capital Requirements bittersweet. Sweet because some key barriers are being recognised. Bitter because the CMA proposes not taking any firm specific actions to redress these issues which distort competition.

I was pleased to note some of the CMA's key findings;

- The capital requirement regime places smaller banks at a competitive disadvantage.
- The PRA has confirmed that the capital requirement differentials in low LTV mortgage lending is larger than can be justified or considered appropriate on prudential grounds.
- Smaller banks have to charge more for low LTV mortgage lending than bigger banks, by definition putting them at a disadvantage.
- Smaller banks are writing proportionately more higher LTV mortgages whereas large banks are writing proportionately more lower LTV mortgages.
- Mortgage lending is the most profitable part of the UK lending market and the profitability of the dominant incumbent banks is materially higher than the small banks.

Putting the above into context, the UK mortgage market represents the majority of lending in the UK. £1.3tn of the total market size of £1.5tn market for lending to individuals is secured on dwellings. The FCA noted in Q4 2015 that the six largest firms control 80% of the market.

The calculation performed in Table 3 in the report is highly flawed as it assumes that the funding costs of the IRB and Standardised banks are the same at 2%. This is manifestly not the case as detailed below. Larger banks fund their deposits at less than half the cost of smaller banks. They dominate the lending market because of huge funding cost **and** capital requirement advantages.

| Company | BARC | RBS | HSBC | STB |
|---|---|---|---|---|
| Year end | Dec-15 | Dec-15 | Dec-15 | Dec-15 |
| Currency | £m | £m | $m | £m |
| Interest expense | 4,643 | 3,158 | 14,658 | 22 |
| Customer deposits b/f | 427,704 | 361,639 | 1,350,642 | 608 |
| Customer deposits c/f | 418,242 | 370,298 | 1,289,586 | 1,033 |
| Customer deposits avg | 422,973 | 365,969 | 1,320,114 | 821 |
| Interest expense / deposits avg | 1.1% | 0.9% | 1.1% | 2.6% |

*Source: Company report and accounts*

Secure Trust Bank
One Arleston Way
Solihull
West Midlands
B90 4LH T 0121 693 9100

Secure Trust Bank
Simple, straightforward banking

I have attached a more accurate assessment of the relative profitability of a 50% LTV mortgage using the RBS 2 year fixed rate of 1.7% advertised by them to customers last week. My analysis shows a large bank will generate a 200% RoE on this sort of mortgage asset (ignoring operational costs and impairments) whereas the smaller bank will lose money. This is exactly why the larger banks are writing proportionately more low LTV mortgages – which are also the safest form of lending. The CMA should note that the large banks make more profits from writing lower LTV / lower risk mortgages than the small banks make by writing higher risk / higher LTV mortgages. Intuitively it seems odds that lower risk = higher profits. This doesn't suggest a functioning competitive market to me.

My prior submissions have noted that the previous competition investigations into UK banking have been abject failures as evidenced by the fact that the six largest firms now control more of the market share than before the failure of Northern Rock. In other words the Too Big to Fail problem has got bigger not smaller. The root cause of the failure of previous interventions has been either unwillingness or an inability of the competition authorities to take a holistic perspective and instead address symptoms not causes. I am therefore disheartened to note that the CMA persists with its myopic focus on BCAs and PCAs. A key reason for offering BCA and PCA products is to amass non-interest bearing balances that can be used to fund lending. This is one of the key reasons for the funding cost differentials above. Logically if the disproportionate capital rules locks smaller banks out of the largest, safest and most profitable part of the lending market they are not going to be in a rush to offer current account products.

I would like to stress that the CMA's observations are based on the current Basel rules. The Basel Committee is considering changes to the standardised risk weights. These changes, if consistent with the calibrations proposed in the latest consultation paper, would dramatically increase the capital disadvantages suffered by banks on the standardised model. This would further inhibit competition in UK banking.

I acknowledge that the CMA has limited powers to influence how the global Basel rules are imposed on the UK regulators and thus UK banks by the EBA. Nevertheless I believe it is unacceptable for the CMA to propose to take no concrete action.

In his recent budget the Chancellor said he would be calling on the EU for a more proportionate approach to the regulation of small banks, especially in respect of capital. Later that day the OBR noted that the taxpayer stood to lose £10bn's on the state investment in RBS and Lloyds. Sir Nick MacPherson, Permanent Secretary to HM Treasury, echoed these sentiments in recent weeks.

Nearly 30 banks, including Barings and BCCI, failed in the 1990's. There was no banking crisis in the 1990's. This was because the banking landscape was much more diversified and banks could be allowed to fail without doing systemic damage. Roll forward to 2007. The failure of just one large bank, Northern Rock, partially led to a domino effect that required the state bailout of RBS and Lloyds, who between them control getting on for half of the UK banking market. As the CMA report notes, under the Basel I regime all banks would have risk weighted a 50% LTV mortgage at 50%. No surprise then that a level playing field helped to foster and sustain competition.

The competitive playing field that exists in 2016 is anything but level. Only this week KPMG warned that the 'golden age of the challenger banks is over'. This serves to highlight the fragility of the smaller banks competitive positions relative to the dominant incumbents. This is exactly why decisive action is required by the CMA if sustainable broad scale competition is to flourish.

http://www.telegraph.co.uk/business/2016/05/03/golden-age-of-the-challenger-banks-is-over/

Secure Trust Bank
One Arleston Way
Solihull
West Midlands
B90 4LH T 0121 693 9100

Secure Trust Bank
Simple, straightforward banking

The CMA has rightly discounted the forced breakup of the dominant incumbent banks as a mechanism to drive more competition. RBS are demonstrating just how difficult and time consuming this is. Superficial gimmicks like price comparison websites are not an answer either as these only favour those with the lowest capital requirements and cheapest funding costs i.e. the dominant incumbents.

The most sustainable way to address the chronic lack of competition in banking and address the ongoing concerns of the Treasury Select Committee is for the CMA to set out detailed and definitive steps that will lead to the creation of a truly level competitive playing field especially in respect of Capital and Funding.

I believe it is untenable for the CMA having identified that the capital regime inhibits competition to state that it does not intend to further consider the capital regime as part of the ongoing review. Ignoring such a huge competitive force will surely doom the current CMA review to fail just like previous investigations have. This would represent a disservice to the public who, absent the removal of the Too Big To Fail problem, remain exposed to the potential costs of having to bail out dominant banks that suffer future difficulties.

The CMA should therefore continue its work in this area with a view to making a clear recommendation in its final report that the PRA and HM Treasury should actively pursue a proportionate capital regime with international institutions. Clear recommendation from the CMA in respect of creating a level competitive playing field will help add momentum to the project to improve the proportionality of capital rules and ensure that competition issues are put at the top of the reform agenda.

I am happy to discuss matters in more detail if that would be of assistance.

Yours faithfully

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

| Prime Owner occupied mortgage at 50% LTV | | Small Bank | | IRB Bank | IRB advantage |
|---|---|---|---|---|---|
| Loan to customer | | 100,000 | | 100,000 | |
| Risk weighting * | 35% | 35,000 | 3.3% | 3,300 | |
| Risk Weight Assets | | **35,000** | | **3,300** | **961%** |
| Capital required (credit risk only) | | 2,800 | | 264 | |
| | | | | | |
| Gross income ** | 1.7% | 1,740 | 1.7% | 1,740 | |
| Funding costs *** | -2.6% - | 2,600 | -0.9% - | 900 | **189%** |
| PBT (before operating costs and impairments) | - | 860 | | 840 | |
| Tax | -20% | 172 | -20% - | 168 | |
| **Post tax profit (before operating costs and impairments)** | - | **688** | | **672** | **413%** |
| | | | | | |
| **RoE / RoC** | | **-25%** | | **255%** | **1036%** |

* risk weights are those detailed in CMA Retail banking market investigation report 14 July 2015

** example uses the 2 year fixed rate advertised by RBS and NatWest 28 April 2015

*** cost of funds are is the gross interest margin paid to deposit customers of Secure Trust Bank and RBS as derived from 2015 annual accounts