The Rt Hon Andrew Tyrie MP
House of Commons
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By email to; tyriea@parliament.uk

30 June 2016

Dear Andrew,

Thank you for continuing to highlight the absence of effective broad scale competition within UK Banking and for inviting Paul Lynam to give testimony on behalf of the Challenger Banks at the Treasury Select Committee 7 June 2016.

The EU referendum result, once implemented, means HM Government and the Bank of England will have the discretion to determine which aspects of legislation derived from the EU they wish to be maintained in the UK and which they wish to reform. We hope that will result in a more proportionate approach to the regulation of smaller banks, particularly in respect of capital. This will help smaller banks and building societies compete more effectively and provide more credit to the economy which will be useful especially should the dominant incumbents reduce their lending appetite in a post Brexit environment.

We would like to follow up on some of the points made by Mr Lynam by setting out below our views on diversified and competitive markets, what we consider to be the major barriers to effective competition, and potential solutions that could be implemented in the immediate future. Annexed to this letter we also provide a more detailed analysis of the underlying impediments to genuine competition in the market – **capital, funding and taxation** – and how these can each be addressed.

The contribution of challenger banks to the economy

We believe there are huge societal benefits from a much more diversified banking industry. These include providing greater choice for consumers and SMEs, speeding up innovation and change, improving resilience to recessionary pressures and reducing the risk that the taxpayer loses money from having to bail out banks that get into difficulty in the future.

The UK economy entered the last recession with the six biggest firms controlling approximately 80% of the lending markets. As these systemic firms sought to repair their balance sheets, in aggregate, they shrunk their customer lending and sucked credit out of the economy when it was most needed, arguably causing the downturn to be deeper and more prolonged than would have been the case had the banking market been more diversified. Indeed, we note that the US banking market is much more diversified and recovered faster and more strongly than the UK.

While the biggest banks shrunk, the challenger banks expanded their lending, particularly to SMEs, helping push forward the economic recovery. For example between 2012 and 2014 the big banks' loan books shrank by 2.9% year on year, while smaller banks grew theirs at a rate of 8.2%. Indeed, the smaller challengers' loan books grew at a rate of 32.3%. Challenger banks lend disproportionately to SMEs. We estimate that around 20% of gross lending to SMEs is provided by challenger banks. We believe that a level competitive playing field will allow us to substantially increase the amount of support we provide to consumers and businesses, thereby helping the broader economy.

Competitive markets and the level playing field

When considering the CMA work to date, it is perhaps enlightening to look at a different industry like supermarkets. For a long time there were 5 dominant incumbents, but then along came Aldi and Lidl. These 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. These new players have taken a combined 10% market share whist the incumbent's profits have suffered.

The consumer has benefited enormously from this example of effective competition in action. Such is the effect that lower food prices are a major factor behind the recent low inflation. This increases disposable income which households are spending elsewhere thereby helping the broader economy. With the exception of 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 because the supermarket industry has a broadly level competitive playing field. New entrants do not require disproportionately more capital to grow and pay the same price for the goods they sell, as do the Tescos and Asdas.

No level playing field exists in banking and the consensus view from smaller banks, politicians and consumer groups is the CMA has not adequately addressed the root causes of ineffective competition, being the very stark inequities in Capital, Funding and Taxation.

As Mr Lynam has told the Committee, nearly 30 banks, including BCCI and Barings, failed in the 1990s, yet there was no banking crisis and the taxpayer lost no money bailing out banks. Back then a level competitive playing field meant the banking market was highly diversified and banks could be allowed to fail without doing systemic damage. We would add that in the 2000s banks including Bradford and Bingley and Northern Rock were allowed to fail, wiping out shareholder value and imposing losses on creditors. By contrast the very largest firms, the 'Too Big To Fail' institutions, received massive direct and indirect government support during the last crisis and now control more of the market than they did before the failure of Northern Rock. In the last two months the Office of Budget Responsibility and Sir Nick MacPherson have noted the taxpayer stands to lose billions of pounds on the bailouts of Lloyds and RBS.

Meaningful change – enabling growth and genuine challenge

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, taxation 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 competitive disadvantages noted above.

Without a far reaching holistic approach smaller banks will remain restricted to a narrow part of the market which is underserved by the larger banks. In consequence the small banks 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 pool of opportunity available to the smaller banks becomes too crowded the challengers will become the challenged. 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 dominate the vast majority of the market. The largest banks would of course prefer to see the small banks compete with each other instead of with them.

This asphyxiation effect will only worsen with time. The huge advantages enjoyed by the Too Big to Fail banks will increase as base rates rise, which will increase the smaller banks' funding costs relative to those of the larger banks due to the latter's dominance of the current account market. Proposals to revise the standardised risk weights currently being reviewed by the Basel Committee could result in smaller banks being required to hold even more capital, especially for activities like lending to house builders in the UK.

For the avoidance of doubt, we seek neither favours nor any special treatment. All we ask for is a level competitive playing field. This will allow normal competitive forces to apply which over time should lead to greater diversity across the whole of the UK Banking market. We believe this has clear societal benefits and is in the best interests of the UK economy, consumers and SMEs.

HM Government via statements made by the Chancellor and the creation by HM Treasury of the Challenger Bank High Level Advisory Group are indicative of the recognition of the need for a more proportionate approach to the regulation of smaller banks (including specialist lenders and building societies). At this stage, though, although officials are speaking positively about the proportionality agenda, the positive talk has yet to translate to any tangible action. The EU referendum result, all things being equal, should allow the HM Government to determine its own strategy for the regulation of banks. We believe it would be helpful for the CMA to take account of the referendum outcome and provide firm recommendations for HM Government to take in a post Brexit environment

Annexed to this letter we provide a more detailed analysis of the underlying impediments to genuine competition in the market – **capital, funding and taxation** – and how these can each be addressed. Any support you are able to provide to see these acted upon will be much appreciated.

As ever we are very willing to meet with you and your fellow Committee members to discuss matters in more detail.

Yours sincerely,

Phillip Monks
CEO, Aldermore Bank

Ian Lonergan
CEO, Charter Savings Bank

Graeme Hartop
CEO, Hampden and Co

Craig Donaldson
CEO, Metro Bank

Andy Golding
CEO, OneSavings Bank

Paul Lynam
CEO, Secure Trust Bank

Steve Pateman
CEO, Shawbrook Bank Limited

Annex – underlying problems and proposed solutions

1 – Capital

The issue

For convenience we have set out below extracts from the CMA's paper on capital treatment. In a nutshell for every £1 of capital set aside to cover credit risk, a large bank can do 10 times more low LTV mortgage lending than a small bank or building society. Put another way, for taking exactly the same credit risk the smaller lenders have to set aside ten times more capital than the 6 biggest firms that control 80% of the mortgage market. As capital is a bank's most expensive resource this is a huge competitive impediment.

Lending product	Capital treatment		
	Small bank risk weights	Average big bank weights	Small bank disadvantage
Mortgages – Owner Occupied			
<50% LTV	35%	3.3%	- 960%
Mortgages – BTL			
<50% LTV	35%	3.5%	- 900%

The CMA's own analysis notes the following;

- 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 the biggest banks do.
- Since the introduction of the Basel II capital regime, the largest banks have written proportionately more lower LTV mortgages and the smaller banks are writing proportionately more higher 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 that of the small banks.[1]

We do not believe that in an effectively functioning market the banks taking the lowest risks and setting aside the least capital to support these risks would generate the highest levels of profitability.

Some point to the effects of the leverage ratio and capital buffers as mechanisms that somehow counter balance the capital advantages enjoyed by the dominant banks. This argument needs to be set in context. 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 a globally systemic firm as an example, by 2019 it will be subject to a 2% GSIF firm buffer. But increasing its 3.30% mortgage risk weights (see above table) by 2% to a total of 3.37% is not going to make much of a competitive impact when the small banks are weighting the same assets at 35%. Moreover neither Lloyds nor Nationwide, who between them control a material percentage of the UK market, are subject to these GSIF buffers.

Crucially the imposition of capital 'add ons' across the board serves to further disadvantage those on the standardised model because of their higher starting position with respect to risk weights. Capital Conservation Buffer requirements began to get phased in for all banks from 1/1/16. This is initially 0.625% of risk weighted assets. So the dominant banks see their mortgage assets move from 3.30% to 3.32% (+0.02%). The smaller banks see their effective mortgage risk weight move

[1] See the CMA's *Addendum to provisional findings*, available at: https://assets.publishing.service.gov.uk/media/5710dc73ed915d117a00006d/addendum-to-provisional-findings-with-appendices.pdf

from 35% to 35.22% (+0.22%). So the quantum increase in capital for the smaller bank is ten times higher than the systemic firm. Therefore the effects of the build-up of the Capital Conservation Buffer and the introduction from Q1 2017 of a Counter Cyclical Buffer, which will operate in a similar manner, will disproportionately impact those banks on the standardised approach.

Whilst in theory the 3% leverage ratio implies a 33.3% risk weight floor on IRB firms, in practice the only large lender that is leverage ratio constrained is Nationwide. The leverage ratio has no practical impact on the competitive activities of the dominant banks. The acid test is a simple cursory glance at the best buy leagues for Personal Loans, Motor Finance, Credit Cards and Mortgages. These are dominated by the Too Big to Fail (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 and circumvent the theoretical application of a leverage ratio. For the leverage ratio to be truly effective it would need to be much higher than 3%, as it is in other countries.

Their stranglehold on the low LTV mortgage and other lending markets gives the dominant banks massive funding advantages. High quality / low risk lending assets are used as collateral to support low cost wholesale funding lines. For example the latest data for Q1 2016 shows that Lloyds Bank alone is using 55% of FLS (£32.1bn of total £58bn). An ability to use low risk loan assets to access low cost funding which is then used to originate new low risk loans, coupled with their huge capital advantages, represents a virtuous circle for the big banks and enables them to price competitors out of markets. It is a vicious circle for other lenders.

Potential solutions

<u>The preferred option – access to average risk weights</u>

The EBA currently mandates that national regulators in all 28 member States must impose the Basel standards in full on all banks, regardless of size. This contrasts with the approach in the USA whereby Basel is only imposed in full on the systemic banks and a more proportionate approach is adopted for all other banks. In the wake of the 'Leave' vote, we believe there is potential for the BoE / PRA to consider whether to adopt the US approach once the UK is outside of the direct remit of the EBA.

This could for example create an option of allowing the established smaller banks to risk weight their lending assets at the average of the ten biggest firms using the IRB approach. Those larger firms with a lower risk profile than average would continue to have a capital advantage which would arguably be justified by their profile. Overall the huge differential that exists would be considerably narrowed without imposing punitive costs on the smaller firms.

This would be the simplest approach.

However, we do not believe this is an approach favoured by the PRA, in part because their levels of discretion are currently restricted by the EBA and Basel Committee. It is therefore likely that the short term requirement means smaller banks will need to move to an IRB approach.

<u>An alternative solution – opening up access to data</u>

One of the biggest barriers to new firms obtaining an IRB waiver is access to data. Many of the newer firms will not have enough data to support the development of the quantitative models required to satisfy the PRA and acquire permission to move onto an internal modelling approach to risk weights. The "Big 6" and other more established banks have significant amounts of data, representative of the vast majority of the UK lending market across a range of asset classes and time periods. We believe that they should be required to share anonymised lending data (origination and performance data) over a period of between 10-20 years to facilitate the development of

Probability of Default (PD) and Loss Given Default (LGD) models. This anonymised data should include all of the characteristics the regulator would expect to see in PD and LGD models.

For example, to develop a PD model, banks would require some data such as each customer's postcode, amount of existing borrowing commitments (secured and unsecured), generic score as well as performance data on other lending at the date of loan origination. Data at customer level should then be provided for any months after the lending was approved, including internal and external performance on internal and external commitments; for an LGD model banks would require full details of collateral against which lending is secured at the date of loan origination. Data at customer level should then be provided for any months after the lending was approved, including data about LTV, collateral re-evaluation, haircut applied and any information related to the recovery amount and process, including the time and costs to recover in a default scenario.

Smaller firms would be able to use the anonymised data, using all of the characteristics therein, to build internal models, enhancing their own (limited) data and thus providing assurance to the regulator regarding the robustness of their assumptions. Moreover, combining the data above with the PD and LGD used for capital calculation will give smaller banks a benchmark to look at when validating the results of their internal models.

We believe HMT and the PRA are sympathetic to this approach, although they note that the data is the property of the banks already using the IRB approach. It is likely that these banks will not be keen to allow smaller competitors to access this data unless they are legally compelled to. Given the timid approach by the CMA to date it feels like addressing the capital disadvantage is going to require strong political direction.

CMA recommendation: The CMA should include amongst its remedies a direction to HMT and the PRA to develop a framework for the sharing of the key data from the bigger banks that can be used to build suitable internal models.

2 – Funding

The issue

Banks make the majority of their profits from lending. In order to lend all banks require money (funding) that they can on-lend. For smaller banks this is predominately sourced via the deposit market. Some also use wholesale funding such as securitisation.

The cost of funding can be considered a combination of three elements:

1. the risk free rate;
2. a credit risk premium; and
3. a liquidity risk premium.

One needs to consider matters from a practical perspective to understand why these factors give the TBTF banks unassailable advantages. These banks utterly dominate the current account and the inert deposit account market. In December 2015 the FCA published a report exposing deficiencies in the cash savings market. They highlighted that in many cases long term loyal, but inert, saving customers are paid much less interest than new customers. The FCA stated customers with over £160bn in balances were being paid interest of 0.5% per annum or less. In some cases savers earned 0%. This dominance of the current account and savings market provides the dominant banks with incredibly cheap funding which facilitates control of the mortgage market through the use of very aggressively priced introductory rates. In turn this very cheap and stable funding is reflected in **their liquidity risk premium**.

In turn, **their credit risk premium** is influenced by their dominance of the low risk, low loan-to-value mortgage market and the implicit Government guarantee, as evidenced by historic behaviours, from HM Government to support TBTF banks. This implicit support generates an annual multi £bn funding subsidy for the big banks.

This entrenched advantage in the credit risk premium and liquidity risk premium paid by TBTF banks is easy to spot. A quick glance at the best buy league tables for mortgages (and other lending products) shows that this is dominated by the systemic firms. In contrast, the best buys for deposits are the smaller banks. It is readily apparent that the systemic 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. Indeed such is the extent of this gap that a customer can borrow money from a systemic lender on a 2 year fixed rate mortgage at 0.99% (HSBC) and get paid more than twice as much credit interest placing this on a 2 year fixed rate deposit with a smaller bank, thereby enjoying a risk free return, ultimately insured by the UK taxpayer via the FSCS. This is another clear sign of a dysfunctional competitive market.

Their stranglehold on the low LTV mortgage and other lending markets gives the dominant banks other massive funding advantages. High quality / low risk lending assets are used as collateral to support low cost wholesale funding lines. For example the latest data for Q1 2016 shows that Lloyds Bank alone is using 55% of FLS (£32.1bn of total £58bn). Whilst FLS is available to all, their inability to write the lower risk and lower LTV lending means the challenger banks do not have the same quality of collateral to use to access the FLS.

In addition, the “funds” provided by the FLS scheme are not in cash form; instead the scheme provides T-Bills, which then need to be converted into cash via repo transactions with wholesale market counterparties. These are typically the systemic firms that make a profit from the repo transaction. As such, the relative costs of accessing FLS are higher for smaller firms.

An ability to use low risk loan assets to access low cost funding which is then used to originate new low risk loans, coupled with their huge capital advantages, represents a virtuous circle for the big banks and enables them to price competitors out of markets.

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

Some of the larger banks are able to get away with paying derisory rates of interest to savers because the demand for deposits from smaller competitors is finite. The funding and capital advantages enjoyed by the big banks are so vast, that they dominate the vast majority of the UK lending market. Smaller banks cannot compete on a like for like basis in key lending markets and achieve economic risk adjusted returns, and so have finite demand for deposits. This vicious circle needs to be broken.

Small banks do not have huge inert customer bases or large back books of low cost deposit customers. The CMA’s view is 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. The switching data from BACS showed that in 2014 only 1.156million personal and business current accounts switched. The figure for 2015 of 1.033 million showed that 11% fewer customers switched. BACS and the CMA believe the total market to be circa 74.2million current accounts. Any notion that an increase in the level of switching could address the root causes of the funding imbalance and achieve more effective competition is dangerously naïve.

Potential solutions

One solution that would protect the interests of inert deposit customers would be to require banks to pay a minimum of base rate on all current and savings account produces, including the off-market back book products. This has very clear implications and HM Government may well prefer to avoid a form of price control.

An alternative is to create a mechanism that would help to equalise the current funding costs differentials between the TBTF and their small competitors, and which would act as a circuit breaker allowing the smaller firms to grow broader based and lower risk lending portfolios. Over time their lending portfolios would more closely mirror those of the systemic banks which would allow the smaller banks to sustainably reduce their credit risk and liquidity risk premiums.

This could take the form of an evolution of the existing Funding for Lending Scheme to allow 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 they continue to enjoy and their total control of the current account market. Operationally the new scheme should provide cash rather than T-Bills for users.

This is a nil cost, low risk option for HMG.

The smaller banks would pay for the scheme and provide collateral to support their usage of it. Reducing their cost of funds would help smaller firms write lower risk lending and thus they would have better quality collateral to offer to access the scheme.

As a final note, it is important that the scheme rules allow all banks to use it. Although the larger players would be unlikely to access the scheme, as they already enjoy very low cost funding. This openness is should ensure compliance with relevant state aid restrictions.

<u>CMA recommendation: In its final report the CMA should direct HMT and the BoE to extend a suitably amended Funding for Lending Scheme.</u>

<u>3 – Taxation</u>

The issue

When explaining the introduction of the bank levy in 2010 Mr Osborne said: *"This was a crisis that started in the banking sector and the failures of the banks imposed a huge cost on the rest of society*". The Treasury's papers and comments from government officials at the time noted the huge benefits the systemic banks enjoyed from the implicit support of the UK taxpayer, and this was used to justify the imposition of the levy on those banks with balance sheets of £20bn or more. Indeed in the same year the Bank of England estimated that the TBTF banks had derived over £100bn of benefit from the implicit UK government support.[2]

More recently the IMF estimated that banks in Europe had benefitted by up to $300bn because they were deemed 'Too Big to Fail' and thus derived huge economic benefit via implicit sovereign guarantees which allowed these banks to fund themselves more cheaply than their standalone ratings would merit.[3]

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[2] See: http://www.bankofengland.co.uk/financialstability/Documents/fpc/fspapers/fs_paper15.pdf
[3] See: http://www.imf.org/external/pubs/ft/survey/so/2014/POL033114A.htm

The big banks continue to enjoy an implicit funding subsidy worth billions of pounds per year. For example, the 2015 RBS Annual Accounts contains the following statement; *The Group's borrowing costs, its access to the debt capital markets and its liquidity depend significantly on its credit ratings and, to a lesser extent, on the rating of the UK Government*. [4]

The salient points here are;

1. The smaller banks did not cause the financial crisis and did not impose a huge cost on society, which is why they were excluded from the banking levy in the first place.
2. Obviously small banks did not – and do not – receive any form of financial benefit from being deemed Too Big to Fail.
3. Smaller and Challenger banks were hugely important in helping the economy recover after the crisis as they were demonstrably increasing their net lending into the real economy at a time when the TBTF banks were shrinking their balance sheets, as outlined at the beginning of this letter.

The recent tax changes only serve to make the competitive playing field more biased towards the dominant incumbents who also enjoy huge benefits from the Funding for Lending scheme. The CMA has noted that the combination of the introduction of the bank corporation tax surcharge and the phased reduction in the bank levy means that the difference in effective rate of tax paid by the largest banks and the smaller banks will reduce over time.

The situation that now exists is that the taxpayer is subsidising the dominant banks' funding costs and the small banks are subsidising the costs of reducing the banking levy. This is hampering the ability of challenger and smaller banks and building societies to provide more lending to consumers and businesses.

Potential solution

We have consistently said that we have no objections to being put on the same footing as the dominant banks with respect to tax, provided we have the ability to compete on a truly level competitive playing field to generate taxable profits. As is made clear in the discussion above, this is not the case presently and the tax regime should reflect this with differential tax rates prevailing until a level playing field is created.

As a minimum the bank corporation tax surcharge threshold should be set at a much higher level than the present £25million.

We appreciate that the CMA cannot set levels of taxation. However, it can deliver a strong steer to officials and Government.

<u>CMA recommendation: In its final report the CMA should highlight the imbalance and competition implications of the taxation system and should recommend a substantial increase in the level at which at the surcharge becomes payable.</u>

[4] See page 400: http://investors.rbs.com/~/media/Files/R/RBS-IR/results-center/annual-report-2015.pdf