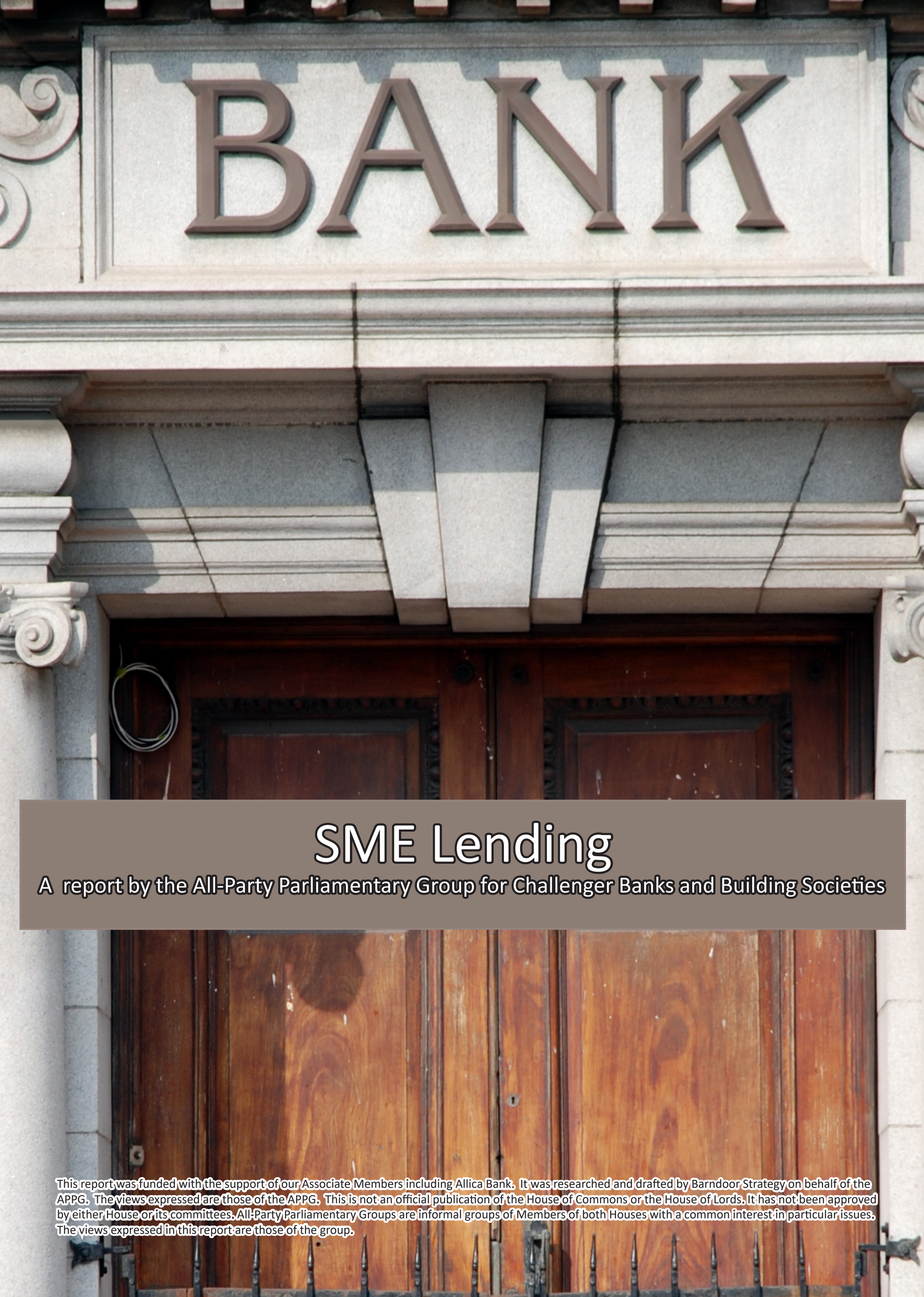


SME Lending

A report by the All-Party Parliamentary Group for Challenger Banks and Building Societies

This report was funded with the support of our Associate Members including Allica Bank. It was researched and drafted by Barndoor Strategy on behalf of the APPG. The views expressed are those of the APPG. This is not an official publication of the House of Commons or the House of Lords. It has not been approved by either House or its committees. All-Party Parliamentary Groups are informal groups of Members of both Houses with a common interest in particular issues. The views expressed in this report are those of the group.

Foreword

One of the great success stories since the global financial crisis has been the emergence of a vibrant and dynamic challenger bank market in the UK.

Names never previously seen on Britain's high streets like Metro Bank and Virgin Money, alongside a re-modelled TSB, were the first warning sign to the big 4 banks that competition could be a healthy thing and was going to be a major priority for Government and policy-makers.

That early progress was boosted by the PRA's new authorisation regime introduced in 2013 encouraging a whole raft of new players and specialist lenders to enter the market.

And with the UK's focus on developing the UK as one of the world's leading fintech sectors – capitalising on huge technology advances and new digital and mobile possibilities that consumers and businesses now take for granted – we've seen an explosion of neo-banks, like Monzo, Starling and Atom.

Nowhere is the change in the competitive banking landscape more obvious than in the SME lending market. The diversity of new and growing SME lenders such as OakNorth, Allica, Shawbrook and Oxbury, is plain for all to see.

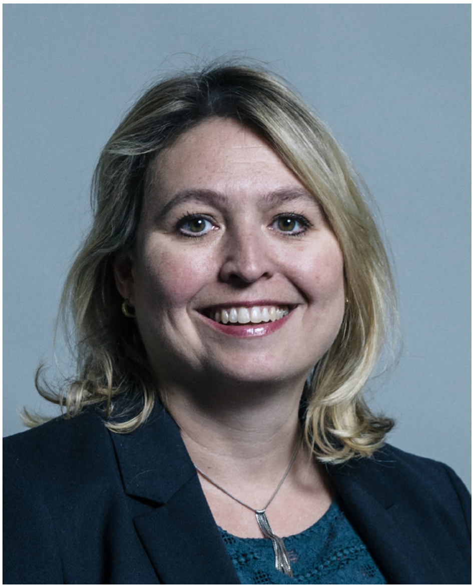
New data from the British Business Bank last month has revealed that for the first time in living memory, challenger and specialist banks now account for 55% of new SME lending in the UK, more than the previously dominant Big 4 banks combined.

Since the PRA introduced its new banks authorisation regime, new banks' lending to SMEs has grown by almost 150%.

This is a remarkable achievement and as the Chair of the All Party Parliamentary Group on Challenger Banks & Building Societies a moment of great significance as it shows the impact of our work to build fair competition, remove barriers to entry and encourage more diversity in the UK's banking, savings and lending markets.

Having said that our APPG's detailed work on post Brexit regulation has found that challenger banks' ability to grow and compete is being held back by a lack of proportionality in our regulatory regime – with the current regulatory approach making it impossible for challenger institutions to compete on a level playing field with the big established banks.

As the Chancellor said in last week's Budget this is a critical moment for the long-term health of the economy. We need our major drivers of growth to be



firing on all cylinders if we're to achieve the strong and sustained recovery needed following Covid.

That's why we held a roundtable to discuss the PRA's current consultation on new capital standards for UK banks.

The Regulator's plans for implementing reforms to the Basel international banking standards could be the biggest shake up to lending rules in the UK for generations to come.

Billed by some as an opportunity to unlock the so-called Brexit dividend, the PRA's consultation runs to a weighty 400 pages.

But our group is focused on what the proposals mean for SMEs and the ability for challenger banks to serve this critical engine of jobs and economic growth across the country.

We've heard major concerns that the new rules new rules could impede the progress of challenger banks in supplying lending to help SMEs invest and grow by requiring them to hold more capital for SME lending than they currently do.

And there's confusion as to why capital requirements could be higher for lending secured on SMEs' property assets, than for totally unsecured lending – a position that seems entirely illogical.

We've seen new analysis from economic experts, Oxera, suggesting that up to £44 bn of SME lending is at risk of being lost to the economy as a result of the proposed changes.

While the PRA's primary objective is to ensure the safety and soundness of financial firms, it appears the proposed new rules could actually increase incentives for smaller banks to take on riskier lending.

And if the impact to SME lending is anywhere near the £44 bn experts believe it could be, then the new rules would also cut across the PRA's objective to facilitate competition in the banking market and obligations to take into account the Government's economic strategy.

The PRA's consultation does not provide a detailed assessment of what the impacts could be – that would have been helpful – but today's roundtable will provide the PRA with an opportunity to demonstrate how different capital requirements between large and small banks are justified and how they won't stop the UK's 5 million small businesses from accessing vital finance.

Clearly nobody should be arguing for the Regulators to simply loosen capital requirements.

The recent Silicon Valley Bank debacle vindicates both the Bank of England's new resolution regime and the PRA's approach to liquidity rules (which are different and arguably more effective than in the US).

But SVB also shows demonstrates the importance of the need for rules to fully reflect the risks being regulated.

Regulators – and Parliamentarians – will quite rightly want to consider the issues sitting behind the SVB episode, but those difficulties had nothing to do with the bank's lending activity, and the failure of an international bank specializing in the venture capital sector shouldn't cast a shadow over domestic SME lending by small challenger banks.

And with its Basel proposals, the PRA's objective should be to implement a capital regime for SME lending that is aligned to the actual risks being taken by SME lenders and ensure there is a level playing field

The PRA's implementation of the Basel rules is a once-in-a-generation opportunity to show how UK financial services can flourish post-Brexit and continue the growth of a vibrant and diverse SME lending market. The CBBS APPG hopes the Bank of England grasps that opportunity for the benefit of us all.

Rt. Hon. Karen Bradley MP
March 2023

Contents

1 Overview

The APPG for Challenger Banks and Building Societies together with the Federation of Small Businesses held an inquiry into SME Lending due to concerns that were raised with us by a number of our Associate Members.

The APPG was concerned that SMEs were in danger of experiencing a substantial reduction in lending at a time when they are feeling the squeeze because of increased energy costs and a weakening economy.

This threat came in the form of the proposed changes the Bank of England's PRA is making to the capital requirements for challenger banks as part of its CP 16/22 consultation on implementing BASEL 3.1.

During this inquiry, we sought to understand:

- What are the changes the PRA are proposing?
- What impact will they have on capital requirements?
- What are the main issues for SME lenders such as challenger banks?
- What are the main issues for SME borrowers?
- Is there a threat to SME lending and does this apply regionally or is it nationwide?
- What are there any regulatory changes that could be made to address the identified issues?
- Are they any alternative SME lending models that the UK could adopt to address some of the identified issues?
- Are there any lessons for UK SME lending from overseas models / experiences of BASEL implementation?
- What role do Challenger Banks perform in the SME lending space?
- What role can Fintechs play in SME lending?
- Is there a clear roadmap for improving access to capital for SMEs?
- What do the PRA's proposals do for the UK's competitive position in relation to other countries?
- Do the PRA's proposals have implications for competition in the UK banking market?

Pursuant to this we took both written evidence and oral evidence from a range of sources. Not least, the oral evidence session with a very wide range of participants on the 21st of March. The full minute of this evidence session is set out in Appendix 1.

2 Unintended consequences from the PRA's Basel implementation

The Bank of England's Prudential Regulation Authority (PRA) are making some welcome updates and in some ways overdue changes to our regulatory system to implement the Basel reforms. This is something that the Challenger Banks and Building Societies APPG overwhelmingly welcomes.

There was also comprehensive agreement from all at that the Basel reforms were necessary and that overall, the Bank of England's Prudential Regulatory Authority had come forward in general with a good set of implementation proposals.

However, this was not true across the whole landscape of the CP16/22 consultation and the APPG was presented with a consistent pattern of concerns from both lenders and representatives of SMEs.

Consequently, given the extensive evidence provided to us by lenders and borrowers, we remain concerned that if the PRA's proposals are implemented as currently drafted there will be a very substantial reduction in lending to SMEs in the UK if not a substantial price increase in the cost of that lending.

The figures disclosed in the Oxera research place this at some £44bn. We note that the Bank of England challenged this figure, but given the depth and detail of the work undertaken both by Oxera and the corroborating evidence provided by our witnesses Allica Bank, Atom Bank, OakNorth Bank, the National Association of Commercial Finance Brokers, UK Finance and the Federation of Small Businesses, we find it highly credible.

From our roundtable oral evidence session, it seems that while the PRA have been extremely diligent in their work, there would seem to be an underestimation of the effect that some of the proposed measures will have on the SME lending market. We were very pleased to see the open-minded approach being taken by the PRA to this issue and their willingness to take further evidence on this point. The APPG hopes that the independent economic study undertaken by Oxera is given full and due consideration when the consultation responses are being reviewed.

We note also that this effect hasn't just been demonstrated in the UK. Other central banks, when modelling similar changes, have also found a potential deleterious effect on SME Lending in Spain and France. Moreover, we note the EU Basel implementation seems to have been influenced by the consideration of the need to facilitate lending to SMEs due to the current economic conditions in continental Europe. From

the information available, it does not appear that the PRA's proposals have made any such considerations yet.

On the basis of the evidence that has been submitted, particularly by Oxera, we would urge the PRA to reconsider its proposals on both on the risk weighting of asset secured lending and also the SME support factor.

3 How risky are SMEs?

One topic that was discussed at length at the APPG's roundtable was the riskiness or otherwise of SMEs to the economy.

While the Bank of England clearly believed it had empirical data demonstrating that lending to SMEs was inherently risky, Members were keen to understand whether there were additional parameters to this risk. For example, the length of time a firm had been established or the nature of its management.

Another aspect to this was the risk that a specialist lender to the SME sector could conceivably pose to overall financial stability. Given the lack of risk concentration in this sector – indeed partly down the proliferation of challenger banks. It was argued by several of our witnesses that actually the risk posed by a lender to SMEs was far from systemic.

"The amount of damage a failed specialist lender could do was significantly different to a tier 2 bank."

Oxera in their evidence suggested that the systemic risk posed by the challengers should not be overestimated. There was a need to balance this with the risk of not lending to the SME sector.

"Average balance sheet for challenger banks is 8bn compared to Lloyds at just less than 657 billion."

The APPG agrees with this assessment and urges the PRA to reconsider its risk assessment of SME lending and, if it insists on proceeding on the current basis, it must provide more detailed empirical evidence (which is available from Challenger Banks) to justify its assessment more conclusively.

4 Conclusion

Overall, the All-Party Group for Challenger Banks and Building Societies continues to be broadly supportive of the PRA's approach. The enlightened approach of regulators in recent years has led to a proliferation of challenger banks, reducing concentration risks and expanding consumer choice and competition. All of which we strongly welcome.

As ever, the issues the APPG has raised are at the margins. But that is not to diminish their importance. We have written several reports over recent years questioning how a challenger bank can realistically scale to be a competitor of the big five. One of the risks we've repeatedly identified in that arena is the seeming preference for regulators to engage with and to advantage the business model of larger banks. So much so with capital requirements it is difficult to see how a challenger could organically scale to become another NatWest or HSBC.

With SME lending, the issue seems to be another example of this. Larger lenders, which pose a greater risk to the stability of the financial sector are less affected by the proposed changes. Not only do they get to mark their own homework through processes such as the Internal Ratings Basis (IRB) model, they have easier access to capital than their competitors who have to raise equity to grow.

This has a knock on effect as the challenger bank's customers, who are themselves SMEs, and look to be substantially disadvantaged.

This could represent a terrible outcome for consumers and the UK banking sector in general. It would serve to undermine competition in the UK financial services sector. But perhaps more importantly, it would have a hugely detrimental impact on the SME lending market and the UK's international competitiveness

The evidence presented to the APPG clearly shows that the proposals as they stand would reduce the availability of SME funding quite substantially with the figure of £44 billion seemingly credible. The proposals would also be likely to increase the cost of funding for SMEs.

SMEs are the heartbeat of the UK economy and, at a time when SMEs are facing a myriad of financial challenges, such a change is something that both the Government and the regulator should be taking all necessary steps to avoid.

5 Key Findings of the APPG

- The Bank of England's Basel implementation is flawed and will result in increased costs and a very significant reduction of lending to the SME Sector, just when the economy is experiencing continuing turbulence due to the unwinding of quantitative easing, the pandemic and the war in the Ukraine.
- The PRA are right to be bringing forward the Basel reforms and correct in ensuring that UK regulation is second to none in ensuring the stability and safety of our financial system.
- Gold plating is alive and well in the regulatory community despite the UK leaving the EU.
- There needs to be a greater balance in regulation between promoting competition and the needs of the wider economy such as SMEs and ensuring financial markets are prudently regulated
- We question whether there is sufficient internal challenge through bodies such as the Independent Panels and cost benefit analysis work before major regulatory proposals are formulated and consulted on in a formal consultation paper.

Appendix 1 - Minutes of SME Lending Round Table 11am Tuesday 21st March 2023

Attendees:
- Rt. Hon. Karen Bradley MP, Chair APPG for Challenger Banks and Building Societies
- Jo Gideon MP (Con, Stoke On Trent Central)
- Richard Davies, CEO, Allica Bank
- James Heath, CFO, Allica Bank
- Mark Mullen, CEO, Atom Bank
- Paul Alton, Chief Prudential Risk Officer, Shawbrook Bank
- Nick Lee, Head of Regulatory and Government Affairs, OakNorth Bank
- Paul Goodman, Chair, National Association of Commercial Finance Brokers [NACFB]
- Martin McTague, National Chair, Federation of Small Businesses
- Andrea Macleary, Senior Policy Advisor, Economics and Finance Federation of Small Businesses
- Cosmo Green, Federation of Small Businesses
- Stephen Pegge, Managing Director, Commercial Finance, UK Finance
- Phil Evans, Director of Financial Policy, Bank of England
- Tamiko Bayliss, Head of Banking Capital Policy, Bank of England
- Andrew Mell, Technical Advisor and Project Manager, Oxera
- Helen Ralston-Smith, Partner and Project Director, Oxera
- Peter Andrews, Senior Advisor, Oxera
- Anne-Sophie Faivre, Office of Harriett Baldwin MP
- Heather Buchanan, Bankers for Net Zero
- Havard Hughes, Barndoor Strategy – APPG Secretariat
- David Spencer, Barndoor Strategy – APPG Secretariat
- Roger Evans, Barndoor Strategy – APPG Secretariat
- Angus McVean, Office of Rt Hon Karen Bradley MP
- Michael Martins, 56° North

Apologies:
- Heather Wheeler MP
- Adam Afriyie MP
- Baroness Susan Kramer
- Lord Howard Flight
- Lord Simon Haskell

The Chair (KB) thanked members of the committee and witnesses for attending this very busy session. The purpose of the meeting was to examine proposals from the Bank of England to make changes to risk weightings and capital requirements for specialist banks, to understand their impact on small and medium sized businesses (SMEs) and to make recommendations based on the evidence received.

Attendees took the opportunity to introduce themselves and the organisations they represented.

Phil Evans (PE) from the Bank of England explained that the proposed risk weightings were the final piece of the reforms related to the banking crisis in 2008. Risk weightings are intended to quantify the risk of lending. There were concerns following the crisis about the risk sensitivity of the weightings and the fact that institutions with similar portfolios were receiving different weightings. The objective of the reforms was to measure risk more effectively and help UK businesses by rebalancing the risk weightings. It was essential that Bank's were capitalised against the risks to which they were exposed in order that they were safe and sound; no SME would benefit if its bank was too weak to lend to it in a stress.

The current risk weights started from, uniquely, the EU choosing to lower risk weightings for SME lending when no other jurisdictions had. This deviated from the global standards agreed at Basel.

Basel, in its latest proposals that the Bank of England is seeking to implement, had now chosen to reduce the SME risk weights, and the PRA had proposed to introduce those new lower risk weights. The issue the Bank was seeking feedback and evidence on is whether those reduced risk weights go far enough, weighing the higher incidence of default aiming SMEs, which makes risk weights higher than for large firms, and the lower correlation with the business cycle, which makes risk weights lower.

Richard Davies (RD) said Allica agree with Basel reforms for unsecured lending as the Bank of England had proposed. However, they have proposed to change the risk weighting for business loans secured on commercial real estate leading to a better risk weight for unsecured lending than for secured lending.

PE: Although commercial real estate lending risk weights aren't changing in the proposals, nevertheless firms have a reasonable point. We want to look pretty carefully at this.

KB: the risk of defaults by SMEs is higher than other firms – is this because there are more SMEs? How do you assess it to be more likely any one SME will fail than a large business go bust?

PE: For any SME or a randomly chosen SME, the incidence of an SME going bust is higher than a large firm – so this is the probability of default. However SMEs have a lower systematic correlation with the economy than large firms, which acts to reduce the risk weight.

KB: Is the risk greater for established or new SMEs? Is maturity a factor?

PE: The risk relates to the average across SMEs, without making allowances for maturity.

Stephen Pegge (SP) from UK Finance said if lending to a few relatively large businesses to what degree have the BoE looked at concentration of risk. SMEs are not correlated with each other so the risk is spread.

PE: This reduces the risk weight. So, take the risk for SMEs in the round. The issue that the BoE has to weigh up is does this go far enough or not?

Jo Gideon MP (JG) There's a whole range of firms from some wanting to double in size to small firms just starting out. Do you have more granular detail of where they are in the journey from start up to growth?

Tamiko Bayliss (TB) There is a more granular split. There are corporate SMEs, which are defined partly in terms of turnover. And there are retail SMEs. Retail SMEs are risk weighted at 75%. Under the internal ratings based approach, firms would have to estimate the probability of default for every single loan extended. This is much more granular and complex.

JG: Is there a measurement of how many SMEs are owned by women?

TB: we are setting out a broad-based policy for Banks to work out the risk. Gender of SME ownership is not part of the available data.

PE: There was a tension when coming up with these rules, as there is for any rulemaking. What we want to do is reduce complexity. Adding more granularity can be more accurate, but it increases complexity. There was always a balancing act between precision and reducing complexity.

Nick Lee (NL) The stats gave on PDs before was this were for banks on IRB but the banks around the table were all specialist banks on Standardised? Was this just the big six who did ACS or everybody?

TB: the data collected broadly represents the PDs for SME lending. The approach was based off the IRB banks data. There was some data on this in terms of what was put into ICAAPs but the larger banks will have greater influence.

TB: PV varies according to particular definitions. There are default and loss rates for accounting purposes etc.

Martin McTague (MMT): Surely the UK is more similar to the EU than other parts of the world so why not follow EU on Basel risk weights?

PE: We now have the ability to tailor according to the UK's data, rather than the EU's. It was therefore possible to make proposals based on UK data. There were competitiveness issues we do weigh up and Sam was asked about this at the Treasury Select Committee. One thing that was deeply underpinning the competitiveness of the UK financial sector was the trust and confidence of other firms and regulators to be able to deal with the UK and adherence to global standards supports this. The EU's approach on SMEs does not meet global standards. On the other hand it was true that the EU had gone with lower risk rates so there was a need to balance all these factors together. The UK could not blindly copy the US or EU, but had to come up with its own proposals.

Helen Ralston–Smith (HRS) of Oxera: SMEs were more reliant on bank lending than others in the economy. UK banks lent 209bn including UK government support. From non-banks there was only 7bn new SME asset finance and 5bn peer – to – peer lending. Bank lending is therefore critical to SMEs.

SME Lending was a great success story. The challenger banks were much smaller and brought stability through their diversity. They are not suggesting relaxing the requirements – merely not tightening them. This is a bad time in the economic cycle to tighten lending requirements.

Andrew Mell (AM): Higher risk weights increase the amount of capital required. What we've done to try and get a handle on the impact was to take the amount lent out right now. Look at quantity of capital backing that. Keep the capital ratio that they had to meet. Keep those things constant. Banks could respond in different ways but they will all come with additional costs.

SP: Big increase for larger IRB banks as won't have 15% discount?

AM: the total number was roughly 44 billion in total.

Don't have enough data on supply and demand curves but we would expect an increase in interest rates charged on lending and cash flow consequences for SMEs.

RD: We have quantified the interest rate increase as being in the range of 1-1.5%, from the current average margin of 3.5% over base rate.

MMT: 85% of SMEs bank with the big 5. Some sectors are finding huge difficulty borrowing at the moment. Retail hospitality and leisure encounter obstacles to getting loans or overdrafts. They were the businesses hardest hit by COVID. Borrowing was becoming a lot more expensive. If nothing was done to correct this these businesses - always the ones that managed to grow in tough times - will be constrained. They would not be able to meet the interest rates and couldn't rely on any other capital sources. This would have a dramatic effect on the UK economy. 99% businesses were in this sector and 60% of turnover.

If 249 employees means expensive and high risk but 251 suddenly means low risk – this arbitrary threshold didn't make much sense.

Paul Goodman (PG): Construction is also starting to struggle now. Almost impossible to get insurance in this sector due to the rise in bad debts. A year ago, 4.5% over base but now 9 or 10% as an all-in rate. Lenders around the table were providing increased debt servicing cover due to the energy costs. High street banks are still working through their books with a covid perspective. From a brokers perspective the supply of funding from the challenger banks needs to grow.

KB: Lots of Leek businesses were finding that things they had invested in pre-covid style on bounce back loans were not effective in the post COVID business environment.

PE: All this colour is really useful. He asked for more detail from Oxera on pricing numbers. On the report, had only just received it and so would have to study it. But the initial reaction was that the Oxera numbers are larger than the Bank's own numbers. There were two key elements - what was happening to risk weights and then secondly what was the consequent effect on lending. On the first, the Bank had lower numbers than Oxera on risk weights. . And on the second, Oxera had taken quite an extreme assumption.

AM: happy to share how achieved these numbers.

PE: What Oxera had predicted on the second part was definitely the worst case. For their research a 1% risk weight change corresponded to a 1% change in lending. There were other studies around on this, such as the EBA study which didn't find a correlation between risk weights and lending.

The Banco de España study found mid-tier lending went up, but SMEs didn't, when the support factors were introduced. In France there was a different picture and some impact on SME lending. There was also an FSB Study showing no strong link looking across countries. Overall, the link was unlikely to be significant enough to reduce lending by as much as 44 billion.

Norman Chambers (NC): could this difference be based on how the Bank of England collected the data?

PE: No, the risk weights were the risk weights. They had done the best they could but this didn't mean the data was perfect.

NC: did this include all the high street banks as well?

TB: it was split up between standardized approach and IRB firms but the BoE's numbers for risk weights were lower.

Peter Andrews (PA): Amount of capital wasn't just a function of the risk measurement and risk measurement is highly imprecise. This could be seen in what the PRA itself said about different IRB firms coming to different conclusions on risk due to different modelling. There was no absolute connection between risk and capital requirements, with the latter's focus being on correcting market failure. Bank stability was vital for the reasons being said. How could this be achieved? The original idea of prudential policy was that the regulators would correct market failure by putting capital requirements on banks so that they internalized to the extent possible the external costs that they might create. The probability of crisis had not materially increased using the EU measure of SME risk as opposed to the Basel risk. The cost of using the Basel number did however represent a

material reduction in lending to SMEs.
So does the benefit of switching to the Basel number outweighed the costs? Don't think the evidence is in the CP.
MMT: it seemed that the evidence for a major change was rather thin and the risks to the SME community were high. Had not heard any reassurance that this would not do material harm.
Mark Mullen (MM): Was there not enough capital in the challengers to meet stability requirements and UK SME lending? To Martin's point shifting to a position whether it was £20 billion or £40 billion but if saying needed to be more capital this would lead to higher costs and less supply. If this was the right answer from a risk-based perspective. The BoE had the macro picture in that it possessed all the data. So, from a macro perspective it looked like there was enough capital in the system and if there wasn't something needs to be done to remedy this now rather than wait until 2025.
RD: The thing for us at Allica Bank was to make it more logical and in line with the objective to make capital requirements risk sensitive. Securing on premises reduces risk. Allica's own recommendation was that the international standard should be adopted for securing on trading premises.
It is different risk where the property itself generates the income to repay the loan via rent.
They were different things in the current consultation but currently have the same proposed treatment and there is a material increase in capital requirement proposed for secured business loans.
TB: There is a distinction between where the income from the property is needed to repay the loan, and where it is not
RD: These figures are embedded via the PRA's formal supervisory framework including C-SREP and TCR, I think secured business loans vs commercial investment are not being distinguished between properly in the PRA's analysis
PE: This was a valid point that the Bank will be considering. Where the income from the property was needed to repay the loan, the case was less strong. However, where it was incidental to the repayment of the loan, this was less risky.
RD: this was where the issue seemed to lie. The lowest risk loan prudentially should have a lower risk capital requirement. This was the biggest reason for increasing cost in the Oxera study.
But would also raise the issue that asset finance for cranes or trucks was different from lending £100K without any security at all.
Allica is recommending a spectrum of risk weights between the three types of lending – unsecured, asset and invoice finance, and business loan secured against trading premises. Recognising

this would simplify the regime and reduce risk.

TB: Thought it was a very interesting proposal of vacant possession valuation. How complex would this be?

RD: This was Allica's proposal as had not consulted with Mark or Nick on this. Banks should backstop the loan with a valuation on the basis that loan and the current occupier had defaulted rather than as if it were being sold as a going concern, this is more prudent. As an extreme example in the case of an equine hospital near a race course if the race course closed the value of the property would be a lot less than it would be if still trading. Most banks already look at this Vacant Possession value as part of the underwriting process, and it is available as standard from RICS valuers.

SP: supported RD's contention that property valuations for security purposes should avoid attaching too much reliance on income generated intrinsic to the business (as collateral should be independent of regular payment capacity

PA: There is a need to revisit the paradox between taking a security and not. So, to have to hold more capital if there was security would be perverse. There would definitely be an increase in cost to the customer from increasing the amount of capital that SMEs had to hold. That cost of capital had to be passed onto the borrower. 100 to 150 basis points on interest rates were not unrealistic. Are we saying there actually are higher risks associated with these types of loans which were not recognized and needed to be paid for. This was a pretty fundamental judgement to be made. Basically, just defending the business model – difficult not to argue there will be a higher bill for SMEs.

Also, there was a competition point. The challengers have done a decent job in diversifying SME lending. It was good for banking that you no longer have the concentration of a small number of big lenders on a perpetual basis.

A universal bank failing was a lot different to a non-universal bank. The amount of damage a failed specialist lender could do was significantly different to a tier 2 bank. The major commercial banks could absorb this risk weighting proposal a lot more easily than the challengers. Taxpayers have paid for the bail out of the systemic banks but didn't have to pay for the bail out of the non-systemic ones. This was actually a dangerous place for competition. This was the only area not dominated by the big 5 and the Nationwide.

AM: There was a need to think why we had these rules and regulations to prevent banks placing their risk on the public when they failed. However regulators needed to think about the risk of doing the lending and whether the lender was systemic or not. There was very healthy competition coming in from the so-called challenger banks who were not systemic. There was obviously some prudential risk associated with these banks but it was not as much as the big 5 high street institutions. Average balance sheet for challenger banks is 8bn compared to Lloyds at just less than 657 billion.

PA: When capital requirements go up for banks there is an evidenced history of a correlation with reduced lending.

PG: Set his own practice up in 2006/2007. Majority of lending now was from non-high street banks, whereas back in 2007 there were no alternatives. On the 1st April lenders would have to think what lending would be priced out. Proposed changes would affect lending from the 1st April onwards even if they were not implemented until 2025. Firms wanted to borrow to grow and demand didn't seem to be an issue.

JG: Government wanted SMEs to grow but they would now have to pay more to do so. Reducing the ability to borrow was completely counter-intuitive. The smaller businesses were lower risk but the lending rates would be higher than for business larger than SMEs.

PA: Talking about two types of risk measurement. SME Loans command higher prices because the individual probability of default is greater. However, from a prudential analysis SMEs were less likely to fail cyclically so the risk was mitigated over time.

JG: Would it be the government's role to fill the gap if lending had to be rescued particularly for the hospitality and construction sectors?

TB: The Bank's role was to see the evidence and get the risk right. The Bank also knew that if they got it wrong and the sector was not properly capitalising the risk failing banks would be a problem for the SME sector. The Bank has a responsibility to promote safety and soundness.

If the government were to provide a guarantee, then this would filter through to the capital requirements.

SP: If prices went up there would be an issue

MMT: if the risk return ratio was wrong then SMEs would not invest

KB: We have two Staffordshire MPs here so the regional effects are an important concern.

NL: understanding on Basel is calibrated for large banks, not the smaller ones. Even in the US there was no requirement to hold anything like the same amount of capital. Was Tamiko saying the SME lenders were systemic because they were important to SMEs? But was this the case? There were many other lenders who could step into the place of a failing challenger bank.

This is not a Silicon Valley Bank (SVB) situation. They were linked to one particular sector of the economy and concentrated there. Challenger banks lend across all regions too including Manchester and Scotland. But they are also penalized under the Pillar 2A rules for just lending in the UK – there is a significant concentration risk capital add on - they would get a benefit if they would lend also in Greece for example. Basel was calculated for international banks not UK specific ones.

PE: The risk weight was meant to capture the risk. It was not meant to capture wider consequences of Bank failure. That is captured elsewhere in the capital requirements.

TB: Challengers are not systemic, but they are very important for the SME sector.

PE: The BoE is less good at capturing pricing impacts – we need firms help for that. This was why we were here, to help gather this information. The things that the challengers were talking about are definitely part of the picture that we want to assess.

SP: One of the benefits to resilience of the financial sector is the diversity of operating model and target markets of the specialist bank sector and this supports financial stability. Any changes in regulation that seek convergence or reduce the role of the specialists in the market undermine this and can create systemic risk.

AM: All SME loans across all sectors turning bad was the sort of risk which would be systemic but very unlikely.

Anne-Sophie Faivre (ASF): Has the assessment of systemic risk changed over the last few weeks?

AM: there was no increase in assessment of systemic risk. The SVB crisis in the US was very different from the UK effects. The balance sheet of the UK subsidiary was 8-10 billion, but this was brought down by contagion from the US parent. 8bn is the average size of SME lending banks with most of them below that. It illustrated successful resolution of the crisis in the UK. SVB had an unusual business model. It was lending deposits taken from the industry to people in the same industry but the thousands of firms had only tens of backers in terms of private equity people who gave them money. They were highly vulnerable to what amounted to a co-ordinated bank run.

NL: if SVB were a UK Bank it would have been considered systemic and MREL would have been in place. And it would have been better regulated.

AM: lots of the things at SVB would not have happened in the UK

PA: at least two things rightly done by the PRA were not done by the US regulators and would likely have prevented the failure of SVB.

Heather Buchanan, Bankers for Net Zero – Fair Business Banking side, how does this come into the calculations of the climate change agenda? There is political pressure to invest to reach Net Zero. But these are conflicting messages in terms of prudential regulation?

RD: The UK has historically low business investment currently and a mountain to climb for climate, which makes today debate about the capital requirements for SME lending that finances investment crucial.

KB: From an APPG point of view today's session has given us something very useful. We will continue to work with the sector as an APPG. One day we would have 85% outside the big 5 plus one. A short report and consultation response will be produced on the basis of today's evidence. She thanked attendees for their valuable contribution.

Meeting Closed at 12:30

Appendix 2

Sources of evidence submitted in response to our call for evidence are to be found on the APPG website https://www.cbbsappg.org.uk

- Allica
- Oxera

Published by Barndoor Strategy Ltd.