BANK OF ENGLAND

Speech

Two years on from the March 2013 publication of 'A review of requirements for firms entering into or expanding in the banking sector'

Speech given by

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If you review different markets where new entrants are prevalent, you see one common characteristic. Some new entrants succeed and some fail. There are no magic ingredients for success and although there is a wealth of literature, written by great business leaders, providing pointers as to how to launch a new business, nobody has to date written the book, ‘A one hundred percent guarantee for success when starting and growing a new business.’ This therefore posed a significant challenge to the previous regulator, the Financial Services Authority (FSA), as it had no mechanism of resolving a failing bank in an orderly manner and had to ensure all new banks held adequate financial resources in their formative years to minimise the risk of their failure.

This resulted in the FSA often requiring new banks to hold levels of capital and liquidity significantly higher than established banks, which created two vicious circles for the new banks. Firstly, many investors were not prepared to commit to the higher level of funding before a banking licence was approved but the licence could not be approved without the funding. Secondly, if the new bank did manage to access the funding, the costs associated to this could place it at a significant competitive disadvantage during its formative years.

The Office of Fair Trading and the Independent Commission on Banking reports published in 2010 and 2011 respectively both concluded that the prudential standards, conduct standards and the authorisation process adopted by the FSA posed excessive barriers to entry and expansion in the banking sector. The successor bodies to the FSA, the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) concurred with this conclusion and introduced a new authorisation process on 1st April 2013.

We have now had two years of this new approach and I wanted to take the opportunity today to reflect on:

- Do we now have a more proportionate regulatory regime for new and growing banks?
- Do we see an increasing number of new entrants?
- Do we see significant growth in retail banking away from the established players?

and given the focus of this conference on the evolution of the mortgage market;

- The impact to date on the mortgage market, and what we can expect in the future.

Do we now have a more proportionate regulatory regime for new and growing banks?

One common misconception is that the FSA only authorised one new bank. This is incorrect. The vicious circles of funding and costs did not prevent new banking licences being granted by the FSA. However, between 2006 and 2012 of the thirty nine banking licences that were authorised, less than ten percent were granted to new entrants; over ninety percent were issued to overseas banks either establishing UK branches, subsidiaries or UK operating entities.

With statistics such as these, you can understand why the Office of Fair Trading and the Independent Commission on Banking reached the conclusions that they did.

From day one, the PRA has had a different approach to the FSA. Our general objective is to promote the safety and soundness of the firms we regulate, focusing on the adverse effects that they can have on the stability of the UK financial system. This means that the PRA is not a zero failure regulator. Rather, the PRA will seek to ensure that any firms that fail do so in an orderly way that avoids significant disruption to the supply of critical financial services.

This different approach requires all new banks to submit a recovery and resolution strategy as part of their banking application and if we deem them resolvable with no systemic impact on the banking system, we are prepared for new banks to hold lower levels of capital and liquidity, than would have previously been required.

The PRA and FCA also recognise that although financial resources are a fundamental requirement, there is much more that needs to be put in place to allow a new bank to successfully operate. Many supplier relationships required for trading cannot be established until a banking licence has been approved. To assist new banks through this conundrum, the PRA and FCA now grant new banks 'mobilisation' status. Their banking licence can be approved, which allows them to finalise their infrastructure build, but it is restricted to prevent them raising no more than £50,000 of retail and wholesale funding. Once all their operations are up and running and fully tested, the restriction is lifted and the bank can fully open its doors.

The feedback we have received from new banks in the last two years does suggest that the new regime is working and is seen as proportionate. I can assure you that in line with our secondary competition objective which was introduced twelve months ago, we will constantly review new prudential policy developments to ensure that this position is maintained.

Do we see an increasing number of new entrants?

In its first two years, the PRA will have granted eleven new banking licences, so the number of new licences per annum remains very similar to the FSA. What has changed is the balance. Whereas the FSA granted less than ten percent of banking licences to new entrants, over one third of the licences granted by the PRA are to new entrants.

Given both the pipeline of applications in progress and investors expressing an interest in submitting an application, we would expect to see five or six bank licences being granted per annum for the next few years. We also anticipate that the trend that has emerged since the PRA was established in 2013 will continue and between one third and a half of new licences will be granted to new entrants to the banking market.

Funding for these new entrants will not just be from the UK; international investor interest in UK banking remains strong, with one of the primary reasons investors are drawn to the UK banking market being not just the proportionate approach taken to new entrants but the underpinning strength and transparency of the UK's regulatory regime.

Do we see significant growth in retail banking away from the established players?

The term 'challenger bank' now seems to be a very commonly used term by market commentators, however it is a very recent term. It does appear regularly in market reviews from 2012 onwards and probably entered our vocabulary in either 2010 or 2011 following the Office of Fair Trading or the Independent Commission on Banking report. It is now so well used it is even defined in a number of dictionaries. So what is a 'challenger bank'? The dictionary definitions would seem to suggest it is a "small retail bank set up with the intention of competing for business with large, long-established national banks". I would suggest that if this is the definition, then perhaps 'challenger bank' is not an appropriate term for the current new entrants.

What we are not seeing are the new entrants yet making big inroads into the market share of the large, long-established banks but what we observe is they have focused and clearly defined strategies, seizing market opportunities that are poorly served by the current incumbents. Their focus may be on a specific:

- product or products – (such as invoice finance)
- customer group – (perhaps small business owners in one geographic region)
- service proposition – (bespoke underwriting to non-standard lending)
- use of technology – (particularly exploiting the connected world in which we now operate)

The new banks are challenging the existing retail bank conventions in a very targeted manner. They are bringing innovation to banking. But, it will take many years for them to make significant inroads into the market shares of the established players. I have been working in banking for twenty-five years and for the first twenty of those years the eminent market strategists spoke consistently about the need for consolidation in UK retail banking. This has resulted in the market dynamics we have today, with five to six banking groups dominating the main retail banking markets.

It is only in the last five years that greater competition and diversification have been gaining influence in the strategic thinking for the UK market. When the UK has been following a consolidation strategy for twenty years, you are not going to be able to recalibrate the market overnight. If the UK wants a more diversified retail banking market, we need to be prepared to wait until 2020 and beyond. By then the ring fenced banks will have been established as part of the major UK banking groups and the new entrants we are seeing today will have had the opportunity to mature.

I would suggest we have not seen the end of consolidation in UK retail banking, even if competition and diversification continue to set the strategic agenda. It would not be unexpected to see some of today's new entrants merging with each other in the coming years and it will be intriguing to see how UK retail banking evolves. By 2020 - will we have today's new entrants becoming twenty banks each with a fifteen billion balance sheet, ten banks each with a thirty billion balance sheet or three banks each with a one hundred billion sheet?

It is not for the PRA to influence the outcome for the new entrants but for us to ensure that, however they should develop, we maintain the safety and soundness of the financial system.

The impact in the mortgage market?

Finally I want to take some time to discuss the impact new banks will have on the mortgage market.

I do not envisage all the new banks will become mortgage lenders. Many will identify opportunities in other markets and that will remain their focus. Others will enter the mortgage market as startup operations, bringing new propositions, products and technology to the market.

I would also expect a number of the non-bank lenders to become banks. Two have already taken this strategic decision, which is centered upon establishing greater diversity to the liability side of their balance sheets.

So is this the end of the non-bank mortgage lender? Probably not. The more proportionate regulatory regime for banks will make this a more attractive option for many non-bank lenders but it will require them to enter a totally new market, raising and managing retail deposits. The skills required to successfully operate in this market are very different to the funding model the non-bank lenders deploy today and for many the diversification will not be attractive.

We anticipate that a number of non-bank lenders will apply for a banking licence but we would still expect to see both bank and non-bank mortgage lenders continuing to operate in the UK mortgage market.

Conclusion

Two years on from the introduction of our new rules, we have already seen a significant change in the mix of applicants for banking licences. We expect this trend to continue over the next few years, particularly where there is a gap in the market – whether it be the service they provide, the customers they target, the products they sell or the technology they use.

However, to see a major recalibration in market shares across many aspects of retail banking will require a constant stream of new entrants, all with plausible strategies, for the next five years and beyond. In these five years we should expect some consolidation among the new entrants but as they evolve, coupled with the introduction of ring-fenced banks, we can expect a different landscape to retail banking by 2020.

I would postulate that forecasting the exact contours on the 2020 retail banking landscape is not possible in 2015 but however the gradual evolution should take shape the PRA will continue to regulate the new entrants in a proportionate way.

Banks authorised by the PRA

Axis Bank UK Limited
Charter Court Financial Services Limited
China Construction Bank Corporation
First City Monument Bank (UK) Ltd
Hampden & Co Plc
Industrial and Commercial Bank of China Limited
OakNorth Limited
Paragon Bank Plc
UBA Capital Plc
Union Bank of India (UK) Limited
U.S. Bank National Association