Allica Bank

ALLICA BANK SUBMISSION TO INQUIRY ON POST-BREXIT REGULATORY REFORM BY THE APPG ON CHALLENGER BANKS & BUILDING SOCIETIES

We are very pleased to submit evidence to the All Party Parliamentary Group on Challenger Banks and Building Societies on its inquiry on post-Brexit regulatory reform.

As we set out in our submission, the APPG's inquiry comes at a critical time for the economy and customers, especially for the small firms like those Allica serves.

In summary we believe the APPG's inquiry is important for a number of reasons:

- In the aftermath of Brexit there is a significant opportunity to shape the UK regulatory landscape so it creates a more level playing field in the SME banking market and encourages a more sustainable and dynamic supply of affordable and flexible funding options for SMEs

- The 'level playing field' debate has featured heavily in regulatory discussions since the financial crisis, with many in the challenger bank community believing that despite the Government and Regulators' pro-competition agenda, the overall regulatory landscape, particularly prudential rules, has left large incumbent banks with ongoing unfair advantages over their start-up / smaller competitors

- These imbalances have been magnified through the pandemic and the roll-out of Covid lending schemes, with the British Business Bank confirming over 85% of Government-backed lending being completed by the major 5 banks, squeezing out much of the challenger bank and specialist / alternative SME lenders, which we believe will have reversed some of the competition gains that had been made in the preceding years

- The regulatory flexibility available post Brexit has to be taken advantage of – to ensure SMEs have access to affordable and flexible funding options to underpin the economic recovery and beyond, as well as to reinvigorate the banking competition agenda. There is also the chance to support continued innovation in SME financial services, ensuring the UK remains a leading centre for fintech for the decade ahead.

- Taking advantage of that flexibility to promote economic growth and competition does not have to come at the expense of the stability and soundness of the UK's financial system. There are practical and proportionate regulatory moves that can be made that can both maintain a strong and robust regulatory regime, while promoting a more vibrant and competitive smaller bank market, for the benefit of the UK's SMEs.

Allica Bank

Allica Bank is a relatively new SME challenger bank, combining leading fintech capabilities with deep SME lending expertise.

Allica's proposition brings together a first-class digital offering with an expert, personal service.

Our focus is on serving established and ambitious mid-sized SMEs, who we believe remain significantly underserved in the UK. The big, traditional incumbent banks still tend to focus on larger SMEs and the mid-corporate market, while digital SME fintechs focus exclusively on sole traders and micro-SMEs, offering much better digital current accounts but without developing any substantive credit offering.

Our ambition is to reimagine local relationship banking for ambitious and established SMEs and we are incredibly proud to be building the UK's first new network of SME relationship managers since the financial crisis, offering a genuine nationally-competitive alternative to the large high street banks.

Having gained our full UK banking licence in September 2019, we opened Allica's doors to new SME lending in March 2020.

Despite the challenging Covid environment, as at the end of April 2021, we have supported SMEs across the UK with c.£100m of completed loans and have a further c.£125m of committed lending offers currently in the process of completion.

Eighty-five per cent of our lending is to businesses outside London, which we expect will remain the case as we continue to build momentum in our lending at pace. We completed as much lending in the first quarter of 2021, as in the whole of 2020 and we anticipate making over £500m in committed lending offers in 2021.

Covid and achieving a SME-led recovery

Clearly the country has experienced an unprecedented year of economic disruption.

Nowhere is this more obvious than in the SME lending market, where the past year has seen £70 billion of new lending extended to SMEs through the Bounce Back and CBILS lending schemes[1]. Government-backed lending now accounts for a third of the UK's SME finance market[2].

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[1] British Business Bank, press release, 25 March 2021

[2] British Business Bank and Bank of England data - Covid lending scheme £bn and SME lending data (stock), 2021

This emergency intervention has been absolutely necessary for many SMEs. Ninety per cent of SMEs looking for finance in 2020 did so because of Covid, with 75% of SMEs using it for working capital and day to day costs[3].

The pressure on these SMEs will remain acute – for over 60% of SMEs using the Bounce Back scheme, the value of their loan is greater than 20% of their turnover – a clear indicator that many could struggle to service their lending over the months and years ahead.

Yet as we have experienced at Allica, not every SME has been pushed to the brink through Covid. The British Business Bank's latest SME finance survey shows over 40% of SMEs either stayed the same size or grew through the crisis. 20% of SMEs expect to grow over the next 12 months – 40% among the UK's vibrant but under-reported mid-sized SMEs where Allica focuses as a bank.

There is clearly a significant opportunity for SMEs to help drive the recovery.

However, given the dramatic and profound disruption in the SME finance market over the past 12 months, we have a concern is that this opportunity could be lost through a lack of flexible and affordable market-based funding options over the coming years for those SMEs looking to run, invest in and grow their businesses.

Our concerns are based on a range of factors including:

- ***The competitiveness and normal functioning of the SME finance market has been disrupted*.** The Covid schemes were very necessary and effective for many SMEs, but there is no doubt they have distorted the underlying strength and competitive landscape in the SME finance market. Bounce Backs and CBILS, with their highly preferable terms, now account for around a third of the entire SME lending market with around 90% of Bounce Back loans borrowed from the big 5 banks. After years of progress in diversifying the SME lending market, many businesses have effectively been pushed back into the arms of the incumbents.

- ***The incentives for large incumbents to grow their SME lending books during the recovery will remain weak*.** With large Covid lending books to manage and an uncertain economic outlook, you can see why the FPC is nervous about whether incumbent banks will keep their focus on lending to established, viable SMEs who have the potential to fuel the recovery. The practical difficulties of servicing even bigger loan books, with higher than normal defaults, while also protecting capital positions and the pressure of shareholder demands, will make further SME lending growth challenging for the larger banks.

[3] British Business Bank, Small Business Finance Markets Report, 2021, 10 March 2021

- ***Smaller and alternative SME lenders continue to face structural disadvantages in the market, especially around prudential regulation and the cost of funding.*** This will continue to put a constraint on smaller firms' ability to offer flexible and affordable funding options for SMEs through the recovery, weakening the competitive pressures on larger firms and leaving them to operate selectively in more profitable areas of the market.

The overall impact of these factors could be a less dynamic and vibrant SME finance market, which will at the very least limit the level of ongoing affordable finance options for many SMEs

Attention is now turning to the economic recovery, where the Government has in our view rightly focussed on policies that can encourage an investment-led recovery. This makes the issue of prudential regulation and the impact on SME access to finance and competition issues all the more important.

In our view there is no better time to consider the shape of the UK's post-Brexit regulatory landscape and how the regulatory landscape could be better calibrated to promote greater levels of economic growth and competition alongside ensuring the stability and soundness of the financial system.

In particular we believe there would be real value in the APPG reviewing potential regulatory reforms in two broad categories:

- Short-term practical improvements (24 month time horizon) that can immediately help SMEs during the economic recovery, facilitating the increased business investment and productivity the Government is hoping to achieve

- Longer-term modifications that will ensure the balance of regulation promotes greater competition in the SME banking market.

Shorter-term (24 month time horizon) practical improvements

In terms of specific policy actions that could be taken, there are three opportunities in the short-term which we believe could be considered:

1) ***Maintaining the SME support factor*** – if EBA preliminary guidance is followed, the SME support factor will cease at end 2022 (with the start of the so-called 'Basel IV' regime), seeing a potential 30% increase in the capital requirements for SME lending, and thereby a reduction in the supply of finance to SMEs by banks. This is likely to begin to bite during 2021 and 2022 as banks prepare for its removal, just as the economy is meant to be growing at an unprecedented 7%. The PRA has flexibility post-Brexit to maintain the support factor, and we understand will be consulting on 'Basel IV' implementation later this year – we would urge at a minimum that they should be maintaining the support factor for SME challenger banks subject to the Standardised capital

regime (which the EBA guidance paper from 2019 did recommend, as it stated the issue with the SME Support Factor was with regard to large IRB accredited banks).

For context, in the wake of the Financial Crisis the EU implemented an SME 'Support Factor' to ensure that tighter regulatory reforms did not 'choke off' credit to SMEs vital to the recovery following the crisis. The 'Support Factor' allowed a c24% reduction in a bank's pillar 1 capital requirement where it granted a loan to a qualifying SME.

The Basel 3.1 reforms, currently applicable 1 January 2023, the removal of the SME Support Factor, will increase the capital requirements applicable to SME as follows:

i) For SME lending of up to EUR 1m, the capital requirement will increase from c.57% to 75%,

ii) For SME lending of EUR 1m up to EUR 2.5m, the capital requirement will increase from c.76% to 85%.

These increases will lead to either a pound-for-pound reduction in credit supplied, or an equivalent increase in pricing, at just the moment where challenger bank SME lending is most needed as a period of unprecedented economic growth is targeted for post Covid recovery, and the CBILS/BBLs schemes have been withdrawn.

2) ***Extending Term Funding for SMEs*** – the Bank of England's TFSME scheme has been vital in reducing funding costs for challenger SME finance providers and supporting more affordable lending for SMEs through the crisis.

Banks that are growing their SME lending are eligible to draw funding from the Bank of England at a current 0.1% cost. This makes minimal difference to major banks but can be a significant factor in a challenger bank's pricing to SME clients. We therefore believe the scheme should be extended beyond October this year and well into 2022 or 2023 underpinning the period of forecast unprecedented economic growth, while also assisting with the objective of improving competition in UK lending.

3) ***The UK treatment of software assets*** – since December 2020, banks in the EU have been able to benefit from an allowance where at least a portion of their capitalised software can be added back to their capital base. We believe this was a considered and balanced decision in recognition that the EUs key banking market competitors in the US, Singapore and Switzerland do not deduct their software assets from capital leaving EU banks at a relative disadvantage. The disadvantage manifests itself in stifling the innovative and digital investment capacity of the banking sector, and is particularly acute for challenger banks seeking to invest in financial technology to benefit their customers.

On 28 December 2020, the PRA took swift action to reverse this element of retained law. This decision primarily based on the lack of available evidence on the valuation of software in resolution as well as being considered a divergence from Basel.

It is indeed plausible that software would have no value if it were to enter resolution or wind down. But equally, depending on the firm and the stage of its development, an acquirer may ascribe premium or value over its cost. This is because it will be intertwined with the customer related assets and liabilities into which the technology has been inextricably linked. So that 'lack of evidence' should not automatically lead us to the assumption that value is absent. On the contrary, the regular independent audit of a bank's financial position will show that software has been valued at the lower of cost or net realisable value, so potentially undervaluing its true 'value'.

Since the deduction of software was first consulted on internationally in 2010 by Basel, there have been significant developments to ensure the soundness of the financial system. This includes an increase in the quality of loss absorbing capital, the quantity of capital via countercyclical buffers, capital conservation buffers, as well as early recognition of loan losses through IFRS9, a liquidity regime requiring a binding LCR and NSFR, a leverage ratio, MREL requirements, a well-developed recovery & resolution regime, and a requirement for new entrants to develop solvent wind-down plans.

In our view, these very substantial safeguards put in place in the overall regulatory framework, should allow the PRA to provide tolerance for measures that would support the continued development of an innovative and thriving UK challenger banking sector post Brexit, as opposed to taking a more conservative position than the EU.

Longer-term competition considerations

In terms of longer-term recommendations for potential regulatory reform, we believe two specific areas of prudential regulation are worth considering through the lens of competition and the level playing field effects between large and small banks.

1) ***The implementation of final Basel standards ('Basel 3.1')***
   Basel issued their final consultative documents on post-crisis reforms in December 2017 after approximately 2 years of consultation and recalibration. The industry understands that the PRA will consult towards the end of 2021. This means that policy will be issued in approximately the first quarter of 2022 leaving less than 1 year for a 1 January 2023 implementation.

   We have a number of concerns with this timeline. Firstly, there will be insufficient opportunity for industry to respond since there is no Discussion Paper, there will be one iteration. This suggests the Policy will be highly aligned to what is in the 'Consultation'.

Secondly, the December 2017 proposals contain significant variability and outcomes on capital requirements uncertain, as there are a number of choices on how to implement at the national level[4], and in the past the PRA has disapplied some elements of BIS standards. Given all terms being provided currently will run well into the new capital regime, this uncertainty around capital requirements hinders challenger bank competition (by contrast major banks follow an IRB approach and so are not as impacted).

We would therefore strongly argue that a) the SME Support Factor should be maintained, as above, b) a transition period should be provided if the UK implementation is to differ materially or be more conservative than that adopted elsewhere.

2) MREL

Although MREL is not a Brexit driven issue, as flagged recently by a range of challenger banks this issue does need careful consideration in order ensure the scale of competition from challenger banks is not limited.

Not only is the absolute balance sheet threshold significantly below that required for European banks, the number of transactional accounts (the lower end being 40,000 to trigger an MREL requirement) creates a 'cliff edge' impact. As a direct result while Allica plans to launch a current account capability for SMEs in Q3-2021, we plan to target only winning c.30,000 SME customers over the coming years, in order not to trigger the punitive additional costs of MREL which would seriously damage our business model and therefore investor attractiveness.

We fully support the need for a MREL threshold related to the number of accounts, given that operational resilience and cyber security of customer services are critical risks for business models that focus on large volumes of accounts but limited lending (and so would never be captured by the balance sheet related thresholds). However the 40,000 threshold is too low, and there should be gradation around its introduction. For example we would suggest an appropriate minimum would be in the region of 100,000, with a pro-rated /tapered introduction of MREL requirements up to 500,000 accounts.

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[4] For example whether loans to SMEs secured on their premises should have risk weight set based on two Loan to Value Bands (whole loan gets same risk weight depending on if LTV below 60% or above 60%), or based on splitting the loan into the portion below 55% LTV and the portion above 55% LTV and pro-rating the risk weight to each. The latter seems the more risk sensitive and therefore appropriate method to Allica.

To conclude we believe that there are a number of significant issues which, individually and collectively can have an adverse or positive impact on the UK economy post-Brexit - legislators and rule-makers will shape that outcome.

It is increasingly obvious that all these issues impact real lending to the SME market that the challenger community is well placed to help serve. So we believe additional scrutiny in a post-Brexit world is needed, and it is important that the rules are consistent in reflecting competition and economic objectives alongside prudential.

We have been happy to highlight these issues and given their gravity, would gladly be available to discuss these points further with you if that would be of use, or to arrange a roundtable with a number of challenger banks.

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