OakNorth

An open letter to the regulators and policy makers from Rishi Khosla, co-founder and CEO of OakNorth Bank

1 September 2020

It's been five years to the day since OakNorth Bank launched and, in that time, the UK has gone through not one, but two unprecedented events – the Brexit vote and the withdrawal process that followed, and COVID-19. It's fair to say it's been a uniquely challenging period to have started and scaled a new bank, but we've been fortunate to have had the opportunity to build a robust business with appropriate support from regulators and policy makers along the way.

In this open letter, I reflect on OakNorth Bank's first five years – the journey to becoming a fully-licensed bank, and the learnings, opportunities and challenges we've experienced as a new bank. I also share some thoughts on what else I feel could be impactful from a regulatory perspective to help set the industry, and other new banks like OakNorth, up for sustainable growth and long-term success.

The past

The computer says 'No', 'No', 'Sorry, but no'

In 2005, my business partner, Joel Perlman, and I were looking for a working capital facility to support our growing business, Copal Partners, a financial research firm we'd founded three years previously. We approached numerous high-street banks and kept getting variations of the same response – "the computer says 'No'". Despite being a profitable business with strong cash flow and retained clients, none of the commercial banks were willing to lend to us. It was too small a ticket to offset the costs the bank would incur in doing a fundamental assessment of our business and structuring a finance facility for our needs. A few months later through one of our institutional client's special situations desk, we managed to secure 100x the amount of debt for a dividend recap. So, an institutional division of a bank was able to support us, but the commercial lending part of the bank was not.

This experience stuck with us.

After we'd scaled Copal Partners to a 3,000-employee business, Moody's Corporation (NYSE: MCO) acquired it in 2014, we then set out to address the funding gap we had experienced first-hand and help growth businesses achieve their potential. We refer to this funding gap in the market as the 'missing middle'. These are the businesses who have the largest multiplier effect in an economy – they're also known as "scale-up businesses", clearly distinct from "start-up". This multiplier effect makes these businesses the genuine backbones of economies and communities globally, which is a key reason why Mark Carney, former Governor of the Bank of England, has been a long-term advocate for closing the funding gap.

We not only wanted to build a very robust and sustainable bank in the UK (OakNorth Bank), but also the technology platform that would enable other banks around the world to more holistically and efficiently lend to the missing middle.

The perfect storm

In March 2013, around the same time we were devising this plan, the UK financial regulator at the time (the Financial Services Authority / FSA), published a paper entitled: "Barriers to entry: a review of requirements for firms entering into or expanding in the banking sector". This review set out changes in two key areas: reforms to the authorisation process for bank applicants; and a major shift in the approach to the prudential regulation of banking start-ups. These changes were designed to reduce the barriers to entry and expansion in the banking sector and enable increased competitive challenge to existing banks.

A month after the paper was published, the FSA was replaced by new UK financial regulators (the Prudential Regulation Authority / PRA and the Financial Conduct Authority / FCA) who understood that any successful market economy or sector needs to have the capacity for new entrants to be able to compete with existing incumbents - they bring fresh ideas, new business models, and innovation. However, until Metro Bank in 2010, there had been no new bank licenses granted in the UK in over 150 years.

The regulators wanted to change this, so they worked together to implement the changes from the FSA's paper which were:

- A simplified application process with stage gates at each point in the process, so applicants know how their application is progressing.
- Mobilisation – authorisation would be granted, but with strict limits on the activities that could be undertaken, until the bank had built its resources, processes, people and systems.
- Capital and liquidity requirements – the PRA removed the automatic application of capital and liquidity scalars to a new bank's requirements, whilst at the same time bringing in the concept of buffers linked to wind-down costs in the first five years of a bank's life.
- More resources dedicated to the supervision of these new banks, with a team of dedicated, highly skilled supervisors focusing on these firms. This included annual capital assessments (SREPS), to ensure that new banks' capital requirements were accurate and up to date as they scaled.
- Removing the concept of 'zero failure' and accepting that not all the new entrants would thrive and flourish. A regime would be put in place to ensure those banks could withdraw from the market with no impact on depositors or financial stability – i.e. removing the risk of "too big to fail" seen during the financial crisis.
- A more progressive and open regulatory culture to new banks, with a focus on providing constructive and timely feedback to prospective new entrants, so that scarce capital would not go to waste in a long and convoluted application process.

However, even with all these new regulatory initiatives, starting a new bank would be a huge risk for Joel and myself, and would require a significant financial investment. So, we sought insight from key stakeholders to try and get the confidence we needed to go ahead.

After the new framework was published in 2013, we had the fortune to meet with Andrew Bailey in October 2013 who at the time was the CEO of the PRA but is now Governor of the Bank of England. We discussed the idea of launching a new bank focused on lending to the missing middle, and the steps the regulators had taken to reduce the barriers to entry into the UK banking sector. That meeting with Andrew gave us the confidence to push the button on proceeding with our plans to build OakNorth.

In early 2014 we were also introduced to George Osbourne who was Chancellor of the UK Exchequer at the time, and Martin Stewart who was a senior Director at the PRA and who was heading the new bank start-up unit. Both continued to be great sounding boards throughout the licensing process and in the years that followed. After he'd left the PRA, Martin joined our advisory board and remains an invaluable resource within the business today.

We were also fortunate to meet several other policy makers who helped provide insight on thematic matters and have continued to support us on our journey. These include Dave Ramsden, Deputy Governor for Markets and Banking at the Bank of England, who engaged with us on the extension of the Funding for Lending Scheme and recently during the COVID crisis; and Andy Haldane, Chief Economist at the Bank of England, who has helped us think through a number of macro trends, and has recently shown great interest in the platform and technology we're using to obtain forward looking views on credit through the COVID crisis.

Becoming the third new bank in the UK in more than 150 years

To be given the green light to submit a banking licence application, we needed to go through an intensive series of interviews with the PRA and FCA to discuss the proposed business model, its viability and sustainability, governance, capital, liquidity, controls, proposed investors and IT.

Our proposed business model was simple: raise retail deposits to fund lending to the missing middle. However, at the heart of that model was innovation by using technology to bring the large cap, institutional approach to small and mid-sized commercial lending.

The challenge for existing banks when it comes to lending to the missing middle is one of economics. In order to extend credit, the bank needs to understand the business' financials, and the forward-look of the business which allows future scenario analysis – something which is done for all larger loan transactions but is a manual process that is time-intensive and costly. Doing this for smaller businesses hadn't been possible historically because of the high human cost of doing in-depth credit analysis. This is why we were unsuccessful in securing a loan from the high-street banks in 2005.

Our idea therefore, was to leverage new technologies (machine learning, massive data sets and cloud computing) to enable OakNorth to undertake the type of forward-looking credit analysis and monitoring that normally only occurs with bigger ticket corporate lending and apply it to the missing middle. By combining these technologies with specialist credit teams, we would be able to provide businesses with a fundamentally better borrowing experience both in terms of speed and getting a facility that's structured to their needs, at a lower cost, unimaginable to the big banks. This next generation credit analytics and monitoring capability is what we today call our *Credit Intelligence Platform*.

The questions we were asked by the regulators were tough, but fair and well thought through. Ultimately, much of regulation is fully consistent with the goals of building a sustainable long-term institution. This fit well with our ethos, as we've always had a very traditional view when it comes to business building, which is that you build an organisation to be profitable and have a positive impact for generations to come.

However, neither of us had any prior commercial banking experience. So, we needed to build a team of experienced bankers across origination, operations, finance, risk and audit. The challenge was that without a banking license, convincing them to leave their secure jobs at institutions which may have been around for hundreds of years, wouldn't be easy. Fortunately, we were able to find some brave souls – most of whom are still with us today.

Neil Evans, OakNorth Bank's Head of Credit Risk and one of the first 10 people to be hired at the business, recalled: *"I can't say that I had any particular desire to leave RBS – I had a secure role at an institution that had been around since the 18th Century, and colleagues who over the 35 years I was there had become close friends. So, when I met Rishi and Joel, I was more surprised than anyone to feel a sudden itch in my feet. Neither of them were bankers. In fact, they'd never even worked for a bank, yet here they were explaining to me how they planned to apply for a banking license and shake up the commercial lending market."*

Ben Barbanel, OakNorth's Head of Debt Finance who was also one of the first 10 people to be hired, continued: *"When I first met Rishi and Joel, I was sceptical to say the least: they wanted to lend £1bn by the end of 2020 - a pretty punchy target considering neither of them were bankers and were yet to secure the banking license! However, hearing about their experience, I quickly began to come around. I'd been working in commercial lending for about 15 years so had experienced first-hand how legacy systems and processes could delay decisions and lead to frustrated borrowers, off-the-shelf products and computer-says-no decisions."*

We submitted our application in August 2014 and were granted approval to the 'mobilisation' stage in March 2015. Mobilisation allowed us to engage with suppliers in a different way and importantly, build the capital we would need to operate as a fully-licensed bank. It also allowed us to increase the pace of recruitment of key staff, offering reassurance to new hires that a banking licence had been granted (albeit with restriction). It was at this stage that our Board began to take shape - initially with Lord Adair Turner as Senior Independent Director in March 2015. He had previously been Chairman of the Financial Services Authority and had led the regulators' response to the financial crisis. He remains on our advisory board to this day. Cyrus Ardalan joined us as our Chairman in July 2015 and has helped ensure the board is made up of a broad and deep range of skills and experience across the banking, debt finance, operations and technology sectors.

The next stage of the process was to go through mobilisation and be granted full approval. We'd been told by the regulators that this stage would probably take a year to complete, so naturally we wanted to do it in half that time!

The team at the PRA and FCA were extremely robust in their process but were also willing to move quickly with us. Diliana Robertson, the PRA Authorisation manager at the time, really helped drive this momentum, responding to emails at all hours of the day and taking a very constructive and collaborative approach with her feedback. I recall getting responses from her and her team past midnight on numerous occasions. I was impressed by this business-focused approach and the informal channels, outside on the more formal supervisory interactions, which allowed us to speak candidly and share views, as well as ensure things kept moving. It was this drive from both sides – us and the regulators – which ultimately led to us exiting mobilisation just five months later, in total just over twelve months from submitting our application for a banking license.

We received final approval and the removal of all restrictions at the end of August 2015 and OakNorth Bank became the third new bank in the UK in over 150 years.

We officially launched and completed our first transaction in September – a £770k loan to Nevasay Limited, an SME housebuilder, for a new residential development in Kentish Town.

Working with AWS and the regulators to become the first UK bank to be fully cloud-hosted

As a new bank, we felt we were in a unique position to build our tech stack from scratch and take advantage of the cloud. However, at the time when we were granted full approval for our banking license in August 2015, there was no regulatory policy in place for banks to be hosted on the cloud. We were informally given feedback from the FCA that we could either input into cloud policy and wait until that was in place before launching or launch and then input into cloud policy. We chose the latter.

Over the next several months, we worked with Amazon Web Services (AWS) and the FCA on policy items around data protection, access to data, security and business continuity, and in May 2016, OakNorth Bank became the UK's first bank to fully operate its systems in the cloud. Two months later, the FCA published its finalised guidance on outsourcing to the cloud and other third-party IT services, with OakNorth providing a real-life example of how an FCA-regulated entity could operate in the cloud.

The initiative was described by the media, industry experts and other key stakeholders as a "landmark move" for the industry as it paved the way for others to follow suit. The FCA's approach to cloud computing has been replicated by regulators around the world – a testament to their forward-looking regulatory approach.

The present

Building a profitable, sustainable, long-term business

Our *Credit Intelligence Platform* has helped OakNorth Bank achieve performance metrics which place it in the top 1 percent of banks in developed countries:

- ROE run rate of 23 percent[1]
- Efficiency ratio run rate of 29 percent
- Net promoter score of 80.5

This is with a team of less than 270 people.

In addition to this, the bank reached cash flow break-even just nine months post-launch (June 2016), repaying all accrued losses within 25 months post-launch (October 2017). Pre-tax profits in 2019 near-doubled to £65.9m from £33.9m, and even amidst one of the most challenging economic periods in 300 years, OakNorth Bank is yet to experience a credit loss and has only had a cumulative seven defaults since inception.

We've lent over £4.3bn supporting hundreds of businesses across the UK who have collectively developed over 15,000 new homes and created 19,000 new jobs (the multiplier effect of supporting the missing middle).

Having good governance and being able to access a deep pool of knowledge and expertise has been critical to our success. This is evidenced by our board which includes: Cyrus Ardalan (former vice chair of Barclays investment banking and World Bank), Navtej Nandra (former CEO Morgan Stanley Asset Management and President of ETRADE), Ted Berk (former partner at Bain Capital) and Robert Burgess (former Lloyds), and advisory board which includes: Lord Adair Turner, Martin Stewart, Lord Philip Hammond who was former Chancellor of the Exchequer in the UK Government from 2016 to 2019. Lord Francis Maude was on our advisory board for three years, travelling up and down the country with us to meet with and hear from hundreds of businesses. Together, we hosted events with businesses in London, Manchester, Bristol, Birmingham, Leeds and Milton Keynes.

'No, nein, nee, tidak'

The issue of the missing middle struggling to access credit is not unique to the UK. It is a similar narrative in every economy in the world. By our estimate, the funding gap globally for the missing middle is between $1.3-$1.5tn.

As noted earlier in this letter, we had always planned to scale the OakNorth proposition internationally, not by obtaining banking licenses in each market, but by enabling incumbent players. As demonstrated by our experience so far, building a strong bank is a worthwhile but incredibly time consuming and challenging process. Instead, we are licensing the technology that has enabled OakNorth Bank to successfully lend to the missing middle in the UK to other banks so that they can do this in their own markets. By partnering with existing banks and enabling them, rather than trying to replace them, we can help close the global funding gap in a fraction of the time it would take if we were to try and do it alone.

Our *Credit Intelligence Platform* leverages machine learning, credit science and massive data sets to model a forward-looking view of a borrower's financial situation, that's informed by industry benchmarks, peer analysis, and scenario analysis specific to that business. The platform can apply proprietary stress scenarios to lenders' portfolios and assign each borrower a risk rating based on determined factors such as liquidity, debt capacity, funding gap and profitability. Through analysing each borrower's data in the context of its geography and sector and monitoring a borrower against its peers, the platform is able to alert lenders when a loan, or borrower needs attention.

Today, OakNorth is working with over a dozen bank partners around the world, including PNC, Customers Bank and Modern Bank in the US, NIBC and OIMIO in the Netherlands, and of course, OakNorth Bank in the UK. Our success to date has helped us attract over $1bn of funding from leading investors, including: Clermont Group, Coltrane, EDBI of Singapore, GIC, NIBC, Toscafund and SoftBank.

[1] Based on required equity, as we are significantly overcapitalised today to support our growth

Our response to COVID-19

The first step we took within the bank when COVID-19 began to emerge in January 2020, was to assess the supply chain disruption from China on our loan book. By mid-February before we were even sure that COVID-19 had reached British shores, we had already run six full portfolio stress tests across our entire loan book, on a granular, loan-by-loan basis.

From 13 March (10 days before the UK went into lockdown), we began hosting daily ExCo and Credit Committee meetings. Within 36 hours of the UK lock down, we had run a reverse stress test on the whole loan book, determining how long each business could survive if their opex were to stay constant, but their revenues shrink to zero. Over the next two weeks, we continually refined the granularity of our stress tests– increasing the severity of the situation as days went by i.e. what the impact would be if the UK lockdown lasted six weeks, three months, six months, nine months

This developed into what we call the *COVID Vulnerability Rating (CVR) Framework*. The Framework integrates 133 proprietary, subsector-specific, COVID-19 stress scenarios with regional overlays, incorporating assumptions for impacts on key financial metrics such as revenue, operating costs, working capital and CAPEX. It enables us to:

- Quickly determine the subsector-specific impact of COVID-19 on our portfolio, using forward-looking scenarios across the three stages in the economic journey – the ‘crisis’, the ‘reboot’, and the ‘new normal’;
- Follow through on this sub-sectoral analysis on a granular, loan-by-loan basis, to support borrower-level interventions, rather than just portfolio-level stress-testing;
- Re-underwrite loans to businesses that are vulnerable, reviewing accounts regularly at each of the three stages of the crisis;
- Continue to lend with confidence that new loans are being provided to businesses which can survive our stress scenarios

By leveraging the Framework, we have been able to focus on continuing to grow our loan book and support businesses despite the ongoing challenges being presented by COVID-19 and future challenges from Brexit. We’ve seen double the lending volumes going to Credit Committee compared to the same period last year and have approved several hundred million in new loans, including via the Coronavirus Business Interruption Loan Scheme (CBILS) and Coronavirus Large Business Interruption Loan Scheme (CLBILS).

We have shared our thinking with senior regulators and policy makers at the PRA, Bank of England HM Treasury, OCC and other regulators. All have taken an interest in the contribution that our *Credit Intelligence Platform* could have in assisting with macro-economic forecasting, particularly in relation to the impact of COVID-19. These discussions are ongoing but are again, a demonstration of regulators and Government’s innovation-friendly and tech-forward approach.

Rishi Sunak, the Chancellor of the Exchequer, has been incredibly open and communicative throughout this crisis, welcoming feedback from us and others in the industry as to how best we can support individuals and businesses, and minimise the impact of the pandemic on our communities and our economy.

The future

Threadneedle is a two-way street

As this letter has demonstrated, we’ve always had a collaborative relationship with regulators, ensuring that we work with them in a cooperative manner with ongoing and open dialogue. As OakNorth Bank has grown and evolved, we’ve ensured that we use information and feedback from the regulators in a constructive way. As we weather the storm of the national and global recession caused by the pandemic, the guidance and frameworks set in place by the PRA and FCA has been critical for ensuring we have more than sufficient capital and liquidity – and importantly the right frameworks for weathering storms.

For example, OakNorth was part of the PRAs 'Fast growing Firms' thematic work in 2019. The feedback we received from the PRA highlighted several areas including the need for us to think about scaling our loan workout function. Whilst we have always had such a function within the Bank, the regulators' well-considered feedback made us think further that it would be sensible to 'over invest' in our capability in this area, rather than trying to increase its size and capacity in a downturn. This was also fully supported by our Board. We further built this function in H2 2019 and our increased scale and capacity in this area has paid off in the current economic environment. It is this type of feedback from regulators that is hugely valuable to a growing bank.

When Philip Hammond took over from George Osborne as Chancellor, he did a huge amount to support UK fintech and help fly the flag for the sector globally. His efforts have contributed to the UK fintech sector attracting more investment than the rest of Europe combined, and globally, only the US and China attract more investment. The fintech bridges he established have helped countless fintechs including OakNorth export their propositions abroad and ensure the UK can maintain its pole position in fintech. We were delighted when Philip agreed to join our advisory board earlier this year after more than two decades in politics.

His fintech work has continued at HM Treasury where John Glen is helping to lead the Strategic Fintech Review with Ron Khalifa. We are of course playing a role in this critically important work.

Removing regulatory barriers to growth: more proportionality = more competition

As we move into the next stage of our journey, we welcome the PRA's announcement of a review to focus on their secondary competition objective and remove barriers to growth for new challenger banks.

However, it is important to note that starting and getting new banks off the ground will not in itself impact competition. Instead, we must ensure that those banks are equipped with the tools to effectively compete with their established, larger peers. Having enabled new players to come to market, it is vital that the right regulatory approach is taken once those banks move into the next stage of their growth. If you take OakNorth Bank as an example, we shouldn't be treated in the same way as a new bank that's only just received a license or one that's yet to turn a profit. Equally, we believe we shouldn't be treated in the same way as an institution that's been an incumbent on Britain's high streets for hundreds of years, makes billions in profits every year, and has all the economies of scale and other benefits of a large business. Non-systemic banks like us pose less of a risk to financial stability. Therefore, scaling back or simplifying certain requirements (e.g. regulatory reporting) for us, or ensuring that new or existing requirements are implemented in a proportional manner for new and growing banks (e.g. operational resilience requirements and recovery plans), would be hugely helpful in enabling us to effectively compete.

Capital requirements

Ensuring that capital requirements are proportionate and truly reflect the risks that each bank represents is vitally important. The playing field needs to be levelled between banks on the standardised approach such as OakNorth, and the large established banks that benefit from capital efficiencies from their Internal Risk Based (IRB) models.

As it stands, the current capital requirements for challenger banks, particularly relating to credit and concentration risk, tighten the reins on growing banks like OakNorth, compared to our larger competitors and further hinder the opportunity to lend to the missing middle. Small adjustments to this objective could improve lending in the UK and provide regions outside London and the South East with an opportunity to flourish, without impacting the PRA's primary objective – ensuring financial stability – whilst enhancing their secondary objective – facilitating effective competition.

There are several ways this could be done – for example, after five years, the regulators could commit to ensuring that high-growth banks' capital requirement are formally reviewed every year, rather than moving to the three-year process for established 'low-growth' banks. This is because a high-growth bank which is growing at between 30-40% a year, will have very different capital requirements within 12 months, so waiting three years hinders its potential.

The regulators could also apply the 'holistic' approach under P2a (credit) for banks on the standardised approach to cover all types of lenders, rather than the primary focus on residential mortgage lending.

If they were to review the pillar 2a geographic concentration risk, banks that lend across the UK would not be penalised with excessive capital add-ons (as the present approach requires) but would instead be encouraged to lend to regions within the UK vs other countries.

As Britain has left the EU, we could take the opportunity to change the Minimum Required Eligible Liabilities (MREL) to move closer to the level in the eurozone (£85bn of assets vs. £15bn of assets). We could also apply a more generous SME discount factor to Risk-Weighted Assets (RWAs), to encourage lending to growth businesses and to apply that definition of commercial lending to £25m vs the current EUR 1m. As I noted earlier in this letter, we need to support the missing middle - the scale-ups and growth businesses - who are the genuine drivers of productivity, job creation and GDP growth in the UK, and have a much bigger impact on our communities and the economy than start-ups, small and micro businesses.

High-growth bank supervision

We have benefitted from excellent supervisors during our first five years. However, we believe the PRA should invest further in challenger bank supervision, ensuring that supervisors and their specialist teams have sufficient human resources to regularly review requirements. This would help ensure they remain risk-sensitive and proportionate for high-growth banks. The creation of a high-growth supervisory area could be considered for example, staffed with subject matter experts, where banks are moved to after their initial start-up period. Challenger bank supervision shouldn't be seen as a 'training ground' for supervisors before they move onto supervising larger, systemically important banks, but rather as a centre of excellence where supervisors can base their regulatory career. As noted earlier in this letter, challenger banks bring fresh ideas, new business models, and innovation – as part of the team supervising these banks, they have a unique opportunity to address the challenges these banks are facing and help ensure they sustainably move from the start-up phase to the high-growth phase.

The Term Funding Scheme for SMEs (TFSME)

Over the years, we've had numerous discussions with senior policy makers at the Bank of England about how the Funding for Lending Scheme could be widened to ensure cheaper funding could benefit SMEs, through a lower cost of credit. With the new Term Funding Scheme for SMEs (TFSME), the Bank of England could make it easier to access, particularly for smaller banks, by introducing a wider range of eligible collateral accepted and lower haircuts than the Term Funding Scheme.

The 8% Corporation Tax Surcharge

We are impacted by the Banking Corporation Tax Surcharge, which was implemented back in 2016 after the financial crisis. The Banking Corporation Tax Surcharge imposes an 8% surcharge to the standard corporation tax rate for banks and building societies, that make more than £25m in profit – OakNorth reported a pre-tax profit of £65.9m in 2019. While I understand the need for taxation, I feel that this should fall on established incumbents rather than new challenger banks, as it seems disproportionate to put this on the new entrants that weren't involved in the financial crisis. We intentionally don't pay dividends so that we can reinvest all our profit into continuing to grow our business and support the missing middle, so not only does it mean we have less capital to deploy to do this, but it also discourages investment in the UK banking sector from international investors.

End of season one…now we move to season two

We have only just started.

The first five years of OakNorth's journey have seen it secure one of the first new UK banking licences in 150 years, become the first bank to be fully cloud-hosted, lend over £4.3bn to the missing middle across the UK helping to create 15,000 new homes and 19,000 new jobs, achieve profitability and metrics which rank it in the top 1 percent of banks in the developed world, and bring the benefits of the *Credit Intelligence Platform* to commercial banks around the world.

If this is seen as 'Season One' of the OakNorth story the title would be 'Build'.

Season Two of the OakNorth journey is now starting and the focus is on 'Scale'. For the bank this means continued growth of the loan book to a multiple of our current size in the next three years. For the platform, this means continuing to license the technology to banks around the world with a particular focus on the US, Canada, Australia, Germany and The Netherlands.

Thank you for your support in changing banking and access to funding for the missing middle in the UK.