



Financial Services Regulation Committee

Corrected oral evidence: Growth of private markets in the UK following reforms introduced after 2008

Wednesday 17 September 2025

10.10 am

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Members present: Lord Forsyth of Drumlean (The Chair); Baroness Bowles of Berkhamsted; Baroness Donaghly; Lord Eatwell; Lord Grabiner; Lord Hill of Oareford; Lord Kestenbaum; Baroness Noakes; Lord Smith of Kelvin.

Evidence Session No. 8

Heard in Public

Questions 82 – 94

Witnesses

I: Nigel Terrington, Chief Executive Officer, Paragon Banking Group; Mark Steele, Chief Risk Officer, OakNorth Bank.

USE OF THE TRANSCRIPT

1. This is a corrected transcript of evidence taken in public and webcast on www.parliamentlive.tv.

Examination of witnesses

Nigel Terrington and Mark Steele.

Q82 The Chair: Welcome to today's meeting, which is the eighth oral evidence session as part of the committee's inquiry into growth of private markets in the UK following reforms introduced after 2008. Thank you, Mr Terrington and Mr Steele, for attending. This session is open to the public, is broadcast live and is subsequently accessible via the parliamentary website. A verbatim transcript will be taken of the evidence and will be put on the parliamentary website. A few days after this session you will be sent a copy of the transcript to check it for accuracy. It would be helpful if you could advise us of any corrections as quickly as possible. If you wish to clarify or amplify any points made during your evidence or have any additional points to make after this session, you are welcome to submit supplementary evidence to us.

Mr Terrington and Mr Steele, would you like to say anything by way of opening remarks? Shall we start with you, Mr Terrington?

Nigel Terrington: Thank you, Lord Forsyth, for inviting certainly me and today to provide evidence on this important issue. One of the things that we face is an overwhelming increase in the level of capital that has been imposed on the banking sector since the financial crisis. In many ways we can accept that there was not enough capital before the financial crisis, and something needed to change. However, the consequences have not only been a burden on the extant banking sector but also cause some level of lending or activity to be almost disregarded—kind of rejected—from the banking sector. That has allowed the growth and proliferation of the private credit markets.

We can get into the detail of what that actually means a little later, but there has been exponential growth in the private credit markets since the financial crisis, and it is not an accident that that has happened. Nor should you think for one second that we regard everything that has happened since the financial crisis in terms of extra regulation as wrong and we want to go back to those heady days of 2007; we absolutely do not. But what we do seek is greater levels of proportionality, a greater understanding of the segmentation of how capital should apply, and an understanding of the consequences of what that means for the support and growth of the economy.

I am the chief executive of the Paragon Banking Group; we are a focused specialist lender purely into the UK economy. We lend money on specialist mortgages into the private rented sector and an area we call commercial, but essentially it is lending to SMEs in the asset finance market and to small and medium-sized housebuilders. We deliberately do not do everything for everyone as we want to be very focused, but we therefore have an insight as to why some markets grow better than others, why some markets tend to struggle a bit, and what that means for the competitive landscape because there is definitely a distortion in

the competitive landscape within the UK banking sector as a consequence of the regulations that exist.

The Chair: Am I right in saying you are the longest-serving chief executive in the market?

Nigel Terrington: Yes, that is correct. Certainly, there might be one or two—

The Chair: How many years?

Nigel Terrington: It will be 30 years this year.

The Chair: You have seen through several cycles?

Nigel Terrington: Yes, one or two cycles and one or two scary moments, but yes, more than a few grey hairs as a consequence.

Mark Steele: Hello, I am the chief risk officer of OakNorth Bank. On behalf of the entire team at OakNorth, I would like to thank you all for inviting us to participate and give you evidence today. For those of you that may be less familiar with OakNorth, it was launched in September 2015 with one fundamental purpose: to serve and empower the lower mid-market SME markets. What that means is businesses with a turnover of £1 million to £100 million. We only focus on the SMEs because we think this is an under-served and overlooked area of the market. We do not serve micro-businesses. To date we have lent over £15 billion over the last 10 years, directly helping to create 36,000 new jobs and 58,000 new homes,¹ the majority of which are affordable and local housing.

Following on from the point that Nigel made around capital, fundamentally, we think the capital requirements for non-systemic and simplified banks like us are too high. To bring this to life, in total OakNorth is required to hold £150-million worth of capital² against a drawn book of £4.5 billion. So that is clearly our total capital requirement—including pillar 2A and pillar 2B. That means that if we do a £1 million trading loan to an SME business, we have to hold circa £150,000-worth of capital. Over the last 10 years we have lost £35 million against that £15 billion, which is a percentage of 0.3%. Arguably, our loss history suggests for that £1 million we should hold £3,000, not £150,000. For development loans, that would be circa £220,000. We firmly believe that that shows the scope that the regulators have to make sure there is a balance between firms that can protect themselves and the economy, but also allow us to free up capital to lend to the SME market. That difference is significant for us. Thanks again for the opportunity to talk to you today.

Q83 **The Chair:** Perhaps I could begin by picking up on that last point you made. We had evidence last week from the former governor, Mervyn

¹ Note by the witness: OakNorth has directly helped to create 58,000 new jobs and 36,000 new homes.

² Note by the witness: OakNorth is required to hold circa £850 million worth of capital.

King, who argued that the emphasis should be on leverage rather than risk weightings. What do you think about that?

Mark Steele: From our view, leverage is best as a backstop. We actually think risk weightings is the right answer, but risk weightings are very conservative. When we underwrite a transaction, we are looking at the interest cover, the LTV ratio, the sponsor, the levels of equity, their past performance and our projections for the future, none of which is reflected in static risk weights. If data was available to the Bank of England and the PRA to understand this more clearly, they might see that the benefit is actually a reduction in the risk weights rather than a hard stop leverage ratio, because what that would then mean is corporate assets that are AAA rated would effectively be treated in the same way as an SME loan, which equally we do not think is the right answer.

Q84 **The Chair:** While I have you in focus, Mr Steele, we have evidence that contradicts the Bank of England's most recent quarterly report, which states that SME financing conditions were close to what would be considered normal. Do you agree with that?

Mark Steele: It is an interesting question. We serve that middle market sector. If you look at the data available to us, in reality since Covid, large corporate lending has grown 13%, but SME has grown 7%. That is the data available to us, and the question is: why? There are a variety of things driving this. We do not believe it is just actual finance available to SMEs. We think the market at the moment is actually quite liquid in the context of our competition, but it is the macro-economy, it is building regulations; there are a variety of things that are stopping SMEs from potentially even seeking finance in the first place.

The Chair: Do you agree with it or not? It is a fact, is it not?

Mark Steele: It is a matter of fact that SMEs have had less lending than corporates over the last few years. The market goes up and down in the context of availability of finance to SMEs, and we probably would see it as a normal state at the moment.

The Chair: So there is not a problem with SMEs getting finance?

Mark Steele: At this moment in time our market is quite liquid. Private credit is a big part of that in the middle-market SMEs, but there is a lot of liquidity in the market seeking to lend to SMEs that want to borrow.

Q85 **The Chair:** Mr Terrington, could you just expand on this point of how the growth of private credit has been a response to bank capital and liquidity requirements? Listening to Mr Steele, he is suggesting there is not really much of a problem here.

Nigel Terrington: Maybe if I just add one extra point to what Mark has said: one thing that has happened in the not too distant past was Covid. The Government reaction to Covid threw a lot of money at SMEs, and that basically withdrew a lot of lending that ordinarily would have been made by the banking sector. If you look, the banking sector system-wide lending to the SME market is still below where it was in 2019. We have

seen Covid loans getting repaid quite rapidly and the level of bank lending increasing, but we are not back to where we were.

I agree with Mark that there is a lot of money available to SMEs in the general sense. You need to look at the segmentation of the market, because there is lots of capital available for large SMEs, there are lots of lenders willing to lend, and equally so for the small and medium size. We are very focused on the asset finance market, so we have good security protection; unfortunately, there is a lot of competition there. What a lot of the headlines might be grabbing has been referred to as the micro end of the market: it is the very small SME that might have one or two people behind that business. As a consequence, that is an area where there might be a shortage, and difficulties for some of those customers trying to raise finance.

The Chair: Just on the general point, and the very helpful note which will be published on the website once you have had a chance to correct anything that arises from this session, you seem to be arguing that the effect of the weight of capital regulation since 2008—if you take the analogy of the balloon—has squeezed the balloon, and that has caused it to expand into private.

Nigel Terrington: Yes.

The Chair: If that is the case, what is the evidence for that? Do you therefore think that this represents regulatory arbitrage, and a new set of risks which are not covered so that the law of unintended consequences is that risk is actually increased as a result of those regulatory changes?

Nigel Terrington: It is regulatory arbitrage. What has essentially happened as a consequence of the financial crisis is that all the rules everywhere got tightened: capital ratios all got tightened. There is probably 300% to 400% increase in capital today, relative to where it was pre-financial crisis, and then on top of that you can add MREL, which in effect doubles the capital requirement. When you look at that, what you have is a general system-wide big increase in capital. Banks need to be able to generate profits to replenish and support the future capital of the business and give a return to shareholders. That does either one of two things: it requires you to push out interest rate margins to support a higher level of capital, or it requires you to be a bit more thoughtful about the areas that you lend to. For example, the way the risk weights work is that they basically look at each different asset class and say, "Mortgages, that is a low-risk asset class", so the risk weights you will get there are going to be proportionately lower. This is being driven by the Basel III rules. You then have higher risk weights for different areas: SME will probably be twice the level of mortgages; corporates will be three times the level; and housebuilders, which is around five times the level, so that is very demanding in terms of the capital requirements.

In my opening remarks I made the point that the granularity of it is understanding what the different segments are. It has caused banks to say, "I like to do this type of lending because my return relative to the

capital is acceptable". I do not like that. For example, and this is a particular point around just normal owner-occupied residential mortgages, the risk weight there is 35%—relatively low—reflecting what is a very low-risk asset class. If you are an IRB bank—that is another layer of this which we should come back to—it is much lower, and that is only available to the large banks in the UK. What that means is they get super-normal return on equity. And guess what? The UK banking sector has seen the larger banks move heavily towards residential mortgages and away from other areas. So, things that do not work quite so well are credit cards, not a particularly strong area, and what we would have called leverage loans once upon a time, which is lending to corporates to support management buyouts and the like. All these things are getting pushed into private credit because the UK or US banking regulatory rules do not apply to private credit. They will look at a loan and say, "What do I think the risk is, and what the potential loss would be, even if I put a stress test on it?" If it is better than the rule, say, from the Bank of England or the Fed, then that is an area I will be interested in because I am arbitraging the regulatory environment as a consequence.

The Chair: Thank you, that is a really helpful answer.

Q86 **Baroness Noakes:** Could I follow up on that? To what extent are you genuinely in competition with providers of private capital?

Nigel Terrington: To some degree, yes, in certain of our asset classes. We are both in residential development finance. I would say probably 40% to 50% of the participants in that market are financed by private credit.

Baroness Noakes: What impact does competitiveness have in terms of the price you have to charge ultimately? It is not just a question of capital because if you are in private capital you are expecting a higher return than your bank shareholders, for example.

Nigel Terrington: It is different in that you would expect a bank's cost of funds to be lower because we are able to raise money from the savings market. The savings market will benefit from the Financial Services Compensation Scheme, together with the brand and the reputation of the bank, and as a consequence you should get your money cheaper. Whereas a private credit fund will have to go out and raise wholesale money from the capital market, so you would expect them to pay more.

However, looking at this particular asset class, we have a risk weight of 150%—not just Paragon, it is all the banks—which is approximately five times higher than residential mortgages. If you look at that, the amount of capital we have to hold is substantial. Therefore, we have to lend at a much higher margin. When I speak to our customers in this space I say, "What are the things that cause you to have a problem in continuing to grow?" There are two things: one is planning, which is probably their number one bugbear, and the second is the cost of money. Without giving away state secrets, you can see it: lending margins are what, 6%

to 7% a year? So the base rate plus 6% or 7%—that is a double-digit interest rate for a housebuilder. It is a very big component.

Baroness Noakes: How does that compare with private capital?

Nigel Terrington: Private capital can probably come inside that because when you look at the return on capital, its capital requirements are not 150%. It has a lower amount of capital.

The key metric for a bank in whether I allocate capital in this direction or that is what return I get from that capital. So, if ours is five times higher than theirs, we have a margin that is five times higher, and then you adjust for the relative cost of funds. We see these guys doing two things: one is trying to undercut on price; separately, we also see them doing higher-risk lending. We might say we only want to lend up to 60% loan to gross development value. They might do 70%. It is that extra layer of risk that they are willing to take.

Baroness Noakes: So it is not entirely comparable?

Nigel Terrington: Because there is no penalty.

Baroness Noakes: Well—

Nigel Terrington: There will be a penalty if it goes wrong, but there is no penalty in any risk-return models that they have.

Mark Steele: There are a couple of points to add to that. From our perspective we are seeing a lot of private credit in the market that we play. Their structure is obviously slightly different in that they tend to offer term debt with bullet repayments so they can get the returns to their investors, which obviously sometimes offers less flexibility for SMEs looking to borrow, so that is an advantage for us. But they are very competitive, and very competitive on pricing.

The other thing to add to what Nigel said is, at this moment in time—as I said in my earlier comment on liquidity—there is a demand for investors to invest in SME markets in the UK, which I agree is a positive. In the last 10 years we have lent through a lot of cycles, in some respects. The risk is that investors will probably not have the same appetite to lend through those cycles that we do, as banks. So I expect you will find peaks and troughs with this market, and then, when they disappear, it will effectively again be left to us to step in and support the SME market.

Nigel Terrington: I agree with that, and we had particular experience of it during Covid. Obviously during Covid, for housebuilders in particular, everyone was off the building site to start with and the work could not continue. Unfortunately, interest would carry on clocking up every day they were not able to complete the construction. The housing market collapsed. It was a very difficult situation: some of the private credit competitors ran for the hills during that period and would not offer any new lending.

When you do a housing development loan you do not lend all the money up front. You provide the finance in stages: as the land is bought, then you have the foundations, then the first floor—you just release it gradually.

On two occasions, with customers that we know, halfway through construction they said, “We are not going to lend you any more money to complete the construction of the properties”. We stepped in and took control of that process and carried on the lending.

I would say that private credit is a very centralised, wholesale-funded, non-relationship-driven model. They want to lend millions and billions, not individual loans. They do not build up a long-term relationship with customers, and when the going gets tough, they disappear.

The Chair: The Covid period is a bit unusual, though, is it not? There were these bounce-back loans being lent to people who did not even have registered companies, without any due diligence.

Nigel Terrington: The bounce-back loans is a separate issue.

The Chair: Yes.

Nigel Terrington: These were not Covid loans; these were loans by private credit firms to housebuilders. The facilities were offered pre-Covid, and when the market got difficult—

The Chair: I was just making the point, if you are looking at lending at that period it was rather unusual because it became a bit of a Wild West. Sorry, Lord Grabiner, you wanted to come in.

Q87 **Lord Grabiner:** Forgive my ignorance, but is the risk weighting per sector determined by the firm, and/or is there a market indicator that is available to every firm determining how that risk factor should be set, so to speak, for the individual lender?

Nigel Terrington: I am afraid it is not as simple as that. There are two ways to assess the risk weighting. The first, as established by the Basel committee in Switzerland, is meant to be a global standard. It is not always applied quite so equally on a global basis, but it is a global standard which the regulators of each country are required to follow, subject to local jurisdiction application. Secondly is a measure called the internal ratings based (IRB) method. That is where the particular firm is allowed to develop its own models to present to the regulatory authority—for us it would be the PRA—for the PRA to then accept that model as being the method of determining what the risk weight should be.

Unfortunately, in the UK this principally applies to the large banks. The process that you have to go through to get to the IRB status is quite tortuous: it is very elongated and expensive to do—you might sense a degree of frustration in my voice because we are going through that

process at the moment—and it creates a distortion, in a competitive sense.

So, the big banks have the internal ratings based approach, and that is, “I present my models and I can show you historically what the loss experience has been. Therefore, I need capital against that”. I completely understand that. The Basel rules take a one-size-fits-all approach. It does not matter whether you are a good or a bad lender, you have great or bad experience: you have one measure of capital. But the large banks principally use this on residential mortgages: they use it on SME and other asset classes, but the benefit is not the same. They have a materially lower level of capital against residential mortgages. So, you do not see specialist lenders—small lenders—operating in the residential mortgage market because we cannot compete. The typical margin that a bank will make on a residential mortgage on the asset side is probably around 50 basis points, or 0.5%. We could not remotely get close to lending in that area; it is just an unacceptable return. But the big banks can: the amount of capital they have to hold is materially lower because they use their own models, whereas we have to use the Basel rules.³ There is a process for obtaining IRB approval, and we are going through that process; it just takes a long time to get there.

Lord Grabiner: What would your suggestion be for getting rid of that unfairness?

Nigel Terrington: The PRA has just published a discussion paper on IRB to try to streamline the process to get this through. I suspect it is going to take many years for that to happen. It is a discussion paper, then there will need to be a consultation paper, then it will need to be transcribed into policy. So, it may be three or four years before that happens. Then you have to start the process, and so far, we have been many years in the process, so it might not be a this decade thing.

The Chair: How many people have succeeded, and how long has it taken?

Nigel Terrington: The last one it approved was over eight years ago. We started our process eight years ago.

The Chair: Lord Hill, you want to come in; I am conscious that Lord Smith is being very patient.

Lord Hill of Oareford: I just want to confirm the observation that you described very eloquently. There is clearly no systemic risk to financial stability in your bank at all, yet the banks that would, or could, apply more systemic risk have a more flexible system than you, who, in any rational world, ought to be below a radar. If you look at the impact of what could go wrong if you get your loans wrong, apart from your clients or the area where you are operating, the impact is systemically zero.

³ Note by the witness: Paragon uses the Standardised Approach set by the Basel rules.

Nigel Terrington: Yes, that is correct. When I was last in front of this committee one of the things I spoke about was MREL and thank you for allowing me to talk about it then because there has been movement on MREL. The Bank of England changed its rules a number of months ago, and that has provided more flexibility to the small and mid-sized banks like us. That was a very positive move and again, thank you for giving me the opportunity to raise that.

I agree with you that we are not a systemic threat to the economy or the financial system. But it is not just about the risk weights, or whether you use IRB or standardised; there are a number of other factors. We have a number of buffers, one of which is called the counter-cyclical capital buffer. The idea is that you have your core capital requirements, and then for the UK you add 2% additional capital on top of that. That is meant to be designed for a neutral position, which is what the current 2% is. However, in the US, Germany and France, that number is either 1% or 0%. Because of that, we are putting a greater burden on the capital requirements on the UK banks. The counter-cyclical buffer, literally as it says, is meant to act on a counter-cyclical basis. That means that if the economy gets too frothy, I am going to increase the capital to ensure I rein you in, and when the economy is not that strong, I can reduce it. During Covid it was reduced to 0%, but today it is 2%. The interesting thing is it applies to everyone, whether you are a big bank or a small bank. So, the idea of using it to rein us in for the sake of the economy feels a little odd to me.

Lord Hill of Oareford: Just factually on that, so we have it on the record, the counter-cyclical buffer—the 2% against the 0% and the 1%—is that a change that the PRA could just make tomorrow?

Baroness Noakes: That is the FPC, is it not?

Lord Hill of Oareford: The FPC, okay.

Nigel Terrington: It is a process: it is not part of a European or global regulatory convention, so it is within their gift.

The Chair: Do you want to comment on this, Mr Steele?

Mark Steele: The only thing I would add is to the point that Nigel made, in that we lend in the US and in the UK, and the counter-cyclical buffer for the US is 0%. So, we actually hold more capital to support lending in the UK than we do to the US, which in itself does not make sense.

Q88 **The Chair:** Over the period of this committee we have had evidence where people have argued that the reason that people do not use their buffers, which they can, is because they are concerned that if they do, they will look like an outlier and be vulnerable. So it is not just the regulator to blame, is it?

Nigel Terrington: No, the regulator says the buffers are there to be used. However, the only firms I am aware of that have used the counter-cyclical buffers is where they had no choice, as in they fell below the

regulatory minimum because there was a problem in that firm, not because it was seen as something tactical or strategic. If you fall below the minimum, you will probably get a phone call the next day, or even that day, to say, "What is going on, why has this happened? What is the plan to get it back to normal?", which is understandable. But, as a consequence, the board is left feeling, "I do not want to go there".

The Chair: But there is a market issue, is there not? If you start using your buffers, your board is going to be nervous. So how do you get around that problem?

Nigel Terrington: We are a public company, so we have to worry about what that sentiment effect will have on shareholders as well.

Q89 **Baroness Bowles of Berkhamsted:** Do you think the counter-cyclical buffer is actually being used for what it is intended to be? Or do you think it is just being used as an additional extra? It was let out during Covid—it would have been very difficult to resist that—but why is 2% neutral, and are we neutral now? Is it the economic situation of the country where the Government do not have enough money? Are they worried about political signalling in any way? Do you have any thoughts around why it is where it is, and it is not in other countries in the same way?

Nigel Terrington: It feels built into the system as in, if now is neutral, it does not feel like the economy is powering ahead on a US-style level of economic growth, and yet the US is zero. The country's willingness to accept almost a higher-risk tolerance seems to be greater in America than it is in the UK, just taking those two as an example. When they reduced the buffer to zero at the beginning of Covid, I am not aware that too many firms suddenly went, "Great, buffers are up, we can start lending". I understand the theory of it but the practice is going to be, "How long is it going to be before they put it back up?", in which case, "I don't want to have to go round and start raising capital again in order to then meet the buffer requirement". It feels like it is a permanent feature rather than one to flex. It was a pretty big crisis to see it flexed, and it has not really moved much, either before or after that.

Baroness Bowles of Berkhamsted: So, it is just 2% extra, whereas other countries have put it at a lot lower when you might say they were in neutral conditions too?

Nigel Terrington: Yes, it is odd that America is a much stronger economy, yet its counter-cyclical buffer is zero.

Mark Steele: I would add that this reflects a layering of conservatism that we have throughout the capital requirement stack. We have talked about the risk weightings at pillar 1, but we therefore have these buffers that just add on to it. The numbers I gave at the beginning reflect our total capital requirement, which includes that 2%. So, in that £1 million loan, £20,000 is because of this capital buffer. The conversations today are reflecting on whether we are concerned that SMEs have enough lending, not that banks are lending too quickly, which is what this buffer

is for. The argument is that unsystemic firms that are specifically helping a section of the economy have to hold the same percentage as a systemic bank that is providing a service for the whole country, which feels strange to me, and it links to this whole point of why we end up with a total capital requirement that is very high.

The Chair: Lord Smith, you have been very patient.

Q90 **Lord Smith of Kelvin:** I am enjoying the conversation. Can I just move away a bit from bank capital and liquidity because we have talked about it quite a bit, but I am sure we will be back to it later? We have heard that low levels of financial literacy, combined with a limited reliance on intermediation or advice, have prevented SMEs seeking equity finance and favouring debt finance. What is your experience?

Nigel Terrington: Financial literacy is poor across the country. It should always be taught at school, and it never is. There should be educational systems provided beyond school. I find it really quite surprising that, because I work in a bank and do things like mortgages, I have friends who ask questions about normal financial matters that, as adults, they do not understand. This is a general, almost endemic problem across the country as a whole, and it starts with schools.

The point of seeking equity finance versus debt finance is because debt finance is cheaper than equity, as you would naturally expect. People, customers, consumers, and small firms would always prefer the cheapest cost. In the last couple of years, one of the reasons why there was this big issue about personal guarantees in the micro-SME market—the smaller end of the SME market—is because banks were asking for personal guarantees. One of the reasons was that the SME would ask for a loan when what it really needed was equity. The problem was, “If I am giving you equity, I am losing some control over my business”. Separately, I am not sure there is much equity of that nature available to the micro-end of the market. Maybe that is a gap in the system that would need to be facilitated, but it would not necessarily be an attractive area for the banks to enter; it would be quite high risk.

Definitely more education is needed, but there would be a reluctance from SMEs to want to take equity finance, and it would be expensive. The way around it is that, where a bank loan is provided, personal guarantees are taken because that ensures you have the full faith and credit of the individual behind the small business engaged without them losing control of the ownership of their business.

Mark Steele: I would agree. From our perspective, we work in the mid-market so most of our businesses are sponsored or PE-backed anyway. They come to OakNorth not to dilute their shareholding and—to the point—it becomes much cheaper to take out debt finance than equity finance.

Q91 **Baroness Donaghy:** We have received evidence that the decline of community banking has contributed to the difficulties that SMEs face

when seeking finance by reducing banks' understanding of local communities. This question may relate more to micros than SMEs, but what are your reflections, and what regulatory changes might reverse this decline? I think you mentioned earlier that you have more contact in private sector lending than with what local needs are in special areas, but that perhaps at micro level there is a much broader need for support other than finance and construction.

Nigel Terrington: Mark's business has just bought a community bank in the States, so he might have a particular angle on this. The withdrawal of banks from the branch system in the UK has been a journey that has been taking place over several decades, and it is not going to reverse from now. It is driven by the economics of people turning to digital banking and not using the branches. A branch is a very expensive asset, and it is no longer economic to support it. You are probably all very familiar with what has happened there. Metro Bank tried to reverse that concept, and it is now unwinding that approach. Economics is at its root, and if you are doing a micro loan to a micro-SME, there is real difficulty in making the economics work because there is a labour-intensive approach to it for what amounts to a small loan, and you need a very big return to justify the expenditure and investment to cover that. That is probably not helpful to the SME or very small business in order for them to pay that through. It is a real problem. The British Business Bank has been a very successful arm of Government to support the SME market, but I do not think its activities go down to that level, but maybe that is an area that could be considered. If you are looking for a recommendation to consider, that would be one I would suggest looking at.

Mark Steele: We tend to hear two responses when we seek to engage customers: "My bank isn't willing to lend to me as they are not currently lending to my sector"; or, "My bank is willing to lend to me, but the timeline of doing that is too slow". That is how we have built our business. I do not necessarily think regulatory change will reverse the decline in community banking. It is less about banks like OakNorth where we target differently; it is more around the fact that the Government have already backed and rolled out the community shared banking hubs. For me, it links to the education point so that SMEs can ask the right questions of their banks around the facilities that they really need to help their business, rather than necessarily changing the regulations to make banks lend to specific communities.

Baroness Donaghy: It was suggested to us that open banking might help reconnect banks with local communities. What are your reflections on that suggestion?

Mark Steele: Open banking definitely gives banks access to further information and data to be able to make an appropriate credit decision. For me, that is where the link to the regulation becomes appropriate. We have talked a lot about the risk weightings being a static number. They do not reflect the underlying risk profile of that business, the LTV, their interest cover, or the quality of the management team. The real reason

open banking will give benefit is if it actually starts to move through and drive changes rather than necessarily helping individual transactions.

Nigel Terrington: Open banking is a fascinating development, as is the use of all modern technologies. However, for those micro-businesses, those small SMEs, they kind of want someone to hold their hand—the education point being one aspect—and some help in terms of enabling them to understand what they are entering into, or what the best route through this is. In one sense, it harks back to an adviser or broker type of role. It has long been suggested that technology will disintermediate the broker market. I am not sure it will happen, but technology is not necessarily the answer to the community banking model.

The Chair: Just following up on that question: you suggested that there are no regulatory issues here but in the old days, certainly when I started in business, the bank manager—I get it that you cannot have the branches—could take a view on the person, on whether they thought that they perhaps deserved to have some support. That discretion, that ability to make a judgment, which you will make with larger clients every day, has gone. If you complain about this, they will say it is because of the regulatory thing and it is the same amount of paperwork and stuff whether they are dealing with somebody who wants to borrow £10,000 or £10 million. Is there really no scope to try to get back to what you described as advisory? But it was more than advisory; it “What is this person’s track record? Do they have a good idea?”, et cetera. That has just gone. Now it is, “Computer says no”.

Nigel Terrington: It might be worth the committee looking at a banking model that has come out of Sweden called Handelsbanken. It is very different; it operates on a regional basis. It might, say, put a ring around Manchester or Birmingham and the local management will then have discretion. Obviously, there are guidelines and rules about what it can do and how it does it, but it will then have local management discretion about the type of people it lends to. It also takes deposits. It is almost like a federation type system rather than a centralised bank model that exists pretty much everywhere else. So, it does exist. I am not sure Handelsbanken is in the micro end of the market, but it is certainly a more community-focused model, but slightly more upmarket in the sense of scale of lending. It is a fascinating model. Interestingly, it pays salaries but no bonuses. It is a very different concept to the rest of the UK or global banking sector, and it is successful.

Baroness Donaghy: It is a bit German-like.

Q92 **Baroness Bowles of Berkhamsted:** I was basically going to investigate that same kind of thought. Where we are, as far as lending, probably both in the banking sector generally and the private sector, is that the rates are determined by the capital in all its forms, and possibly by whether you are big or smaller. Then, it is just a mechanical exercise that the due diligence checks: “Are you in or are you out”? There is no, “Well, you can be in if you pay a little bit more”. Is that right? Once upon a time, when I went to see my bank manager with my business, he would

analyse it and then he would tell me what rate my borrowing would be at. I could then present additional material and get a slightly better rate, and you could do quite well. There was actually competition between branches. They would come to you and say, "Well, we can probably beat that". All that has gone. Now you have a fixed rate for a category, and you are either in or out.

Nigel Terrington: I would say it is largely like that in terms of the UK banking sector, which is very much a centralised model, meaning head office determines that the type of customer that looks like this should get that rate. It will be driven by models. Capital is one feature, but it is not the only feature; there are a variety of factors, such as the relative funding cost or the ambitions of the bank in that particular sector, but capital is an important one. However, it is very much a centralised model, so the branch manager in that sense has zero discretion—maybe with the exception of Handelsbanken—but it is very much that.

Baroness Bowles of Berkhamsted: There is a size cut-off where the micro-businesses are just not being serviced. The thing that was good about the loans that came out to the micro-businesses during Covid was that it was the first time ever that anybody lent to them. Of course, there was abuse and stuff like that, but you could manage to cut out the abuse by allowing the banks to do some kind of due diligence. Nobody is doing that, so the micro-businesses just have to borrow in their private capacity. Is that what is happening?

Nigel Terrington: Do you mean as an individual?

Baroness Bowles of Berkhamsted: Yes.

Nigel Terrington: No, you can go through as a firm.

Baroness Bowles of Berkhamsted: They will not get in because they are too small.

Nigel Terrington: If you have a small firm that is an individual or maybe two individuals who happen to have a firm, then the connection between the individuals and the firm is almost like they are the same thing. That is where personal guarantees are very important, because if one of them decides to leave then the business is no longer there.

Baroness Bowles of Berkhamsted: Would that be applicable to those who are in professional practice—solicitors, accountants, architects and all the vast network of professional businesses, many of which will be micro-businesses? Are you saying that is the same as just an individual?

Nigel Terrington: You might have a sole practitioner in a law firm.

Baroness Bowles of Berkhamsted: There might be three or four with an office and a business.

Nigel Terrington: That is what I mean. It depends on the scale of the firm. When it moves from being micro to a more traditional SME, using the definition that we might know, it is separate from the micro.

Baroness Bowles of Berkhamsted: Some could have enormous turnovers. I was a patent attorney and one could have very large turnovers if one was dealing internationally, with all kinds of very interesting currency transactions and so forth. Are you saying that they would still be treated like an individual because they were small and there is no discretion available?

Nigel Terrington: Some discretion is possible, but when you are a large or even a medium-sized bank, the amount of effort and cost required to support a customer that might have a relatively modest level of loan requirements or deposit requirements is disproportionately high. In order to justify whether that is economically sensible for a bank to do, it either charges more or says it cannot realistically operate in this market to support those customers.

Baroness Bowles of Berkhamsted: So, most of the time they are cutting out the market? Is the same true on the private credit side as far as you are aware, that they are also excluded?

Nigel Terrington: I do not think the private credit area is remotely interested in small lending.

Mark Steele: Obviously, the middle market sector is what we target; we do not target micros. We do bespoke lending, so we will have conversations around the level of equity, and the rate to give a bespoke loan that suits our customers' needs. We can do that when loans range from £1 million to £70 million because of the economic return. It is uneconomical to do that for every individual micro-business that wants to borrow £10,000. That is why the large organisations have to move to some level of automation which creates these rules that if you are a yes, you go through to the next stage, and if you are a no, you do not.

To go back to the capital point, our concern is that I could undertake a development loan with an LTV of 50% and a really strong management team with a great track record, and I could have a development loan of 60% LTV with a brand-new management team, and I will have to hold the same level of capital. That is the distinction for us. Private credit is more in our market than the micro-market—they are not in that market and they will do less bespoking than we do because they need to get those longer-term loans to create a return for their investors, which is why we are able to play alongside private credit in the market.

Nigel Terrington: There is a transaction that happened this week that might explain a little about the private credit market, what it is interested in and what it is not. This was an acquisition undertaken by KKR, one of the world's largest private equity and private credit businesses. It bought a business in the UK in the credit card market, which you may think is unusual. That is lots of little loans, credit card balances being acquired; it

goes against everything I have just said. What it has, in effect, done is it has bought the portfolio, but the operations and the management have been separated. So, the original owners still run the business; it still offers new credit cards, finds new customers, and manages those customers. The private credit business is buying the portfolio of loans. I think it was £1.8 billion, so a meaningful-sized transaction. It is not interested in the individual loans; it is interested in putting £1.8 billion to work. It is the separation that actually explains what private credit is interested in and why they are not interested in community banking or micro-lending or, actually, the operational side of running a bank or even a non-bank.

Baroness Noakes: I just have one follow-up on the buffers, which we talked about earlier. Suppose we reduce the counter-cyclical capital buffer to zero in line with the US, that would not necessarily release 2% of capital because you potentially then have a PRA buffer coming in under Pillar 2B. What is the practical impact of reducing the counter-cyclical buffer overall?

Nigel Tarrington: It is a couple of things. First is if you felt the counter-cyclical buffer would be reduced to zero permanently. If it was going to be reduced for six months or 12 months, then you would be sitting there waiting for it to go back up again. The understanding of the permanency of that is important. With the PRA, there is a conservation buffer. The PRA is able to add buffers, known as scalars, on an individual basis. If something is not going right at the firm, you are required to hold more capital to cover that extra risk. But you also have the Pillar 2B, which is the product of stress tests. In essence, there is your core capital as determined by the Basel rules or by your own internal rating basis rules. You then have additional buffers like the counter-cyclical, and capital conservation buffer, and then you are required to go through a stress test. That is to say, "What happens to my customers, my loans, when there is a stress event?" Usually, the PRA dictates what sort of stress test should be applied. If you use one that you choose, then obviously it needs to be at an appropriate level of severity. Once a year, they are reviewed and published by the PRA.

What that extra stress test tends to do is cause certain asset classes to perform not very well, whereas some asset classes do okay. Residential mortgages are a good example. They do okay because you usually have lots of security, so it does not cause a drain of capital to the bank. Credit cards do not do very well at all. Unsecured lending to SMEs does not necessarily do very well. As a consequence, what happens is the banks say, "Actually, my capital requirement, even if it is okay under the Pillar 1 and Pillar 2A rules, by the time I put the Pillar 2B on, the capital requirement goes up here and either I say that is not a market I want to lend into or I have to reprice upwards to adjust for it".

Baroness Noakes: If you take the counter-cyclical buffer out, is it just replaced by a Pillar 2B PRA buffer?

Mark Steele: It depends on the stress test. In effect, they run the stress tests, and you calibrate your performance to the 4.5% total buffer, which is the counter-cyclical and conservation buffer. If your stress test suggests that you do not need to hold that much capital, it is capped at 4.5%. If you reduced the 2% and we ran a stress test that said, "Actually, we did not need to hold more than a buffer of 2.5% as Pillar 2B", you would save that 2%.

Baroness Noakes: That is what I was trying to find out. What difference is it likely to make in practice? To what extent would the PRA buffers take over?

Mark Steele: That is a good example. That is very much linked to the credit risk and the underwriting of the institution itself. So, the OakNorth balance sheet will be stressed, and our stress test does not take us through the 4.5%. We would, therefore, have a reduction.

Baroness Noakes: You would have a reduction?

Mark Steele: To use the numbers I gave earlier, in effect, 2% on an investment loan would be the capital we would take. So, on a £1 million loan, it would be £20,000.

Baroness Noakes: Would that be the same for Paragon?

Nigel Terrington: Yes.

Baroness Noakes: The whole 2% would flow into capital, because you would not need it on a stress basis?

Nigel Terrington: Can I let you know about one other buffer, to cover concentration risk? If you put all your eggs in one basket and that basket goes wrong, then it becomes quite painful, so you can understand why a regulator would want to ensure that you were not overly concentrated in one region, sector and the like. Unfortunately, the regulator regards any lending you do in the UK as a concentration, and it is quite a lot. The amount that we hold is around 1.4%. There is a formula that determines this which is quite complicated, but we hold around 1.4% capital for concentration risk because we are operating only in the UK. Rather perversely, we did a little example that showed that if we chose to lend to an SME in Luxembourg, we would have a lower level of capital, which cannot be right.

Baroness Noakes: Would that just be because of the counter-cyclical buffer?

Nigel Terrington: No, it is nothing to do with the counter-cyclical buffer.

Baroness Noakes: Would it affect concentration as well?

Nigel Terrington: It is in addition to. For us, and for our sub-sector of the banking grid, you would expect that if I rocked up to the Bank of England and said we were going global, it would rightly be concerned. We

are a UK-focused business. Pretty much most of the mid-tiers are UK-focused. In fact, most of the clearers are now UK focused whereas once upon a time they were not. It feels kind of odd that you have a concentration risk in an area where the regulator wants you to be, and the Government probably want you to be here to support the UK economy, yet there is a penalty in capital terms to doing it. I accept if you are all in one market or one part of the country that creates an additional risk, but it feels rather odd to me that being in the UK gives us a penalty.

Mark Steele: Obviously, we also lend in the US. Perversely, what that does is reduce the capital we have to hold for concentration risk. As I said, the counter-cyclical buffer is zero for the US lending. We have a strong view that regional diversification should be reflected in capital requirements, and at the moment you have that 1.25%-1.4% they can add on, which is a significant element of your capital.

The Chair: What would the impact of that be in terms of the amount of money you can lend?

Mark Steele: I will go back to that £1 million loan: 2% of it. Therefore 2% of our total capital requirement—

The Chair: Sorry, it was a stupid question. You do not want to talk about your own business, but do you have any idea of what the UK impact of that would be on the amount of lending that might be available if that were not there?

Nigel Terrington: Allow us to come back.

The Chair: Yes, okay.

Nigel Terrington: We will report back to you, but it will be a big number.

The Chair: That is why I asked the question.

Lord Hill of Oareford: You have set out a number of areas very clearly: counter-cyclical buffer, risk weightings, and IRB. When you have these conversations with the regulators, what do they say to you?

Nigel Terrington: They listen. To be fair, I was at the PRA yesterday and we were talking about the competitiveness and growth agenda. It is clear there is a lot of work going on at the PRA. Everything I have told you today, I told them yesterday. They were making notes. It is early days. I mean that seriously. They were listening and they wanted to hear what our views were on what could be done, but it is early days; we will have to watch and see.

Lord Hill of Oareford: From what you have said, it sits on the IRB; you have been talking for seven or eight years. I suspect you have raised these other issues before. Would you say there is perhaps a change of attitude under way? You say it is early days, but would you say you are

feeling a slightly more open response to some issues than was maybe the case a year ago, two years ago, three years ago?

Nigel Terrington: Yes, I think that is true, but I will reserve judgment until I can see the outcome.

Mark Steele: I have some sympathy with the regulators in the sense of the primary objective versus the secondary objective. Both the FCA and the PRA talk about risk-based supervision but, for me, a risk-based judgment is about balancing the risk and the reward, and they are not being targeted with the reward. This automatically leads you to be overly conservative, just executing on your day job, and we see that proliferate on everything. Our view would be that the secondary objective should be enhanced and should reflect adding value and capacity to the economy in how you deliver your regulations. You have a genuine risk/reward decision to make rather than ending up as we are in a world where non-systemic banks hold circa 15% capital against their lending, which is significant.

Lord Hill of Oareford: On the point you just made, Mr Terrington, the Government's policy would appear to be to encourage growth and investment in the United Kingdom, in SMEs, and in the regions to promote housebuilding. Would you say, as you have just described, that the current regulatory regime feels as though it is at odds with that political and economic objective?

Nigel Terrington: Yes, but adding to Mark's point, they also have to ensure financial stability. It is a difficult job; they are diametrically opposed objectives in many ways. They are understandably more nuanced about it than they are just not doing it. There are many things beyond regulation that could be done as well. I referred to the planning system; it is awful. It is the number one issue for housebuilders and why more houses are not built in the UK. The sooner that is resolved, the better it will be for the housebuilding community and the economy.

Lord Eatwell: I would like to follow up on that. Obviously, the UK has a fundamental problem in that the level of investment in this country as a proportion of GDP—both public investment and business investment—is low compared to the other G7 economies. It is equally obvious that the Government are desperate to increase it. Looking at business investment, what sort of things do you think would get it up?

You have said the planning system, but what about other institutional reforms? Is a different sort of banking required? Is the British Business Bank going to do that? It does not look as if it is, because it always argues that it needs private sector partners. If it needs private sector partners, it is not doing anything different.

Given your experience—it is a big question, I know—are there any suggestions you would make for reform of a fundamental character which would likely improve the investment performance of the British economy?

Nigel Terrington: You probably have to go back to the root of the issue, which is the UK economy needs to be seen as a great place to invest, and it therefore needs growth prospects. If you look at some fundamentals that have been affecting, say, the stock market—although the stock market has been performing well—you see that the flow of money into listed equities is really poor. It is quite common that investment from overseas is the area of greatest weakness. You have had a construct that has caused pension funds to be pretty much wholly invested in bonds, which is driven by regulatory requirements, so there is a flow out of equities. This has not happened in the reign of the current Government or even during the last 10 years; it has been a much longer trend.

You also have a situation where there is a lot of regulation everywhere on everything; a cultural drive towards regulation and bureaucracy has happened over an extended period. It is such a big issue that it drives through probably every Government department, not just the Treasury.

How then do you get a more entrepreneurial culture? When I go to see shareholders in the USA—we do not have many, but some—I am always struck by the can-do attitude that exists there. That entrepreneurial culture is very non-British; we are quite happy to knock things rather than support them. That is a big, sweeping cultural statement—it is not true of everyone, and it is not true of everything—but it is the devil's own job to try to change it because it is endemic in much of the thinking.

There is lots being done. Work has been happening on the listed side, and the FCA has done a number of things there, which is good. The committee may certainly be interested in things like conduct risk within banking; for example, the motor commissions issue.

UK banks are rated lower; they are perceived as being of lower value than a European bank and materially lower than a US bank, because the fear from investors is that they will wake up one day and suddenly find that something they have never heard of is wrong. They are going to have to go back five or 10 years and remediate back to customers on an area that was grey; it was not black or white, but now it is very clear that it is black because it has been defined as such. They are told, "It was always wrong, and therefore there are billions of pounds to pay back".

The concern is twofold. First, suddenly there is a loss of value: banks are not worth what they thought they were. Secondly, what next? When is this going to happen again? To use a phrase that has been used before, it makes banks uninvestable for an investor who says, "Do I invest in this sector, that sector, or that sector?" There is no other sector I am aware of where you wake up one day and find that everything you have been doing for the last 10 years was wrong. As a consequence, investors have a very low level of confidence in the reliability of the investment returns they can get over an extended period, so they do not invest.

Lord Grabiner: Out of interest, did you mention that point on the motor vehicle issue to the PRA yesterday?

Nigel Tarrington: Not yesterday because that was a very particular discussion, but it has been a topic of conversation in the past.

Lord Grabiner: The suggestion is that we should not go back 10 years, but 18 years; I do not know if you are aware of that.

Nigel Tarrington: That would be 2007; I am aware. We have a small motor finance division, so we have an interest in the area. It is not big, thankfully, but it has also caused us to say, "Do I want to grow in this area, because I do not know whether what I am doing today will be acceptable when viewed retrospectively in five years' time?". But yes, it has been a big topic of conversation.

Lord Eatwell: What would you like to change?

Mark Steele: I would reflect on a couple of things. First, when setting regulation, you should be able to deliver on your side of it. For example, regarding the building safety regulations following Grenfell—I know that the House of Lords is currently holding an inquiry into this—we have a customer who completed a development six months ago and has waited six months for an inspector to come and sign it off. When delays are raising costs, and people are paying interest, that puts people off wanting to invest in the UK. These things have a big impact.

On the discussion around the conduct risk element, financial crime is another good example. We have had a proliferation of fines across a number of banks in the financial crime space. The obvious question you get when you engage with the regulator is, "What have you learned from these?" We look at that, we take on board the key findings, but it drives you to be even more conservative. It drives you to go, "These are the regulatory expectations, but we are going to do a bit more". That then flows through to the availability of credit and the availability of funding for customers who may be on the edge. It leads you to say, "The computer says no", because of the fear of falling foul of really complex regulations, and making quite grey judgments on individuals around where their funding has come from and how they structure their businesses. It drives a conservatism which also then drives the ability to lend credit and the willingness to lend credit to the market.

In some respects, it creates a circle of negativity; there has been a proliferation of financial crime fines in the last 24 months, which is a good example of what is driving our conservatism.

Q93 **Lord Kestenbaum:** Could I ask you both to comment on what has been dubbed the funding gap, particularly as it relates to small and medium-sized businesses? We have taken contrasting evidence across these sessions from a variety of people who have sat in those seats. Some have said that this so-called funding gap is a complete misnomer; even among small and medium-sized businesses, investable entities which have a strong offer, a good product, and elite management can find investment, and indeed find debt. For those that are declined borrowing, that is on straightforward investment criteria; they did not pass a threshold.

Therefore, this funding gap is, in essence, an illusion.

There are others who have very strongly argued against that. They have said that there is plenty of investable proposition with strong product, good offer, elite management, and that it is the commercial constraints around the lenders—along the lines of what you have said about buffers and capital adequacy—which has, in essence, left this huge community of investable entities bereft of lending. I wonder where you both come out on that argument.

Nigel Terrington: In the sectors that we are involved in—the housebuilding side and asset-backed lending—I would say that there is enough, if not plenty, of capital available to support the propositions that we get from customers in those marketplaces. Clearly, we want to lend to good customers, and that will dictate our level of interest. The level of capital requirements will dictate the returns that we wish to make and influence the interest rate charged to the customer; the interest rate we charge on development finance loans is much higher than on SME asset finance loans, and it is driven by the capital requirements. So, there is enough capital for the sectors in which we are involved.

Now the pricing may not work for the customer because it is too high as a consequence and that might be the noise that people are hearing, whereas actually the capital is there, the funding is there, it is just a bit more expensive than they would prefer and it may not make the project economic for them.

Mark Steele: We were created because we believed, and the evidence suggested, that what we call the missing middle found it difficult to access the funding they needed. Notwithstanding that, as I said earlier, currently there is a lot of liquidity in the market. This is an area where in some respects the larger banks—and because of the complexity of underwriting the proper credit funds—are willing to participate, so at the moment we would not say there is a lack of liquidity in the market.

I go back to my earlier point on whether that remains through the cycle and gives the consistency for that middle market. That is ultimately how we have been successful. We have not been anywhere, we are consistent, we underwrite bespoke loans that are reflective of the business and what their needs are. Yes, we also charge a premium price, but it is in the context of having the ability to access the funding that you require over the term that you require.

Lord Kestenbaum: Were an entrepreneur to be sitting here, they would say, “Look, that argument that there is no shortage of capital, there is plenty of liquidity in the market and then the small print is that it is very expensive”—I am paraphrasing your point—“that is actually a way of turning us down, because it is priced in a way which makes it non-commercial for us”.

Maybe that gives credence to those who would say “Look, the funding gap at its heart is about pricing, in that these entrepreneurs are being

priced out". How would you respond to that?

Nigel Terrington: We want to lend. I would say we have much greater growth ambitions than our current level of lending, so it is not through desire or ambition on our side; we have capital to put to work. We are thankfully quite profitable, we generate capital every year, but obviously we need to do it diligently and we need to make an adequate return on capital for our shareholders.

Individual circumstances might be complicated and the entrepreneur might have an issue with the price, as in, "It makes it too expensive for me". It does not sound very good, but we are not a charity. We are not here to cross-subsidise people's borrowing requirements.

Mark Steele: I totally agree. We want to grow, and we have plans to grow, and the counter argument is that equity is more expensive. If you get an equity investor, they will potentially be more costly in the longer term, so that is why they are seeking debt. There is that balance. Ultimately, we want to get to an end state where they feel comfortable with the lending they have, they are comfortable with the cost and it meets their business needs to grow to the next stage of their evolution, and we get a sufficient return for our shareholders.

Lord Grabiner: Just following on from that exchange—which I found very interesting—I have a couple of points for the record.

At the beginning of our discussion this morning, you told us that there had been only very small growth in the lending market to SMEs—I think a 7% figure was mentioned—but there is good liquidity. Where is that liquidity coming from? It is presumably not coming from the banks but from the private lending sector. Is that right?

Mark Steele: The figure is 7% and I can provide information about that in more detail. At the moment, we are seeing it from a variety of areas; we are seeing large banks wanting to participate in the better premium property locations—for example, in the West End of London—and we are seeing private credit. I think it reflects the fact that at the moment there is a general appetite to invest in mid-market SMEs in the UK. But we find it goes from peak to trough, and it is tailing off a little now. In the first six months of the year, there was a lot of liquidity, but it has withdrawn slightly at the moment. In that context, it is quite cyclical.

Lord Grabiner: But for the small person or somebody just starting out with a great idea, such a person is presumably not of great interest to the banks because there is no asset that can be used as security. There is a gamble or risk in not knowing whether this great idea is going to work, so that potential borrower is not going to have much success with a bank. Is that person simply going to go to a private provider? Then of course they are going to have to give a personal guarantee, because there are no assets anyway. They are not very keen to give equity because that means giving away something that they have a very strong belief has great value. So what do they do? The answer is probably that there is

nothing they can do.

Mark Steele: We do not lend to the micro-market, in part because of the realities of what you said; someone with no track record and no assets cannot demonstrate their ability to repay the loan. Fundamentally, as our chief lending officer says, we are here to get our money back. That in reality is what we are here to do.

On personal guarantees, we take personal guarantees even in the sophisticated types of transactions that we do, and for a couple of reasons; first, where we do not think the security quite marries up to what we would need to lend. Secondly, throughout a three-year or five-year term of a loan, there are periods where a business has difficult times, developments might be delayed, or they may not have sales. The provision of a personal guarantee—I should be clear that we do not ever guarantee on people's personal homes—shows that when it becomes difficult, they have skin in the game to work with you.

That is a reflection of our losses; when our customers go through those difficult times, we collaborate with them to do that. From our perspective, we think personal guarantees are a benefit to the discussion. Obviously, you do not get capital benefit for that, so there is no sort of economic benefit; it is fundamentally a commitment to work together when things get difficult.

Lord Grabiner: You mentioned Handelsbanken; that has been mentioned a couple of times, and indeed Lord King mentioned it to us last week. What is the model it has which copes with the point that I am seeking to have addressed?

Nigel Tarrington: Handelsbanken tends to be focused on property-related lending. The point I was making is that it works on a regional basis, so its local management will have local discretion. It is kind of a pull-back against the withdrawal from the branch networks. But as far as I am aware, it does not finance entrepreneurs who just turn up with a good idea.

Lord Grabiner: It is really about property, which it knows about presumably; it makes a local judgment about it and so on. I understand.

Nigel Tarrington: It does a variety of things, but it does not tend to do the smaller entrepreneurial type of business.

In America, there is a phrase, "jingle mail". When something goes wrong with a loan, quite often mortgage related, or property backed, you put the keys in an envelope and you send them back in the post, saying "It's your problem now". Clearly, we do not want that; we want a borrower to take their obligations seriously; hence, in the circumstances that Mark was referring to, we want the full faith and obligation of the individual who is behind the business to stand by that. Even if there are difficulties, we will work with them, but we do not want them washing their hands of it and walking away.

Q94 The Chair: We might invite Handelsbanken to come and talk to the committee; it sounds as if it is quite interesting.

I am sorry to pick on you, Mr Steele, but you have worked both for the FSA and for the Bank of England. As an amateur listening to the evidence today about how concentration risk penalises institutions that simply lend to the UK, to my mind that is actually reducing risk, notwithstanding the points you have made or the points that we have made about the counter-cyclical buffer. I am hesitating to use extreme language here, but it seems a little hard to understand why the regulators would not apply common sense and do something. Mr Terrington, you have said you will wait to see what happens; behind that there is a feeling that several years of consultation documents and whatever lie ahead.

My question to you, Mr Steele, having been there, is: what is it about the culture in those regulators that leads to—perhaps lethargy is too strong a word—this inability to move on things which appear to be just common sense?

Mark Steele: I would go back to the point I made earlier. I have some sympathy when the objective is to protect the economy, but it drives behaviours and has led to conservatism. I do genuinely think that could be changed with an enhanced secondary objective that, in effect, incentivises people at all levels in the Bank of England and the PRA to state that we have to deliver a growth objective of X. With any organisation, your strategy and what you seek to deliver change your behaviours.

The Chair: I am sorry to interrupt you, but to my mind it sounds bonkers when Mr Terrington tells us that it is more profitable for him to lend money to someone in Luxembourg rather than the UK because of the concentration risk regulations.

Mark Steele: It is a bit bonkers; it is a quirk of the complexity of the regulations that we have to work through, even standardised and simple—

The Chair: My question to you, having been there, is why these very clever, decent, committed public servants in the regulators do not see that and do something about it.

Mark Steele: I go back to the fact that their objective is not necessarily to grow the UK and the SME economy in particular; their objective is to protect financial stability.

Lord Kestenbaum: May I make a comment on the Lord Chairman's question? When we took evidence from the regulators—and I note that one of you said that these objectives are completely diametrically opposed to each other—they said very forcefully, "No, we find them well aligned and we are in rapid pursuit of both these objectives". Mr Steele, you seem to indicate that, if not diametrically opposed, they are pretty irreconcilable.

Mark Steele: The evidence suggests that we are overly capitalised for the risk that we pose. If therefore the capital was more reflective of the risk, it would enable more capacity to lend to the economy. Not enough attention is given to driving that economic benefit.

Nigel Terrington: You can pull those two objectives in different directions. To cut the regulators a bit of slack here, these things are difficult to achieve, and they are in a transition stage, so the secondary competitiveness and growth objective is really only starting to bite now. The MREL discussions we had with the Bank of England last year and this year were very constructive; they listened and we got what we asked for, so that was good. I would say other things are in the process of being dealt with. There is a discussion paper, then a consultation paper to come on the IRB. The wheels will never turn fast enough for us, but there is government and regulatory machinery that has to be gone through.

It is early days in that machine turning and that is why I have said we will have to keep pushing on this and keep measuring it to ensure that we maintain the rebalancing of the competitiveness and growth agenda so that it fits in with the primary objective of financial resilience.

Lord Eatwell: After the events of 2007-08, a particular doctrine which was very powerful in the Bank of England—that if every firm is safe the system is safe—exploded. It was demonstrated that the system had its own market dynamics; thinking each individual firm was safe was not adequate.

I remember a senior figure at the Bank coming and giving evidence to a committee that I sat on. They said that if every firm is safe, the system is safe, and that turned out not to be true. There is a thing called systemic risk, which we referred to earlier.

Now, the problem is that getting hold of systemic risk is enormously difficult. For example, a lot of what happened in 2007 and 2008 in this country was generated by mortgages failing in Florida; how do you get hold of that? There is no way you can get hold of that through your national regulator. The reaction has been that, since we cannot get hold of systemic risk, we ramp up the safeness of individual institutions. We have concentrated on making individual institutions safer and safer and safer, with more and more and more capital, to compensate for what we know is a failure—the fact that we cannot get hold of systemic risk.

That is the pattern we have seen since 2008, and it is the problem that you are addressing, Mr Steele.

Nigel Terrington: I would just make an observation. This conversation started off about private credit, and private credit is sitting out here. It is doing the stuff that banks do not want to do, either for return purposes or risk appetite purposes. The banking sector, however, might be lending money or have an exposure to private credit, so if the private credit firms are doing the stuff that banks do not want to do but they fail, then there is a risk that it can feed back through the system. It is absolutely right

that a regulator should understand that; it should be measuring individual banks and system-wide exposures to the private credit market.

Last week, there was a failure in the States of a subprime motor finance lender called Tricolor. It was worth £1 billion, so it was not particularly big. The interesting thing was that the lenders to that firm were JP Morgan, Citibank and others, that now have exposures of hundreds of millions of dollars that could result in losses. Obviously, it is very early days to determine whether that would be the case, but it is a little like the exposures back in 2007 and 2008 to the US mortgage-backed securities, which were indirect exposures through very complex derivatives that then permeated their way across the global financial markets. The question for the regulators—and I think they are alive to it, they are doing it—is whether private credit should be regulated. That would be a massive change, and arguably you are making the UK banking system safer by making that lending go away, which is fine so long as it is not interconnected in another way.

The Chair: On that note, you have just summarised exactly what the committee—

Lord Grabiner: I am sorry, just pursuing that—it is an extremely interesting point—do we know to what extent private sector finance is derived from lending by British banks? Do we know what the figures are, or the extent of that lending, or proportionately in terms of the resource available to private sector lending?

Nigel Terrington: I do not have the figures; I do not know whether Mark does.

Lord Grabiner: Do you have a concept of it? Do you have an idea of it?

Nigel Terrington: People have loosely described the private credit market where the banking sector has typically grown in line with nominal GDP. At various times it will change, depending on inflation, but it is probably running at about 3%, 4% or something like that. When you look at the growth in private credit, you see that it is way beyond that. As I say, we do not know the exact numbers and it is very difficult to get them, but there have been suggestions—probably more in America than the UK, just because it is further ahead, but I am sure we will play catch up—that somewhere around half of lending is being done through the private credit market.

Lord Grabiner: To what extent is their resource coming from British banks?

Nigel Terrington: I have no data.

Lord Eatwell: I do not think anyone has.

The Chair: That is the point.

Nigel Tarrington: In the example I gave of the American subprime lender, it was being financed by the large American banks. What you see more generally is that the private credit market is making significant use of securitisation; they are creating pools of assets, refinancing them into debt securities and then selling them through the capital markets. It is very difficult to discover the end buyers of those; it is even harder to tell. But again, it is a systemic point, because a failure here could have ramifications all the way across the financial system.

The Chair: That is precisely what the committee's inquiry is focused on. To coin a phrase, the known unknowns seem quite deep. Unless anyone has any further questions or points they want to raise, I would like to thank you both on behalf of the committee. This has been a fascinating session, not just for the points that you have made but, speaking personally from the point of view of financial education for the committee members, you have very carefully explained the complexity of how the regulatory system operates in respect of capital, and we are extremely grateful to you.

That concludes this part of the public part of the committee. On behalf of the committee, I thank you for the time you have taken. If there are any further points, information or data you could provide for us arising from this, we would be very grateful to receive it. Thank you so much.