Paragon Banking Group – Written evidence (SCG0045)

Introduction

Paragon is FTSE 250 specialist lending and savings bank, alongside being one of the UK's leading and fastest-growing specialist banks, with over £17 billion of assets under management. We provide mortgages and other financial products to landlords, SMEs and housebuilders, helping to support the UK economy.

Paragon and the mid-tier banking sector's contribution to growth in the UK is significant, as highlighted by new research from EY. The mid-tier and specialist banking sector today comprises of around 73 banks – a quarter of all banks – providing almost £350 billion in customer loans and almost 50,000 jobs.

We are now the main providers of SME bank funding, lending £35 billion to SMEs in 2023, totalling a 60% market share[1]. The sector also provides 22% of the BTL mortgage market and tends to provide the top deposit rates for customers[2]. A strong mid-tier banking sector is an integral part of the future growth and prosperity of the UK economy.

Mid-tier banks, such as Paragon promote choice, competition, innovation and specialist expertise for customers across the country; often in parts poorly served by the mainstream providers. We provide SMEs with finance to grow their business, support housebuilders to meet the growing housing needs in the UK, enable businesses to invest in green assets, and offer the best value to customers looking to save their money[3].

Summary of recommendations

With the SCGO's recent implementation, there is significant opportunity for the FCA and PRA to strengthen the UK's FS sector and enhance the UK's international competitiveness through a balanced regulatory approach that fosters competition, promotes the mid-tier and specialist banks, and supports sustainable growth.

[1] British Business bank, Small Business Finance Markets report 2024
[2] EY report – "The value of the small and mid-tier banks to the UK" published in October 2024
[3] Money Week - In 85% of cases small and mid-tier banks had the top savings deal for £10,000 gross savings, across 14 Savings and ISA products and four time periods (Jul 21, Jul 22, Jun 23 and Jul 23)

Given the SCGO has only been in force for a year, reaching a definitive answer on its efficacy at this early stage is challenging. Nevertheless, this submission makes a number of key recommendations on the regulatory environment as it relates to the secondary objectives:

1. **Enhanced role for the SCGO**: The SCGO needs to be properly embedded within existing regulatory processes across the PRA and FCA, and an individual should be appointed to champion the objectives within the regulatory bodies with authority to take action if they are unfulfilled.
2. **Assessing policy outcomes**: Regulators should provide counterfactuals in policy documentation, showing how secondary objectives specifically impact policy outcomes.

3. **Transparent, outcome-focused metrics**: Annual metrics reporting is positive, but metrics need to be more outcome-oriented to reflect competitiveness and growth and compare the UK's performance internationally against other jurisdictions. Metrics with sector-specific granularity would also better assess regulatory impact, especially for mid-tier banks.

4. **Supporting growing banks**: While the UK is a great place to start a bank, the UK's unique mid-tier sector has been squeezed by a regulatory system and compliance burden intended for the largest banks. For the SCGO to be effective, the regulators must consider how to increase competition with the large, incumbent banks, to facilitate sustainable growth of the unique mid-tier and specialist banking sector.

5. **Review of competition**: We would recommend that the Government commissions an independent review of competition in the banking sector to consider changes that could be made that can facilitate greater competition for the mid-tier sector with the large banks, which would foster innovation, drive improved customer outcomes, support SME lending, and promote growth of the UK economy. Two critical areas that we set out in the submission that should be included in a review relate to:

    - **MREL threshold:** While not subject to the SCGO, MREL is a significant barrier to the growth and competition of mid-tier and specialist banks, reducing their lending ability, and we

believe the eligibility threshold should be increased to £50bn, beyond that proposed by the BoE in its recent consultation which will have a minimal impact. Extending the secondary objectives to the Resolution Authority (part of the BoE) should also be considered.

- **IRB access and approval**: The IRB approval processes should be streamlined for mid-tier banks, addressing PRA resourcing gaps to expedite accreditation. This would reduce capital requirements, enhancing our sector's competition with large banks and supporting growth.

Response to questions

1. **What opportunities or changes should be prioritised in order for the regulators to meet their secondary growth and competitiveness objectives effectively?**

- The Secondary Competitiveness and Growth Objective (SCGO) is a positive development and was generally welcomed by the industry, particularly given the BoE's central role in policy making following the exit from Europe. The SCGO is focused on international competitiveness and growth in the medium to long-term and we would hope that the SCGO provides, when appropriate, some balance in the broader policy making framework. However, for this to be effective this secondary objective alongside the existing Secondary Competition Objective (SCO) needs to be properly embedded within existing processes within the PRA. We would agree with the comments and submission on this point made by UK Finance in terms of having an individual appointed that champions the secondary objectives across the PRA and FCA and has power to make changes if the regulators are not fulfilling their mandate. This individual should also report on performance against the objectives to both the Treasury Select Committee and Financial Services Regulation Committee on an annual basis.

- The PRA's willingness to have metrics they report on annually is a level of transparency beyond that we have seen in the past and should be encouraged. However, these metrics are internally focused for example covering the efficiency of internal processes and the level of resourcing, while sector metrics tend to be aggregate measures of well-established and reported financial metrics such as LCR, CET1 and NSFR. There are no metrics that look at competitiveness and growth versus other jurisdictions. It is also not clear what will happen if the PRA is under-performing against these metrics.

- While the transparency is good, the metrics are not outcome focused and it's unlikely that meeting these metrics will lead to any demonstrable change in competitiveness and growth – our worry is this is a framework to maintain the status quo rather than leading to significant change and impact. We make a number of suggestions on how the metrics could be improved in our response to question 6. In addition, we would advocate for increased granularity in terms of how

regulatory impact is measured, with regulators taking different sub sectors of firms into account, as opposed to only looking at the banking sector as a whole. We believe this would present a fairer reflection of the impact of policies and support a better debate on how policies, often intended for the largest banks, end up disproportionally impacting mid-tier and specialist banks.

- Moving on from the framework around the SCGO, and as discussed during the evidence session, the regulations on **MREL**[4] are a significant barrier to growth and competition for mid-tier and specialist banks. We explained that the MREL regulations are the responsibility of the Resolution Authority and, unlike the PRA, not subject to the secondary objectives. We would note the following:

    - MREL is an important component of UK and International resolution regimes brought in to mitigate the "to big to fail" issues that underpinned the global financial crisis.

    - The eligibility threshold for MREL in the UK is set against total assets between a range of £15-25bn, which causes non-systemic mid-tier and specialist banks to be caught by a regime intended for the largest, globally significant firms. The UK's approach is also a clear outlier compared to other jurisdictions with thresholds significantly lower than in the US ($100bn) and EU where the full MREL regime tends to apply to larger banks at €100bn[5].

    - The costs of issuing debt to meet MREL requirements alongside the refinancing risk increases the vulnerabilities faced by our sector – the lack of scale compared to the larger banks means that the impact is disproportionally high.

    - As a result, the growth and lending ability of mid-tier banks is reduced. EY analysis suggests this could reduce mid-tier bank lending by £62bn[6] over five years.

---

[4] MREL stands for Minimum requirements of own funds and eligible liabilities.

[5] National discretions can be applied. The full regime is when subordinated debt requirements are applied. EU banks with assets above €30bn tend to be supervised by the ECB will also be covered by the Single Resolution Board (SRB), if the case then it is possible these banks will be set an MREL requirement "transfer" resolution strategy and capital requirements are moderated down on that basis.

[6] EY report – MREL: Financial implications for mid-sized and challenger banks, originally published in September 2021 with figures updated by EY in September 2022. The £62bn figure is based on indicative rates for new senior debt issuance of 9% as at 26th

- A recent BoE consultation on MREL proposes a small increase in the threshold indexed to nominal GDP growth. However, while this is a positive step, the impact is minimal as after adjusting for GDP, in real terms the threshold will be lower than it was in 2015 when the thresholds were initially set out.

- Since the last MREL review in 2021, there has been a tightening of the regulatory regime for mid-tier and specialist banks: Basel 3.1 significantly increases the amount of capital we need to hold for the same risks, new solvent exit planning requirements will reduce impact on depositors in a solvent wind down event, while the new Bank (Recapitalisation) Resolution Bill will significantly reduce the impact of a small and mid-tier bank failure on depositors and tax-payers. We believe it is critical that, despite the independence of the Resolution Authority from the supervisory side, changes in going concern requirements must be reflected in gone concern requirements otherwise there will continue to be a doubling up of requirements for firms.

- We believe this provides the necessary conditions to justify a more significant increase in the thresholds to £50bn still below other jurisdictions but at a level that ensures MREL is not a barrier to growth and competition nor an impediment to the UK's international competitiveness and ability to attract investment.

- A very important area for growing banks is the application process to obtain approval to use **internal rating based (IRB) models** to calculate credit risk capital requirements.

  - IRB status enables banks to hold an amount of capital that is aligned to the risks it faces, optimising capital efficiency and embedding a higher standard of credit risk management that enables banks to compete more effectively. The large banks have had these models in place for many years despite them not always performing well.

  - Due to changes in the regulatory requirements for IRB models, the large banks with existing models have been prioritised and because they had previously approved models the regulatory bar for future

approvals was lower than for smaller firms making their first application (a regulatory discrepancy only now corrected as part of the policy package linked to Basel 3.1). Resourcing gaps in the respective PRA teams have, in the past, significantly delayed the speed of accreditation, with the process taking several years to complete and at a very significant cost. A few mid-tier banks have commenced the process but have experienced extensive delays.

- The capital benefits of IRB, while reducing due to Basel 3.1, remain significant. At present this is a benefit for only the large UK banks and building societies. This perpetuates a significant competitive disadvantage for the mid-tier banks, impeding our ability to compete with the large banks, which would lead to better customer choice, outcomes and drive innovation.

- The PRA has acknowledged that the IRB accreditation process has not worked well and has sought in previous years to deploy revised processes for approval ("modular" approach) and also improved scheduling of reviews. However, these developments have not made any significant positive impact; we are not aware of any IRB aspirant bank achieving IRB accreditation in the last 7 years. We understand that the PRA is looking to make more use of third parties to cover some elements of the process and is also looking to have a singular point of contact for IRB aspirant firms. These are positive developments, but with the process taking so long and with standards continuously changing, IRB aspirant firms face a real challenge meeting requirements increasing costs disproportionately.

- In the absence of IRB model approvals, mid-tier and specialist banks are subject to higher capital requirements on lending and are therefore pushed into parts of the market that are considered to be riskier, where there is less competition with the large banks.

2. To what extent are the regulators focused on the objective to promote international competitiveness and growth? Are there areas where the ability of the regulators to fulfil their secondary objectives might be constrained by having to fulfil their primary objectives?

- The PRA's primary objective is the safety and soundness of the UK financial system and the secondary objectives covering competition

and competitiveness are very much subordinate to this – as they should be. So, without a broader change to the regulatory framework, we need to be a little cautious over expectations on what the PRA can do to support competition and growth.

- With the SCGO only having been in force for a year, reaching a definitive answer on its efficacy at this early stage is challenging.

- The PRA has made significant reference to the SCGO in recent Policy proposals and new requirements. For example, despite the SCGO not applying to Basel 3.1. policy development[7] the PRA still discussed how some of the changes could be seen through the international competitiveness and growth lens (PS9/24).

- However, it is difficult to know whether changes made post consultation for policy proposals are an outcome of having the SCGO (and SCO) or whether the changes would have been made anyway and can be conveniently applied to the secondary objectives. The PRA (and FCA) should produce the counterfactual when they produce policy, outlining how the policy is different (or not) to what it would have been had the two secondary objectives not been factored in.

- The mixed experience the industry has had with the existing Secondary Competition Objective (SCO) – may provide some insight on how the SCGO will turn out.

    - The SCO was set up post the global financial crisis (GFC) following significant institutional reform and concern expressed by the Parliamentary Commission on Banking Standards (PCBS) that the PRA could neglect competition without a specific objective. The SCO was implemented in 2014. Since 2016, the PRA has been producing an annual competition report.

    - Initial achievements following implementation of the SCO were positive. The New Bank Start Up Unit (NBSU) in 2016 and a push to "level the playing field" on capital with the Holistic approach to P2A (Refined methodologies for P2A – so called "Credit Offset" applied to smaller firms to offset the big advantages the large banks had from

[7] Provisions are disapplied by regulation 4 of the FMSA 2023 (Commencement No. 2 and Transitional Provisions) Regulations 2023 as amended by regulation 18 of the FSMA 2023 (Commencement No. 4 and Transitional and Saving Provisions) (Amendment) Regulations 2023.

IRB) in 2018 and risk weight floors under IRB (2018) again to reduce the benefits of IRB.

- Developments since then have been more muted and often more targeted at the very smallest firms. The Strong and Simple framework (now known as the Small Domestic Deposit Taker regime – SDDT) could be beneficial but likely only for the smallest firms, as the PRA point out, for some banks the SDDT regime will lead to a higher level of capital than under Basel 3.1 proposals.

- Interestingly, the PRA's annual competition report in 2020 highlighted that "stronger competition was associated with greater stability for UK banks in general". The report also provided a quantitative analysis across a number of statistical measures to determine how levels of competition had changed since 1994 noting that since the Global Financial Crisis (GFC) "competition intensity had remained subdued". The PRA has not included this analysis in its competition report since then. As Sam Woods referenced his Mansion House speech in 2019 it is notable that no new or small bank has successfully become a large bank and this fact remains true in 2024. In fact, with the recent acquisition of Coop and Virgin Money by larger institutions competition metrics have probably got worse since then.

- While the SCO has had led to some benefits and arguably the NBSU has created a pathway that has significantly changed the banking landscape in the UK creating significant competition at the mid-tier level and below; <u>in 20 years it has had a limited to no impact on competition with the large, incumbent banks – the area of primary concern when the SCO was first implemented.</u>

3. **What are some of the barriers in the current regulatory framework (including the role and responsibilities of other regulators and bodies such as the Payment Systems Regulator, The Pensions Regulator and the Financial Ombudsman Service) that could hinder efforts to drive economic growth and international competitiveness in (a) the UK economy and (b) the financial services sector?**

- We have limited interaction with the other regulators and our submission is focused predominantly on our experiences with the PRA and the Bank of England.
- From this perspective the main barriers to growth are MREL and IRB as discussed earlier.

4. How effectively have the FCA and PRA consulted or engaged with industry in relation to the new secondary growth and competitiveness objective?

- The PRA has produced a number of papers on the development of the SCGO and the metrics. It also ran a conference to discuss how the SCGO could be implemented. The PRA has also responded to the IEO's review of the SCGO and has produced its annual review of the secondary objectives. Overall, the PRA has been fairly transparent on the development and implementation.
- However, as mentioned earlier, it is difficult to see in its current construction (and particularly in terms of metrics and performance management) how this objective will lead to material and new changes.

5. How should the regulators ensure that any measures introduced to meet the secondary growth and competitiveness objectives work for businesses of all sizes across the sector, including startups, scaleups, and incumbents?

- The UK is a great place to start up a bank, with 37 new banks authorised by the PRA since 2013, and 10,000 more jobs created since 2018. For the smaller firms the long awaited Small Domestic Deposit Takers Regime (SDDT) is a flagship policy that the PRA argues supports both their secondary objectives.

- The principle behind the SDDT is a good one and follows on the back of the NBSU in 2017 and the authorisation of 50+ new banks creating a pathway for them to grow. Although it is still early days with the regime not coming in till 2027, the potential increase in capital requirements as part of this regime may depress interest. Judgement on its success should be based on how many banks join the regime.

- One thing that will no doubt make the decision more difficult for some banks is that, as the PRA has been clear on, some banks will be holding more capital in the SDDT than in Basel 3.1. The upside will be a more streamlined approach to certain processes (reporting, remuneration etc). It's a balance that banks meeting the criteria will need to think very carefully about. It is not clear whether the PRA has fully considered the possible implications on certain markets from these banks holding more capital for the same risks. Given the types of metrics used for monitoring the SCGO (and lack of metrics for monitoring the SCO) any impacts would likely not be picked up through reporting.

- The UK regulatory framework has 53 thresholds for UK deposit takers[8]. These must be navigated and often come with significant increases in regulatory expectations, capital requirements, liquidity requirements or additional reporting. Streamlining the regulatory regime is critical. The SDDT is a step in the right direction – however, this will only be appropriate for the smallest firms and won't address the issues for firms that are bigger (in the £15-20bn+), looking to scale up and provide meaningful competition with the largest banks.

- The ability of banks to scale up and grow has been squeezed by MREL and impacted by the problems of obtaining IRB approval as covered in earlier questions, which is reducing our lending ability, with serious knock-on impacts for the small businesses and communities that we serve, and our national economy.

6. Are there any additional metrics over and above those already agreed by the regulators that would better enable stakeholders to track progress and support scrutiny of their work against the secondary growth and competitiveness objective? How should a measure of growth be included in these metrics?

- A number of metrics are already available so it's not clear how this will lead to any significant changes with the SCGO (e.g. CET1 capital ratios, outcomes from IMF FSAP reviews etc).

[8] BoE's Underground blog "Setting boundaries: finding thresholds in bank regulation" July 2020

- Some of the metrics will rely on survey data (e.g. satisfaction and trust score) and the quality of this data is always going to be variable depending on how anonymised the surveys are.

- There are no metrics that look at competitiveness and growth versus other jurisdictions – this secondary objective is "outward" facing yet the metrics all look at what the PRA can do and not what the overall outcome is.

- There is little information on how these metrics will be monitored independently, what the tolerances/risk appetites are around these metrics, and what actions could or should be taken if it is determined that performance is sub optimal.

- Relevant metrics should also be looked or the different sub sectors of firms – looking at data at an aggregate level across all banks oftens provides a misleading picture of what the impacts (or not) are. We would argue this should be the case across all policies and cost benefit analyses.

- The PRA and FCA are able to "stop the clock" on regulatory approvals so the outcome of the metrics may not always be a true reflection of the length of time of the application. Having an extra bit of context that sets out how many applications were subject to a "stop the clock" and what their actual timelines were would provide a better reflection.

7. Does the requirement within the secondary growth and competitiveness objectives to align with international standards create any constraints to fulfilling those objectives?

- It depends on what the PRA mean by international standards. Ignoring domestic market issues and comparisons with other jurisdictions (like the US and Europe) and just replicating standards set out at Basel would not necessarily lead to an appropriate regulatory environment in the UK and could leave the UK at a significant competitive disadvantage impacting investor interest.

- The UK banking sector is fairly unique in having a strong mid-tier sector of banks. Our concern is that this often gets lost in the policy formulation and application (as discussed earlier) with global regulatory standards developed for the largest banks being applied to

much smaller, domestic mid-tier banks without due consideration of the impact on them (so called "squeezed middle") because the assessment against SCO, SCGO or the cost benefit analysis is undertaken at an aggregate level.

- The final rules for Basel 3.1. implementation is a good example. The PRA listened to broad industry concerns and made a number of tweaks, which were well received. The approach to portfolio BTL remains the same despite significant evidence to support a more moderated approach in the UK (as has historically been the case). For the majority of portfolio BTL lending, Basel 3.1 will increase RWs by between 30% to 70% depending on the loan to value of the mortgage, yet for 24 of the last 25 years, the sector's credit performance has been superior to owner-occupied mortgage lending.

8. Are the existing accountability measures around the secondary growth and competitiveness objective adequate?

- Like the SCO, the PRA will produce an annual report setting out what has been done to meet the SCGO. This will include the metrics as well as a qualitative assessment. This should receive parliamentary scrutiny via the Treasury Select Committee.
- It is not clear if there are any other forms of public accountability i.e. through industry groups (UK Finance etc), through industry panels or whether any other options have been considered. Independent oversight, challenge, and determination of actions to address under-performance will be critical to ensuring the SCGO (and the SCO) has an impact. This is an important area and one that deserves more thought from both the PRA and FCA.

Further requests from the Committee

9. The overall number of data requests the FCA and PRA make of you (e.g., bespoke, number of suspicious activities reports, and KYC/KYB products), as well as the examples of forms you feel are duplicatory.

- This information is considered confidential.

- One of the key areas of FCA rule changes and expectations has been the implementation of Consumer Duty last year. Consumer Duty is not

a one-off project but requires constant work to continually ensure that processes are embedded and being followed.

10. The Committee would also be grateful for Paragon Bank's reflections on the Government's use of the remit letters, and where Paragon Bank considers that the Government will need to take a lead to adopt a higher risk appetite (e.g., setting new capitalisation ratios).

- The remit letter to the PRA acknowledges that the regulator plays an important role in the government's growth mission and emphasises that the PRA must have regard to creating a regulatory environment that facilitates growth through supporting competition and innovation. This is positive and aligns directly with the sector's views. However, the objective to increase the level of competition should not be at the margins and just between the mid and small banks, but should be focused on the large, incumbent banks. This will only happen with progress on the issues discussed in this note (MREL, IRB, granular assessment of impacts, streamlined regulatory regime for mid-tier firms etc).

- As noted earlier, despite significant regulatory tightening and new powers via the Bank Resolution Bill, the Bank of England has not sought to increase MREL thresholds materially – in part because the Resolution Authority do not have secondary objectives – this is an example that demonstrates potential "trade-offs" are often discounted or ignored.

- We would recommend that the Government commission an independent review of competition in the banking sector to consider changes that could be made that can facilitate greater competition with the large banks. Greater competition leads to improved choice for customers, fosters innovation, and would help to enhance the potential of the unique mid-tier banking sector in the UK to support lending to SMEs and help grow the UK economy.

13 December 2024