Banking on the mid-tier

The value of small and mid-tier banks to the UK

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In this document, Ernst & Young LLP (EY UK) highlights the vital role of the UK's small and mid-tier banks, a vibrant and dynamic sector that makes a unique and increasing contribution to the banking landscape. We provide a broad overview of these banks' functions, their expansion and the substantial benefits they offer to individuals, enterprises and the broader UK economy.

Our focus on this sector stems from having professional EY teams well-versed in the diverse business models of these banks, offering tailored support across the growth trajectory. The small and mid-tier banking sector in the UK has seen a remarkable surge in the last ten years, with the Prudential Regulation Authority (PRA) issuing new banking licences to 38 UK entities since 2013.[1] These banks now account for over two-thirds of all UK-incorporated banking institutions.

The collective impact of these banks is often underrepresented and deserves emphasis. As indicated in our recent analysis of the effects of Basel 3.1 on small and medium enterprises (SMEs) and buy-to-let (BTL) sectors, these banks play a pivotal role in parts of the economy that can influence policy decisions.[2]

How do these banks contribute to the UK?

1. **They are key providers of finance to SMEs:** £35bn of funding came from small and mid-tier banks for SMEs in 2023, making them the main providers of SME bank lending.[3] SMEs represent a significant portion of UK employers, so their expansion is key to economic growth.
2. **They support regional growth and wealth creation:** Small and mid-tier banks employ 50,000 people, mostly outside London, which aligns with government policy efforts to address the skills gap and decentralise key jobs.[5] Further, these banks lend across the UK, supporting regional growth.
3. **They support non-mainstream groups:** These banks support sectors of the UK with specialist and non-mainstream banking needs, including firms focused on sustainable lending and the agricultural sector.

Small and mid-tier banks provide **60% of SME lending in the UK** – a doubling over the last decade.[4]

[1] New banks authorised since 2013 | Bank of England, As at January 2024, the Bank of England shows that there are 155 banks incorporated in the UK , plus other banks authorised to accept deposits through a UK branch. https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/authorisations/which-firms-does-the-pra-regulate/2024/list-of-banks/banks-list-2401.pdf. We continue to see new entrants into the UK banking market; however, small and mid-tier banks also exit the market via failure (e.g. SVB) or acquisition (for example, the proposed acquisition of Co-op Bank by Coventry Building Society).
[2] EY publication: Impacts of Basel 3.1 on SME lending and BTL mortgages. Focus on Mid-tier banks, March 2024
[3] British Business bank - Small Business Finance Markets report 2024
[4] ibid
[5] EY Challenger and Specialist banks database

4. **They finance housebuilding and housing provision:** The small and mid-tier banks support the efforts to meet the UK's housebuilding targets, particularly by acting as a key source of finance to SME housebuilders who develop smaller sites. Many of these banks support both owner-occupied and rental housing provisions with business models focused on property lending, particularly buy-to-let mortgages.
5. **They benefit UK consumers by offering favourable deposit rates:** These banks are subject to price competition for retail deposits, which has resulted in retail customers and SMEs benefiting from higher deposit rates.
6. **They deliver new models of customer service and innovation:** Many of these banks are cloud-native and able to respond to market changes quickly, resulting in tailored customer-centric solutions and innovative business models. These have helped to evolve the broader FinTech landscape and enabled banks in this sector to deliver leading customer service.

22% of the BTL mortgage market belongs to small and mid-tier banks.[6]

85% of savings categories saw small and mid-tier banks offer the best rate to retail customers.[7]

3 different customer service surveys (covering business and retail banking) have all seen small and mid-tier banks consistently take the top two spots.[8]

Lastly, this paper highlights the UK regulatory landscape applicable to these banks, such as the upcoming introduction of Basel 3.1 and the Small Domestic Deposit Takers (SDDT) regime, part of the PRA's 'strong and simple' framework. Further, we note how, even for existing prudential regulatory requirements, the obligations for these banks evolve as they grow through defined regulatory thresholds, for example, the minimum requirement for own funds and eligible liabilities (MREL).

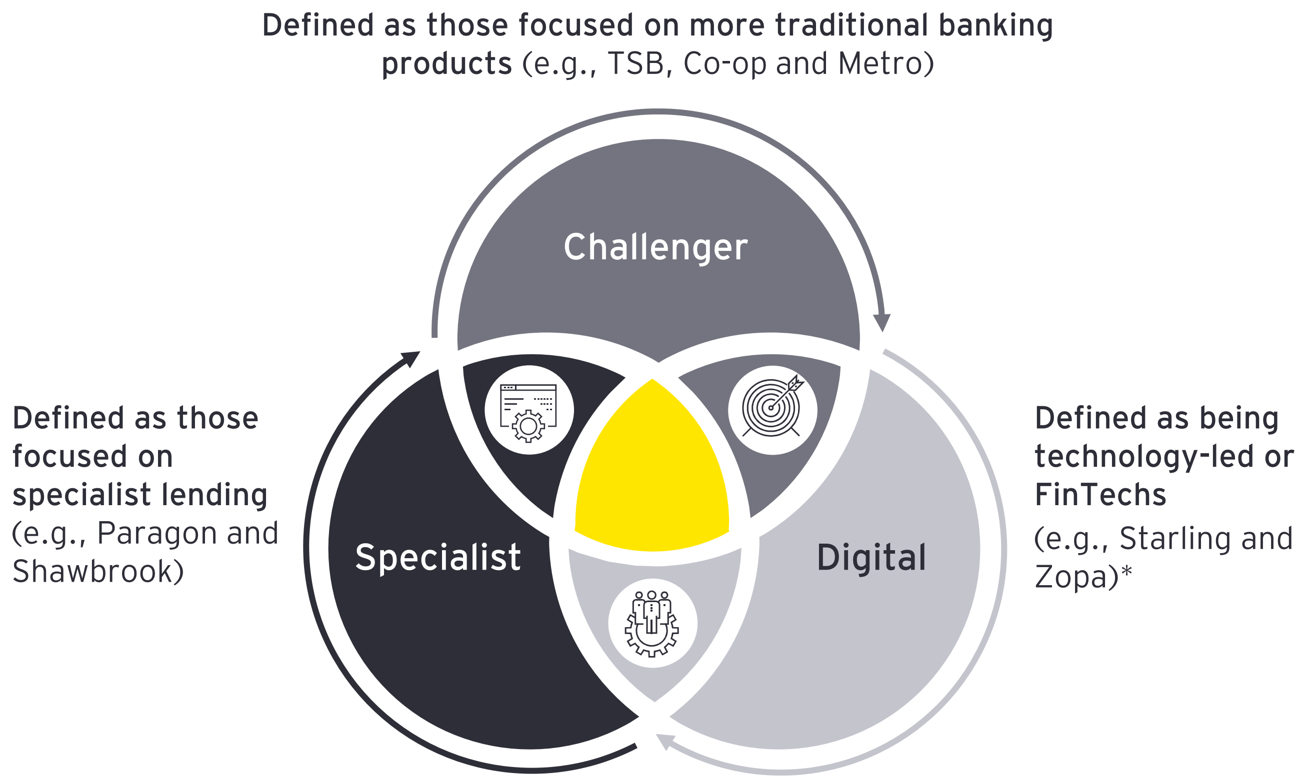
[6] BoE publication: The buy-to-let sector and financial stability
[7] https://moneyweek.com/personal-finance/savings-rates-more-than-double-in-year
[8] business banking service quality, Aug 2024 Ipsos: Personal banking service quality, Aug 2024 and Best banks and bank accounts in UK 2024 - Which? (referenced as at July 2024)

Who are the UK's small and mid-tier banks?

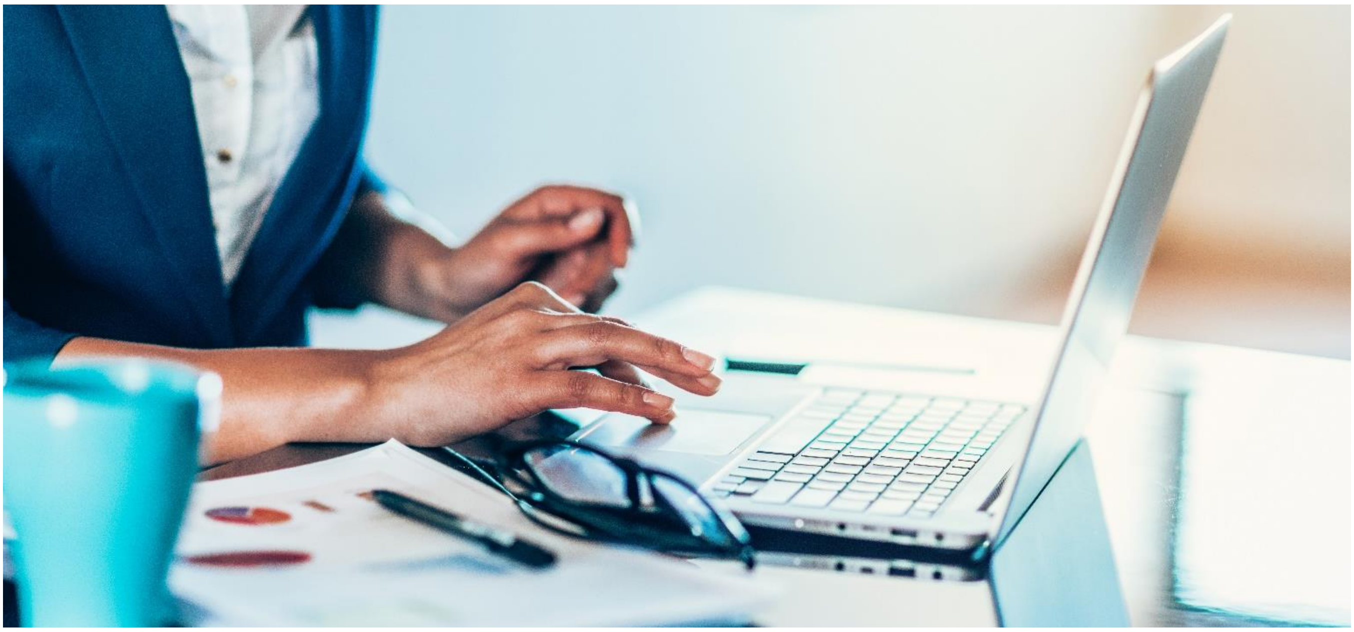
The UK's small and mid-tier banks form a unique sector with a wide range of business models servicing different customer segments.

Below, we set out three main categories of UK small and mid-tier banks: challenger, specialist and digital.

Types of UK small and mid-tier banks



* Digital also captures banks that offer clearing and Banking as a Service (BaaS) to other firms.



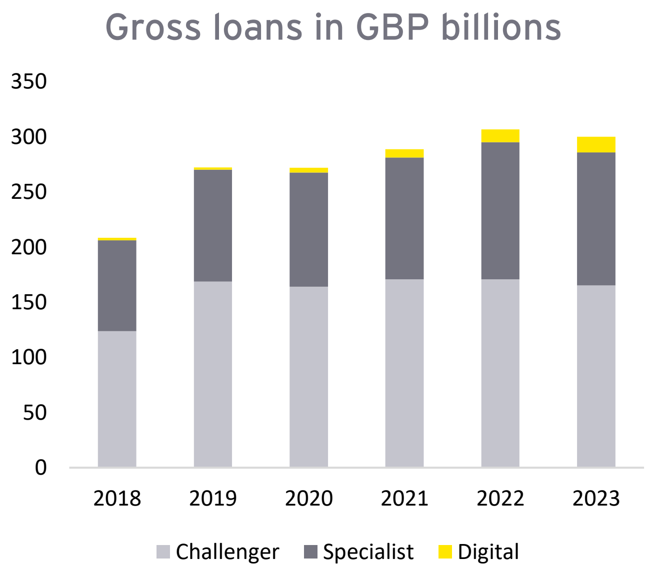
UK small and mid-tier banks in numbers

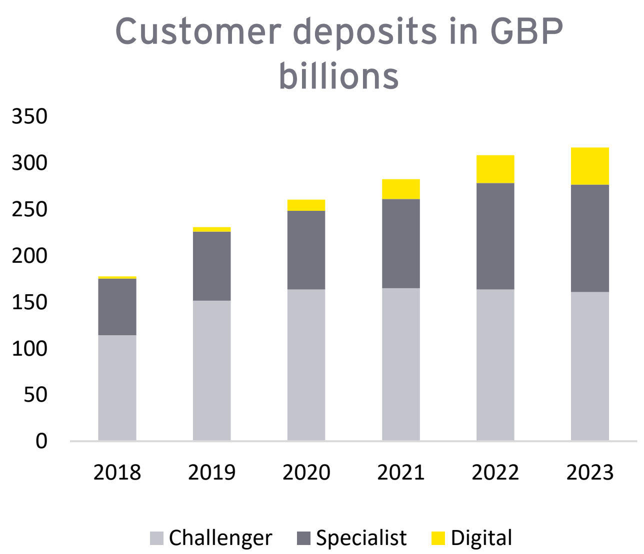
The majority of small and mid-tier banks captured in our EY Challenger and Specialist banks database are profitable businesses, generating shareholder returns and creating an increasing number of jobs:[9]

- Profitability in this sector is a function of maturity and scale, as well as trading conditions, business and operating model, and risk profile. The median return on equity (RoE) in this sector was 11% in 2023, with some specialist banks reporting RoE in excess of 15%.
- The sector employs over 50,000 people, many of whom are in highly skilled roles, an increase of over 10,000 since 2018.

Lending

- **Gross lending held by the small and mid-tier banks in 2023 was £300bn, of which 80% is concentrated in 10 banks.** This includes:
  - £158bn (52%) from five challenger banks (Co-op, Handelsbanken, Metro, TSB and Virgin).
  - £84.1bn (28%) from five specialist banks (Aldermore, OSB, Paragon, Shawbrook and FCE Bank).
  - The remaining lending is attributed to the smaller specialist banks and the digital banks.
- **Small and mid-tier banks continue to grow strongly, with loans growing 44% between 2018 and 2023.**[10]





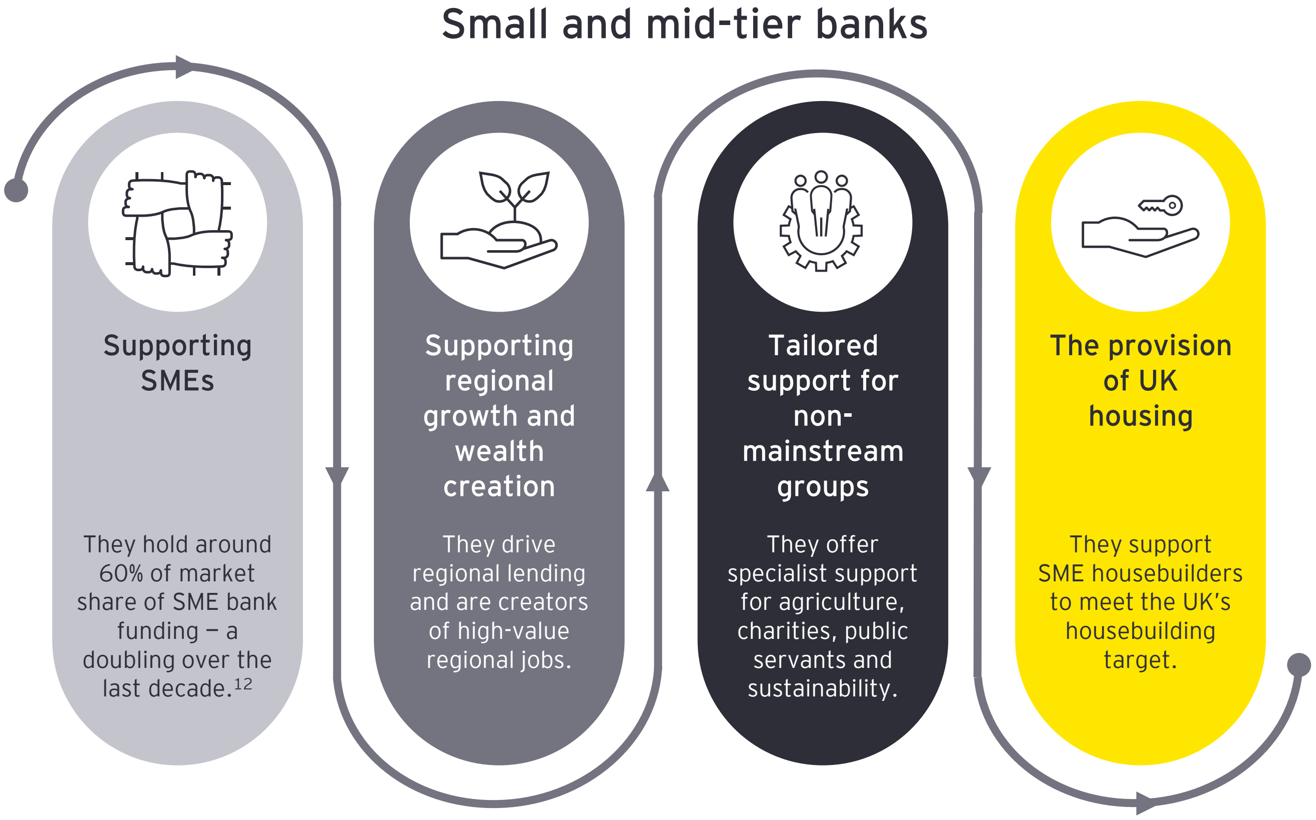
Deposits

- **Small and mid-tier banks saw an 80% increase in deposits between 2018 and 2023 from £180bn to £320bn.**[11]
- The majority of this increase has come from specialist bank deposits, which almost doubled from £61bn in 2018 to £116bn in 2023. The deposit balances attributed to the six digital banks has also increased by £38bn (94%).

[9] EY Challenger and Specialist banks database collates information from 50 challenger, specialist and digital banks to enable comparison across key metrics. Data is sourced from banks' annual statements and Pillar 3 disclosures. The majority of the banks in the database are standalone UK banks; however, it also contains some international banks' subsidiaries, such as Handelsbanken and Triodos.
[10] ibid
[11] ibid

How small and mid-tier banks support the UK economy

We set out four areas where small and mid-tier banks support economic growth and social development.



The key providers of finance to SMEs

Small and mid-tier banks provided £35bn of funding for SMEs in 2023, meaning they are now the main providers of SME bank lending.[13]

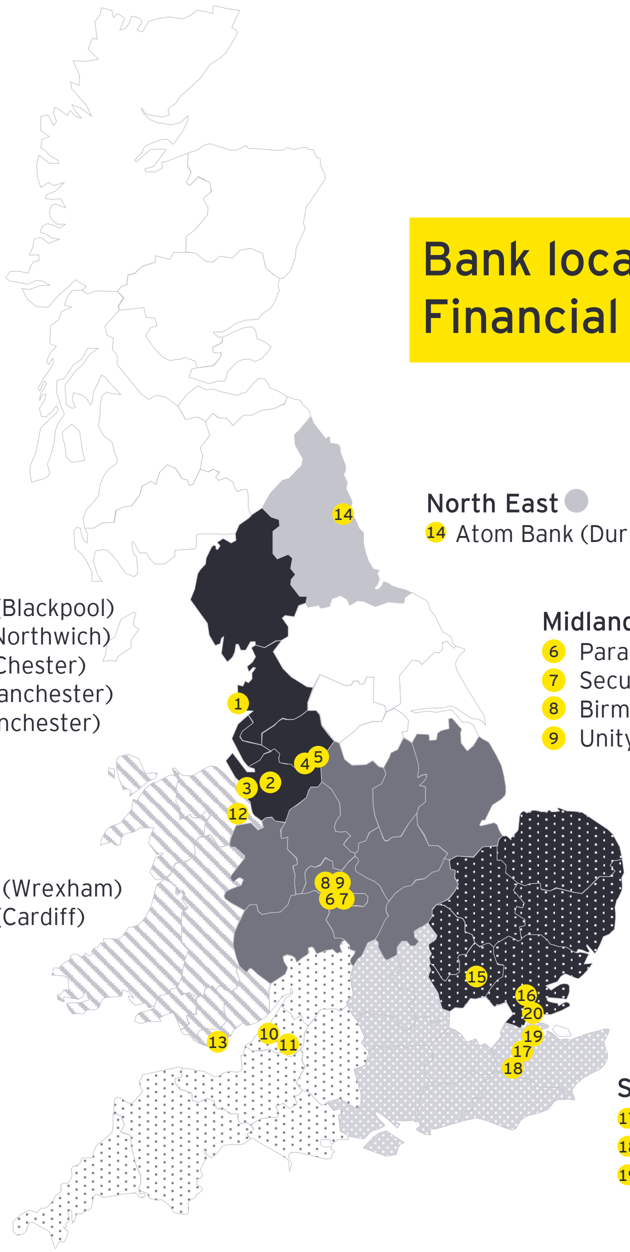
- SME funding provided by small and mid-tier banks takes many forms, including asset finance, which enables SMEs to invest in the assets and infrastructure needed for growth.
- Bank lending is even more critical outside of London, where SMEs have less access to alternative sources of funding (e.g., equity and debt financing).[14]
- SMEs make a significant contribution to the economy. The six million SMEs in the UK contribute 52% of private sector turnover and are responsible for 60% of UK employment (rising to 70% in South West England, Wales and Northern Ireland).[15] Furthermore, SMEs are more likely to employ younger apprentices and those living in disadvantaged areas.[16]
- The House of Commons Treasury Select Committee report on SME Finance notes the importance of accessing finance for SMEs and that more needs to be done to increase SME's confidence in raising funds and extend the availability of finance.[17] In line with these objectives, the small and mid-tier banks have the potential to continue expanding their support to SMEs; however, changing capital treatments under Basel 3.1 have the potential to reduce levels of SME lending.[18]

[12] British Business bank: Small Business Finance Markets Report 2024
[13] ibid
[14] HM Government, Levelling Up the United Kingdom (Figure 1.42, page 67), February 2022
[15] OECD
[16] HM Government, Levelling Up the United Kingdom
[17] SME Finance - Treasury Committee (parliament.uk). Treasury committee report.
[18] EY publication: Impacts of Basel 3.1 on SME lending and BTL mortgages. Focus on Mid-tier banks, March 2024

Supporting regional growth and wealth creation

- Small and mid-tier banks contribute to regional growth through direct lending and employment and by facilitating the investment and scaling of other firms.
- These banks employ 50,000 people, mostly outside London, creating regional high-value tech and finance jobs in the UK banking industry, aligned with government policy efforts to address the skills gap and decentralise key jobs. Many have large regional operational hubs and satellite offices, and a third have headquarters outside of London (see map below).
- Further, many small and mid-tier banks have a regional remit as a core component of their strategy, lending across the UK's regions, including to SMEs outside the major cities.

Bank locations – from the Financial Services Register [19]



North East
14 Atom Bank (Durham)

North West
1 Tandem Bank (Blackpool)
2 Access Bank (Northwich)
3 Oxbury Bank (Chester)
4 Co-op Bank (Manchester)
5 DF Capital (Manchester)

Midlands
6 Paragon Bank (Solihull)
7 Secure Trust Bank (Solihull)
8 Birmingham Bank (Birmingham)
9 Unity Trust Bank (Birmingham)

Wales
12 Chetwood Financial (Wrexham)
13 Julian Hodge Bank (Cardiff)

East
15 Redwood Bank (Hertfordshire)
16 Shawbrook (Brentwood, Essex)
20 FCE Bank (Laindon, Essex)

South East
17 CAF Bank (West Malling, Kent)
18 Charity Bank (Tonbridge, Kent)
19 One Savings Bank (Chatham, Kent)

South West
10 Triodos Bank (Bristol)
11 Bank of Ireland UK (Bristol)

[19] Register Home Page (fca.org.uk)

Tailored support for non-mainstream groups

- Small and mid-tier banks increasingly focus on specific groups and segments of the economy with strong social and economic significance, tailoring their product offering accordingly. Some examples are:
  - **Charities:** 42% of charities surveyed by the Charity Commission reported experiencing banking problems.[21] Several small and mid-tier banks support the sector through specific charity offerings which provide additional banking choice and availability.
  - **Sustainability:** Several banks in the sector have long had a green ethos, offering customers ethical ISAs and impact investing (for example, Triodos Bank).
  - **Sector-focused business models:** Oxbury Bank, which focuses on agriculture and the rural economy, is an example of a bank in this sector that has been established or is seeking a banking licence exclusively to focus on a specific sector or societal group. Other examples include business models that focus on military personnel or public sector workers.

Financing housebuilding and housing provision

- **Building homes:** Many small and mid-tier banks focus on development finance and actively support SME housebuilders, who provide 10% to 12% of the total private sector newbuild programme.[23] However, a UK government report notes that under the right conditions (finance, planning and land), SME housebuilders have the potential to build a higher proportion of the total new homes and increase overall supply, for example, by developing smaller sites. It is estimated that SME housebuilders could add 5,000 to 10,000 homes annually.[24]
- Historically, smaller housebuilders have struggled to access finance, and small and mid-tier banks play a role in helping unlock finance through normal lending activities and their work with the British Business Bank's ENABLE Build programme.[25] As an example, OakNorth publicly states that from the £10bn the bank has lent since its authorisation in 2015, it has directly contributed to building 29,000 new homes across the UK.[26]
- **Rental housing provision:** Small and mid-tier banks hold a 22% market share of all UK BTL lending, focusing on lending to professional UK landlords.[27] The UK BTL sector plays a central role in the provisioning of accommodation, providing housing to 45% of private renters.[28]

22% of the UK's BTL mortgage lending is done by small and mid-tier banks

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[20] Charity Commission research: New-data-suggests-nearly-half-of-charities-experience-issues-when-banking
[22] Meeting housing demand (parliament.uk)
[23] House of Commons Library: Future of small and medium-sized housebuilders, May 2023
[24] ENABLE programme - British Business Bank (british-business-bank.co.uk)
[26] Our Story: OakNorth Bank
[27] The buy-to-let sector and financial stability | Bank of England
[28] Ibid

The benefit to UK consumers through higher deposit rates

Small and mid-tier banks have provided value to customers by **offering top-of-market interest rates on savings deposits.**

Small and mid-tier banks offer competitive rates of interest to attract new deposit balances, which translates into more interest income for price-sensitive UK consumers and SMEs. The last few years have seen increases in the Bank of England (BoE) base rate, which has increased the incremental interest gains available.

Retail customers benefit from higher interest rates on savings – 85% of savings categories saw small and mid-tier banks offer the best rate to retail customers.[29]

Faster to increase savings rates

FCA data highlights that specialist banks passed on interest rate rises faster, and to a greater degree, than some of the Big 9 banks.[30] This has a particularly material impact on UK consumers in the context of the BoE base rate increases seen over the last few years (from 0.25% in January 2022).

For example, in July 2023, when the base rate was 5%, specialist banks offered an average of 3.7% on easy-access savings accounts, compared with 2% by the larger banks.[31]

More recently, in April 2024, the small and mid-tier banks offered the top rates on their instant saver products, with the highest rate being 5.2%. The highest rate offered by the Big 6 high street banks was 4%, with the majority offering under 3%.[32]

Higher rates for SMEs: For SMEs, the gap between rates offered by big banks and small and mid-tier banks can also be significant, with higher rates provided by the latter. In April 2024, the best small and mid-tier savings rate was over 4%, compared with an average Big 6 high street bank rate of 1.6%.[33]

Billions in extra interest

£200bn of savings deposits subject to an extra 1.7% interest puts an additional £3.4bn back in the pockets of the UK consumer

[29] 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) https://moneyweek.com/personal-finance/savings-rates-more-than-double-in-year
[30] Cash Savings Market Review 2023 (fca.org.uk) - the Big 9 Banks are the Big 6 UK banks (HSBC, Lloyds Banking Group, Barclays, NatWest, Santander and Nationwide Building Society, as well as Challenger Banks (Co-op, Virgin Money and TSB)
[31] FCA data referenced by the Financial Times: Challenger banks look to exploit higher savings rates (ft.com)
[32] EY research using Moneyfacts Compare Website
[33] New SME Savings Tracker Reveals Massive and Persistent Gap in Savings Rates Offered to SMEs by Big Banks Compared to Digital and Challenger Banks (ffnews.com)

Delivering innovation and new models of customer service

One recent feature of UK banking has been the rapid growth in digital and mobile banking. Small and mid-tier banks have contributed to UK banking innovation, the use of technology and the empowerment of other firms to grow and innovate. This has supported some of these banks **consistently topping customer service and satisfaction surveys.**

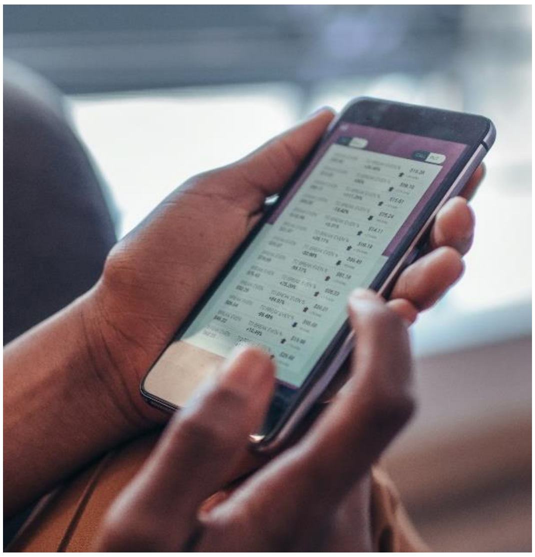
- **Agile, cloud-native and able to respond to market changes quickly:** Small and mid-tier banks typically benefit from a modern technology infrastructure from the start with relatively simple governance and decision-making frameworks. Furthermore, many have been early adopters of cloud.

- **Digital and mobile banking services that deliver tailored customer-centric solutions:** These banks have been able to accelerate technology investment to offer flexible, cost-effective and customer-centric services. This provides customers with accessible financial services, wider choices and offerings targeted to their market segment (e.g., SME banking or digital wealth management). They have also pioneered new customer-friendly services, such as letting customers split bills and track spending.

- **Partner with third parties and provide services that allow firms and other FinTechs to innovate:**
  - Some banks in this sector have adopted innovative business models that extend other firms' capabilities. An example is banks that offer their proprietary banking technology to other banks in the UK and internationally (for example, new greenfield digital banks or existing banks that are re-platforming). Starling Bank is one such provider, offering its banking platform, Engine, as a software-as-a-service (SaaS) proposition.
  - Other small and mid-tier banks partner with intermediaries and other third parties to develop new, specialised propositions that expand customer choice. This includes Banking as a Service (BaaS), where banks provide access to payment and clearing infrastructure and the ability to embed regulated banking products into their product suite. For example, ClearBank's clients include payment firms (such as Tide, a FinTech that provides SME lending).
  - Furthermore, these banks increasingly use third-party deposit providers and their customer-centric apps to raise deposits.[34]

Innovation valued by customers Three different customer service surveys (covering business and retail banking) have all seen digital banks consistently take the top two spots.[35]

In customer satisfaction surveys, small and mid-tier banks took four of the top five places for business customers and have consistently been in the top two for retail customers.[36]



[34] EY Publication: Third-party deposit providers. Greater understanding and better risk management, 2024 UK Market Survey
[35] Bva-Bdrc: business banking service quality, Aug 2024, Ipsos: Personal banking service quality, Aug 2024 and Best banks and bank accounts in UK 2024 - Which? (referenced as at July 2024)
[36] Ibid

The UK regulatory landscape

The regulatory landscape has changed rapidly over the last decade. Global, European and UK regulators have all focused on ensuring the banking system is safer, more resilient and with a limited taxpayer impact in case of failure. In the UK, changes included an evolution of the bank authorisation process to support new bank entrants. In building the 'new bank start-up unit', the PRA has been highly effective in supporting the establishment of new banks and the emergence of new business models and product offerings.

The prevailing challenge for regulators is to ensure that the regulations applicable to small and mid-tier banks appropriately reflect the risk profile of these banks and do not unnecessarily restrict their ability to compete effectively and scale. This involves the PRA balancing its objective to maintain safety and soundness with its secondary objectives around banking competition and UK competitiveness and growth.[37] The below sets out key areas of regulatory change applicable to these banks, including an example of regulatory thresholds that apply once banks reach a certain size.

Applicable regulatory thresholds

- The UK's small and mid-tier banks remain subject to multiple regulatory thresholds, which drive requirements across areas such as capital and reporting. Setting thresholds at a proportionate level is a challenge for regulators, and depending on where they are set, they can impact banks' incentives for growth.
- An illustrative example is MREL, whereby UK banks meet the MREL threshold when they grow to a particular size (for example, £15bn to £25bn of assets). MREL requires holding sufficiently higher reserves of equity and eligible debt capital at an additional cost.[38] We highlight in our paper on MREL's financial implications how having to hold MREL is material for eligible banks, impacting the cost of funding, profitability and ability to lend.[39] Further, banks in the sector challenge whether the MREL threshold should be higher in line with comparable thresholds in the US and EU.

Strong and simple

- The PRA's strong and simple framework launched in 2022 aims to 'simplify regulatory requirements for smaller banks, thus reducing compliance burdens without compromising on strong standards'.[40]
- This project has resulted in the publication of the Small Domestic Deposit Takers (SDDT) regime, an optional regime applicable to UK banks with below £20bn in assets and limited trading activities.
- For banks that opt to become SDDT firms, the regime introduces a reduction in disclosure requirements, the removal of some ongoing capital and liquidity assessment obligations and the application of simplified approaches.
- Further, the PRA's September 2024 consultation paper proposes that SDDT firms hold one Single Capital Buffer (SCB) to replace the existing buffer stack.[41] This would be firm-specific, set using non-cyclical stress testing and floored at 3.5% of risk-weighted assets (RWAs).
- Other core capital and liquidity requirements, such as LCR and Pillar 1 credit risk weights, do not change under SDDT, albeit evolving capital requirements under Basel 3.1 (see next page) come into effect one year later, in January 2027.
- Not all small and mid-tier banks will meet the SDDT criteria. Or they may not follow the regime, given that they plan to grow through the applicability thresholds in the short to medium term. Therefore, banks undertaking similar activities may follow different prudential regimes.

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[37] Our secondary objectives | Bank of England
[38] Minimum requirement for own funds and eligible liabilities (MREL) is set by regulators with the objective of ensuring that firms have enough funds to absorb losses so they can fail safely, thereby reducing the need for a taxpayer-funded rescue. Interim and end-state minimum requirements for own funds and eligible liabilities (MRELs) | Bank of England
[39] EY publication: MREL Financial implications for mid-size and challenger banks, August 2021
[40] PS15/23 – The Strong and Simple Framework: Scope Criteria, Liquidity and Disclosure Requirements | Bank of England
[41] CP7/24 – The Strong and Simple Framework: The simplified capital regime for Small Domestic Deposit Takers (SDDTs) | Bank of England

Evolving capital requirements: Basel 3.1

- The upcoming introduction of Basel 3.1 means that many UK small and mid-tier banks are forecasting an increase in risk-weighted assets and capital requirements. As outlined in our recent Basel 3.1 publication, the net increase for these banks reflects how the capital regime changes impact asset types in which they are concentrated (for example, professional BTL mortgages).[42] In an update to initial proposals, the PRA is to apply a firm-specific SME lending adjustment through Pillar 2A with the intent that capital requirements for SME exposures are not increased.[43]
- Standardised banks that do not opt to be SDDT firms, or enter the Interim Capital Regime (ICR), will need to apply Basel 3.1 capital requirements in their entirety in January 2026. In contrast, banks and building societies that have approved IRB capital models benefit from a transition period to January 2030 and typically lower capital requirements for comparable portfolios. Whilst all banks can seek an advanced internal rating-based (IRB) approach to credit risk measurement, this can be an expensive and time-consuming process given significant data requirements and an involved regulatory approval process.

In Conclusion

As the UK government seeks to prioritise policies that promote economic growth, this paper highlights the value of actively supporting the contribution of the UK's small and mid-size banks.

These banks play a key role in providing innovative and in-demand banking services to SMEs and retail customers and in specific markets and regions, whilst operating within the protection of the highly regulated banking sector. Continuing to support these banks and facilitate their growth has the potential to further amplify the benefits of a diverse and competitive UK banking sector.

[42] EY publication: Impacts of Basel 3.1 on SME lending and BTL mortgages. Focus on Mid-tier banks, March 2024
[43] PS9/24 – Implementation of the Basel 3.1 standards near-final part 2 | Bank of England

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