Executive Insights

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Why the Big Banks' Return to Lending Is an Inconvenience, Not a Calamity, for Challenger Banks and Specialist Lenders

At the onset of the financial crisis, high street banks significantly retrenched their lending activities, both to consumers and to small and medium-sized enterprises (SMEs): They retreated to lower loan-to-value (LTV) ratios on secured lending and mortgages, exited sub-prime and almost all near-prime, and tightened lending criteria on other non-standard risk categories, such as self-employed people seeking mortgages.

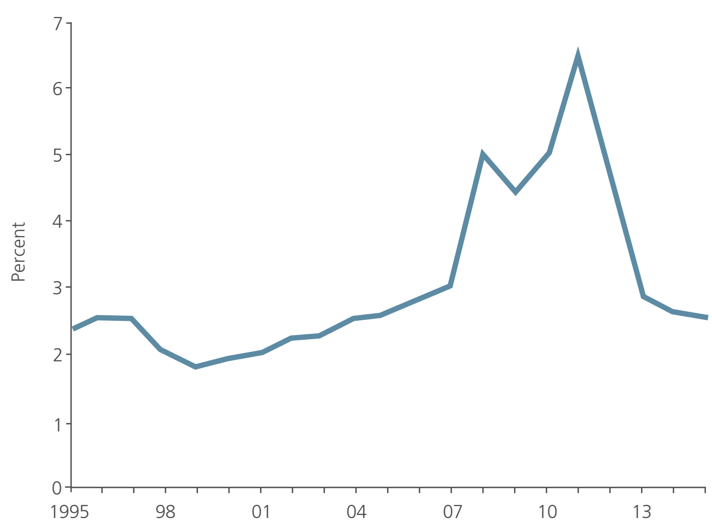
To fill the gap, a range of specialist lending models emerged, either in the form of new or re-directed challenger banks, the most successful of which pursued multi-niche strategies[1], or non-bank specialist lenders pursuing mainly monoline strategies[2].

Since the recovery of the economy, the big banks' business models have returned to a more stable footing, with a dramatic fall in personal debt write-offs (see Figure 1). As a result, other lenders and investors are concerned that the high street banks will return to the lending areas they left, threatening the new businesses that sprung up in their wake. Challenger banks and specialist lenders are right to be cautious, but many niches remain sustainable opportunities, providing they take some crucial steps to ensure their ongoing success.

Where to play: considerations for major banks

The large banks are drawn to markets where they have the greatest advantage — where their economies of scale in operating and

Figure 1
Write-off rates on lending to UK individuals



Source: BoE

[1] See L.E.K. Consulting's How Challenger Banks Can Finally Live up to Their Name: Pursue a Multi-Niche SME Strategy

[2] See L.E.K. Consulting's Consumer Specialist Lending: Newly Sustainable or Another Boom-and-Bust?

Why the Big Banks' Return to Lending Is an Inconvenience, Not a Calamity, for Challenger Banks and Specialist Lenders was written by **Peter Ward** and **Diogo Silva**, Partners, and **Rob Wild**, an Engagement Manager in L.E.K Consulting's Financial Services practice. Peter, Diogo and Rob are based in London.

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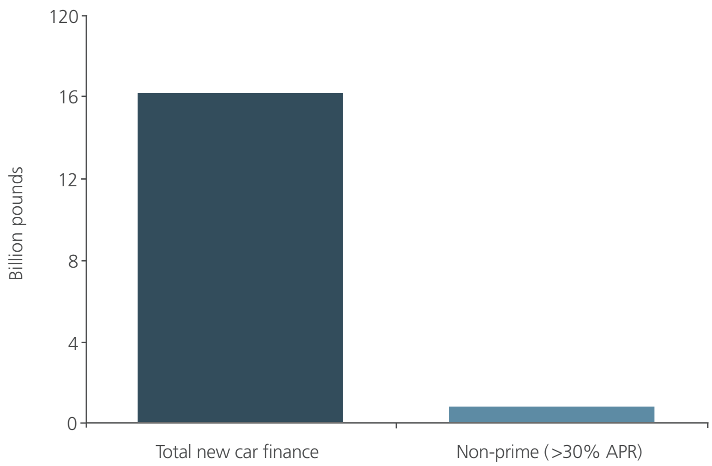
Figure 2
Market value of prime vs. non-prime car finance in 2015



Source: L.E.K. analysis

capital costs make it very difficult for smaller players and nonbanks to compete. They will also consider re-entering the lending markets they left, so in reviewing their own strategic options, challenger banks and specialist lenders must first analyse how the big banks may approach recovering their old territory.

In looking at their options, the big banks will have three principal considerations: the scale of the opportunity, underwriting risk and capital requirements.

"Is the size big enough for the divisional head or the CEO to even look at it?" will be the first question asked. Challengers often have to aggregate multiple niches to become a viable small banking operator, so in the main, most of their business areas are likely to be too complex and without enough potential scale to be attractive to the big banks. As an example, the combined outstanding balance for higher APR unsecured consumer lending is only £13 billion. Most of these are just too insignificant for big banks to be interested, for example non-prime car finance (see Figure 2).

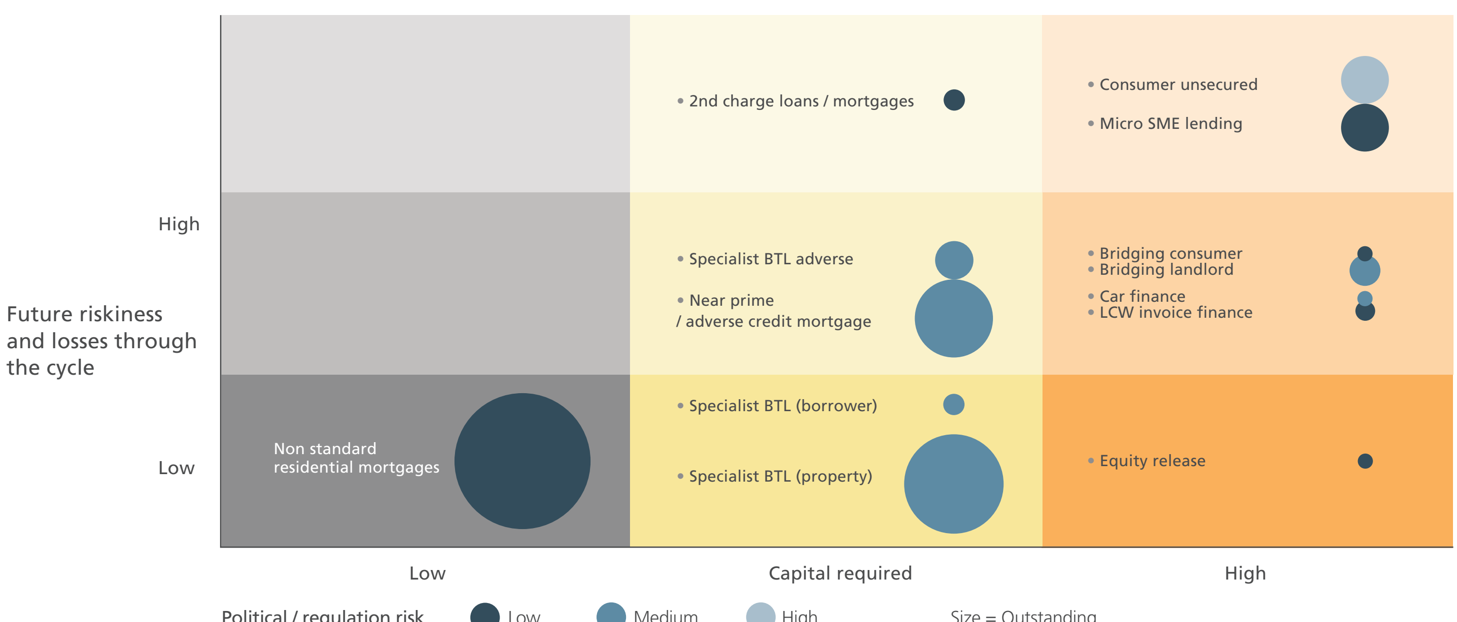
The big lenders will also review other risk factors, including:

- Likely losses from underwriting new customer segments
- The cost of holding regulatory capital against the money lent in a particular product or customer segment
- Customer service costs
- Regulatory or political risk
- Whether or not they have the required capability and resources to operate in the categories under consideration

Increased automation and data availability should help banks reduce their customer service costs over time, but this may be balanced by increased regulatory "know your customer" requirements, which have forced costs upward. In self-employed mortgages, for example, the Mortgage Market Review now requires more underwriting work, making this a less compelling sector for the high street banks.

The extent to which lending is likely to attract attention from regulators, principally the Financial Conduct Authority (FCA), or political bodies, for example the Treasury Select Committee

Figure 3
Relative attractiveness of banking products in terms of opportunity size, risk, capital requirements and political / regulation risk



Source: L.E.K. analysis

(which has heavily scrutinised or intervened in a number of lending markets), is important. Furthermore, entering such segments might have considerable negative perception risks attached, such as being seen as contradicting the bank's corporate statements about being more responsible and having moved away from higher-risk lending. For example, Wells Fargo, a US bank, discontinued its deposit advance products (a payday loan type of product) due to the labeling of these products as "predatory" by consumer advocate groups.

Re-entering mortgages?

Considering the size of the market, future riskiness and capital requirements, mortgage products are the most likely category for mainstream banks to re-enter. High LTV mortgages and longer track record self-employed mortgages are prime examples, with others such as near-prime motor lending also possibly making sense (see Figure 3).

However, from a cost, regulatory risk and capabilities perspective, even these segments look tough for the big banks to re-enter. This is because most banks no longer have the relevant specialist in-house capability, which would be very expensive to rebuild. Given the current political and regulatory environment, it would be considerably brave to ask a board to review such options, especially given their size when compared with mainstream lending segments.

The big banks react

In most niche product areas, challenger banks and specialist lenders are fairly safe for now, but the big banks won't be resting on their laurels. They will be keeping careful watch over what smaller banks are doing and ensuring they distinguish between genuinely difficult-to-write lending and areas where they either overreacted following the crisis or simply took their eye off the ball —areas of business that might become future opportunities. They will also continue investing in data and operational efficiency to reduce their cost-to-serve and expected losses across the lending cycle, which may bring some product areas owned by the niche players back into their addressable range. They will ensure that their capital weights reflect the reality of their diversification of risk across their large books of business and many decades of underwriting experience through the cycle.

Navigating the risks

There are other ongoing and emerging risks that the challenger banks and specialist lenders need to manage.

Changes in capital weightings under Basel III and IV have increased capital requirements in many areas. The most impactful change under consideration is a move to a "Sensitivities-based Method". This is a revision of the standardised approach currently adopted and will mean banks have less flexibility in their use of the internal model approach. It acts as a floor value to the amount of capital banks have to hold, and this floor value is above the amount of capital banks themselves believe they require when they calculate risk using their own models today. These changes may be particularly impactful for the bigger banks using internal models and may therefore reduce big bank participation in some lending areas. However, the FCA has talked about bringing non-bank lenders into the same or similar capital regimes as banks (though not much has happened and industry sentiment seems to be that this is unlikely to change).

There is also the likelihood of further competition crowding the specialist lenders' space. Continuing improvements in data availability and changes in consumer purchasing behaviour are making lower-cost and online business models more viable and eroding the specialists' underwriting advantages. To stay ahead, challenger banks and specialist lenders must focus on leveraging the longer-term strategic opportunities in front of them. They may also look at temporary market openings, which, while risky, can also be profitable if resourced and managed appropriately.

Challenger banks and specialist lenders must also continue to invest in understanding and developing better relationships with their customers, lowering their loss rates, and building differentiation, making it tough for others to compete on price. This includes focusing on customer research by segment, data analysis and horizon scanning for new opportunities. It also entails lobbying the regulators to ensure the continuation of capital-weighting advantages where these exist — for non-bank lenders, keeping other non-bank lenders out of the banking capital regime; for challenger banks, leveling the playing field by stopping the big banks using bespoke models that result in lower capital weightings.

The challenger banks and specialist lenders are to be congratulated for the business they have built in the wake of the big banks' cutting back their lending over the past 10 years. The future has the potential to be bright, but complacency is not an option; they must keep focused on protecting and enhancing their competitive advantage from the big banks and from agile new entrants snapping at their heels.

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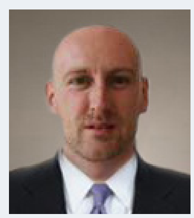

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