INDUSTRY OVERVIEW

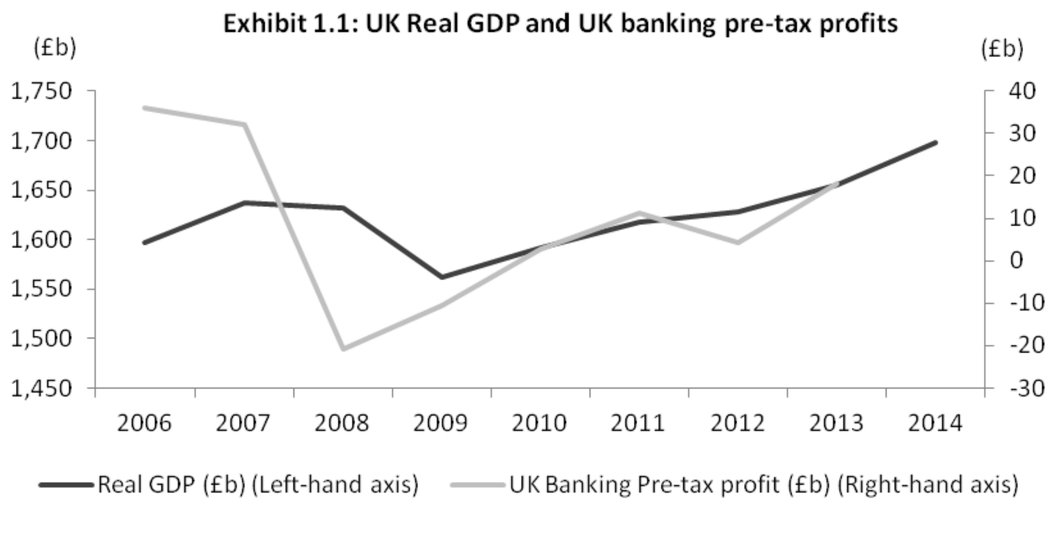
*The following information relating to the banking industry in the United Kingdom has been provided for background purposes only. The information has been extracted and derived from a variety of sources released by public and private organisations. The information has been accurately reproduced and, as far as National Australia Group Europe Limited ("**NAGE**") is aware, and is able to ascertain from information published by such sources, no facts have been omitted which would render the reproduced information inaccurate or misleading.*

1. UK Economic Context and Overview of the Banking Industry

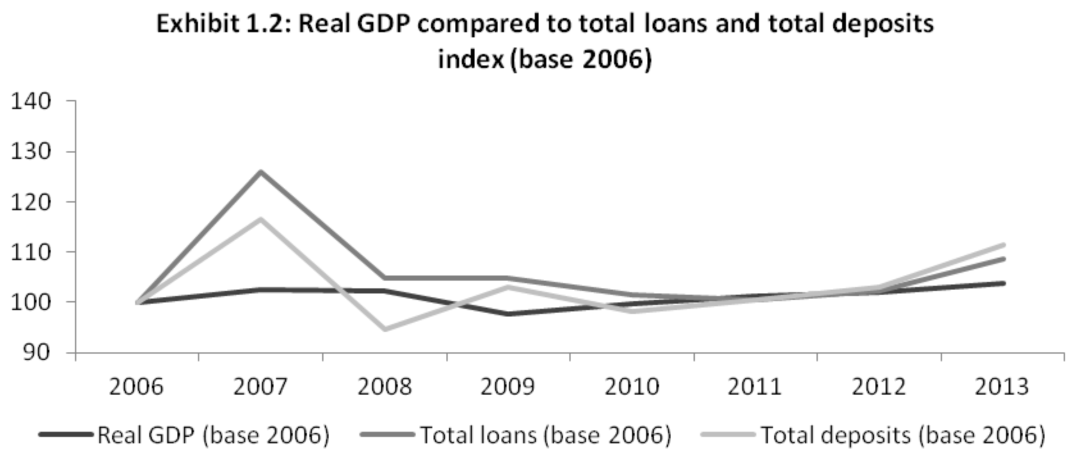
1.1 *UK economic context*

The financial services industry, encompassing banks, investment funds, insurance companies, credit unions and a range of other organisations, is an important part of the UK economy. As at January 2014, the industry employed approximately 1.1 million people in the UK, with UK banks directly employing over 400,000 people. In 2013, the industry represented 7.9 per cent. of UK GDP, compared to 4.9 per cent. in France, and 4.0 per cent. in Germany. The financial services sector accounted for 12.0 per cent. of total UK tax receipts in 2012 and 2013.

UK banking performance is correlated with the health of the UK economy. In 2008, the first year of the financial crisis, the UK banking sector collective pre-tax profits decreased from a sector-wide £32 billion in 2007 to a loss of £21 billion. Real GDP in the UK decreased by 4.3 per cent. between 2008 and 2009 from £1.63 trillion to £1.56 trillion, as shown in Exhibit 1.1 below. However, there has been a considerable period of recovery between 2009 and 2014 with real GDP growing by a compound annual growth rate ("**CAGR**") of 1.7 per cent. and the UK banking sector achieving collective pre-tax profits of £18 billion in 2013. UK GDP growth, which has been increasing ahead of European peers, further grew by 2.8 per cent. in 2014, and real GDP is forecast to grow 2.1 per cent. in 2015 (*Source: Office for National Statistics*). This trend is reflected in the trends in total loans in the UK banking sector, which have increased by a CAGR of 1.1 per cent. since 2009, and total deposits in the UK banking sector, which have increased by a CAGR of 2.4 per cent. since 2009, in line with GDP growth.

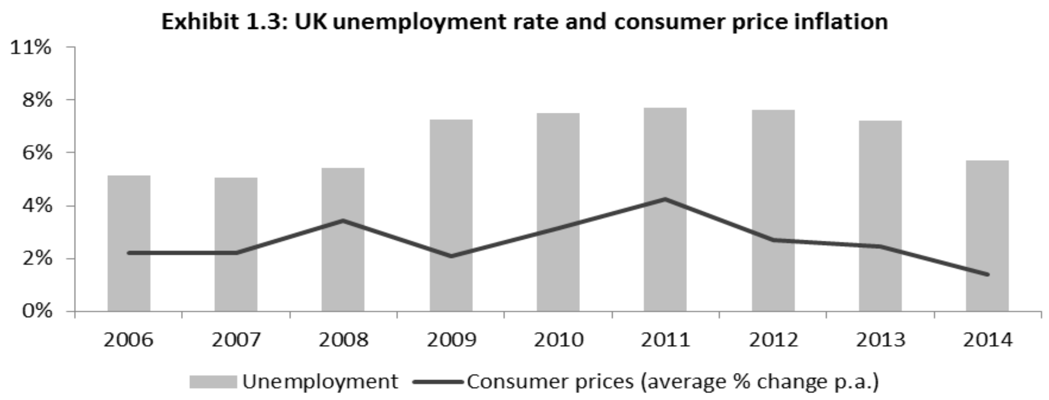


Source: Office for National Statistics, The Economist Intelligence Unit, Bank of England.



Source: Eurostat, The Economist Intelligence Unit

Other UK macro-economic indicators have also shown improvements. Unemployment decreased from 2.7 million in November 2011, representing 8.5 per cent. of the working age population in the UK to 1.9 million by December 2014, representing 5.7 per cent. of the working age population in the UK. The total number of people in employment increased from 29.3 million to 30.9 million over the same period, from November 2011 to December 2014. Between 2012 and 2014, inflation remained within the Monetary Policy Committee's target of 2 per cent. ±1 per cent. Having since fallen below this range, the Bank of England forecasts that inflation will return to the target range by 2016 and will stabilise at 2 per cent. by 2017.

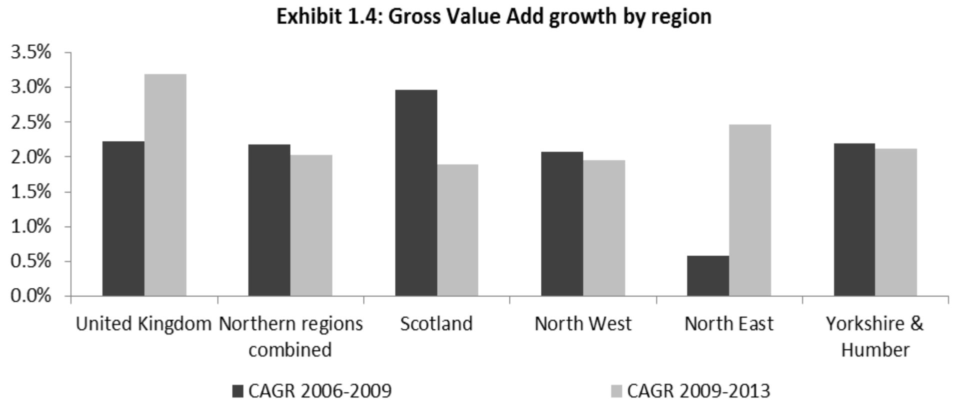


Source: The Economist Intelligent Unit, Office for National Statistics.

1.1.1 *Regional economic context*

The UK government reports on economic data from twelve regions, including NAGE's core regions: Scotland; North East England; North West England; and, Yorkshire and the Humber. The data reveals diverse demographics and macro-economic performances.

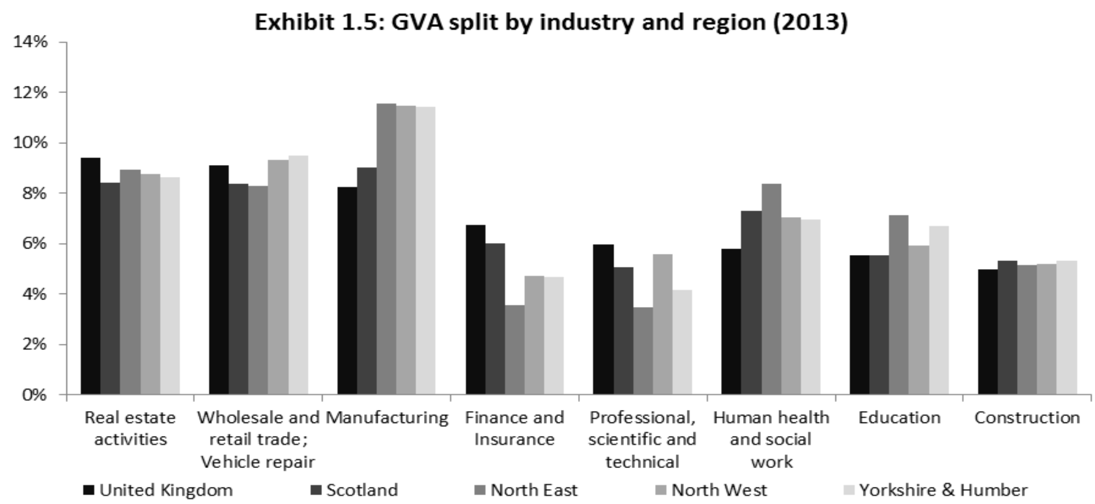
By 2013, in general the UK had recovered from the financial crisis to reach a higher nominal level of output (measured as gross value added ("**GVA**")), compared to 2006. Between 2006 and 2009, GVA in the North West and Yorkshire and the Humber grew in line with the UK average of 2 per cent. CAGR and 3 per cent. CAGR in Scotland. In Scotland, the North West and Yorkshire and the Humber GVA continued to grow between approximately 1 per cent. and 2 per cent. CAGR between 2009 and 2013, although at a slower rate than the UK average of 3 per cent. CAGR, as shown in Exhibit 1.4 below. In the North East, GVA grew at 0.6 per cent. between 2006 and 2009, but accelerated between 2009 and 2013, growing at 2.5 per cent. The Northern regions combined remained around 27 per cent. of the UK total GVA throughout this period.



Source: Office for National Statistics.

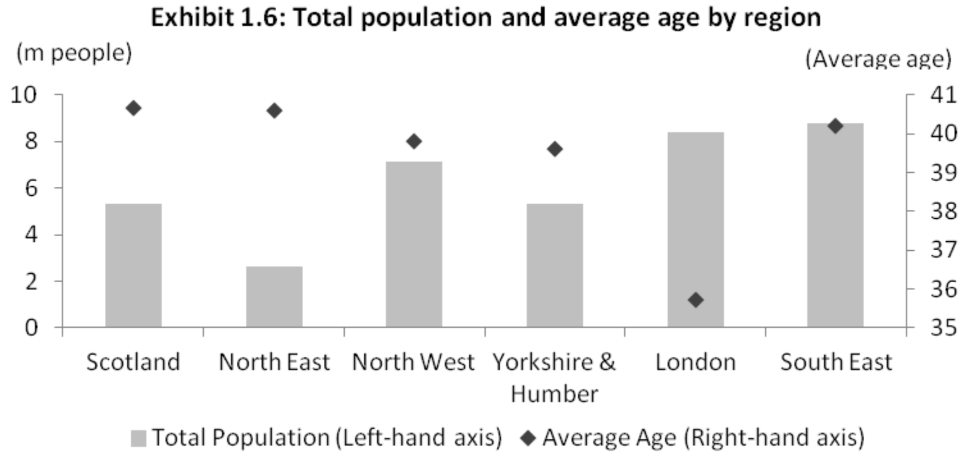
Note: Northern regions combined is the combination of Scotland, North West, North East and Yorkshire & Humber.

Exhibit 1.5 shows the GVA per industry in the UK and in each of the four core regions and for the UK as a whole. The output per industry, for the eight largest industries representing 56 per cent. of total GVA, in each region is broadly similar to the UK average. Manufacturing GVA in three of the core regions is an exception, producing outputs of approximately 11 per cent., compared to the UK average of 8 per cent. (*Source: Office for National Statistics*)



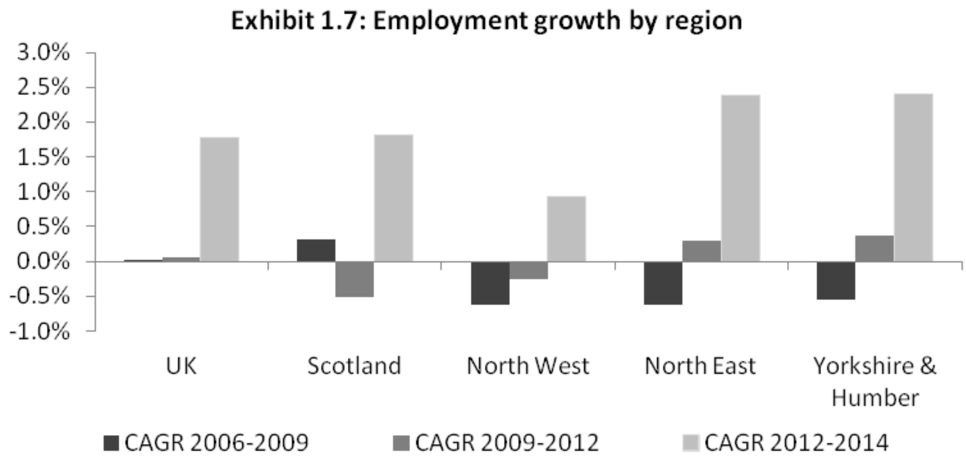
Source: Office for National Statistics
Note: 'Other' (which is not shown) comprises: 'Agriculture, forestry and fishing'; ' Mining and quarrying'; 'Electricity, gas, steam and air-conditioning supply'; 'Transportation and storage'; 'Accommodation and food service activities'; 'Administrative and support service activities'; 'Public administration and defence'; 'Arts, entertainment and recreation'; 'Other service activities'; 'Activities of households'; 'Information and communication'; 'Public admin and defence'. Chart displays available data as at 31 December 2013

The demographics of the population differs between London and the rest of the UK. Whilst the average age of the UK population, including in NAGE's core regions, is 40, London's population is notably younger, averaging 36 years of age, as shown in Exhibit 1.6 below. (*Source: Office for National Statistics*)



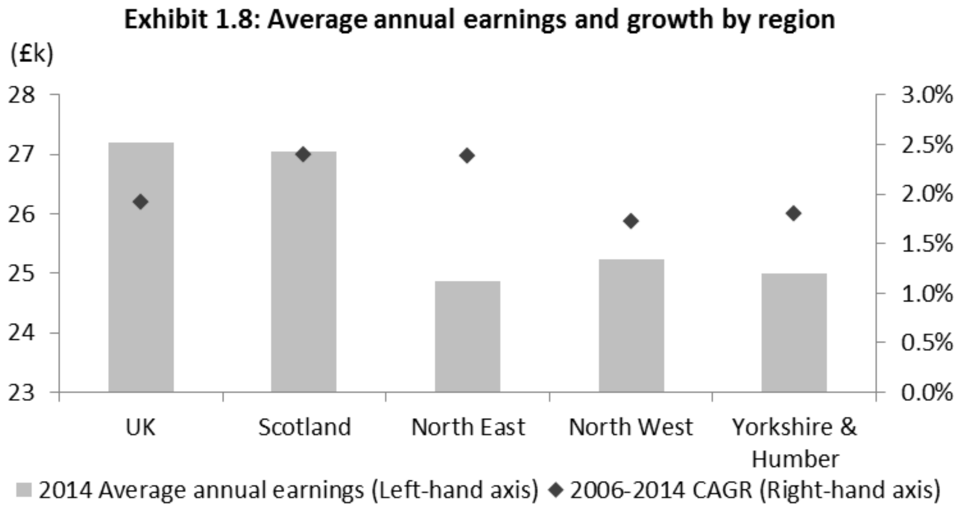
Source: Office for National Statistics; chart displays data as at mid-2013

Employment also differs significantly between regions, as shown in Exhibit 1.7. Employment increased by a CAGR of 2.4 per cent. between 2012 and 2014 in Yorkshire and the Humber and the North East. Only employment in London increased at a faster rate, by a CAGR of 3.8 per cent. Employment growth in Scotland was more in line with the UK average increasing by a CAGR of 1.8 per cent. However, in the North West, employment fell between 2006 and 2012 and only grew by a CAGR of 0.9 per cent. between 2012 and 2014. (*Source: Office for National Statistics*)



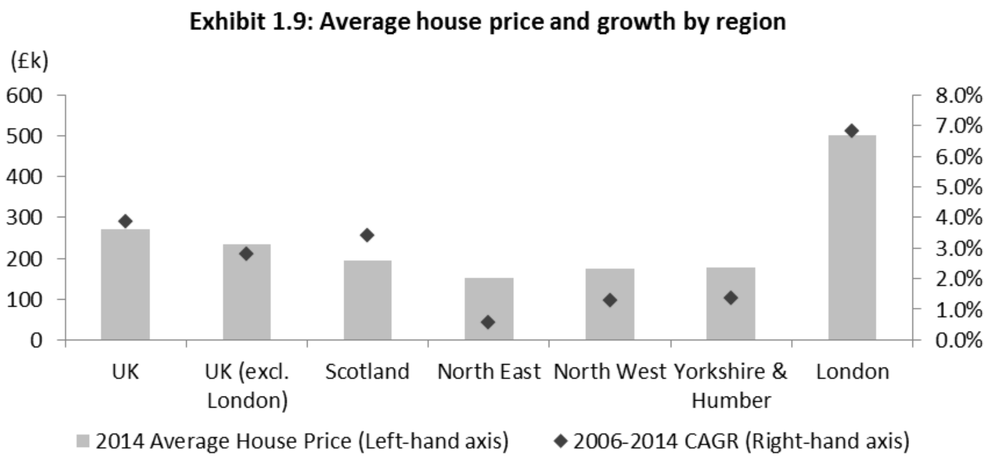
Source: Office for National Statistics.

Exhibit 1.8 shows that average earnings also differ between regions. Average earnings in Scotland are approximately £27,000, reflecting the UK national average, while average earnings in NAGE's other core regions are slightly lower at approximately £25,000. Although London is an outlier with average earnings of £35,000, earnings growth rates in the core regions have almost equalled or surpassed earnings growth rates in London since 2006. London earnings grew by a CAGR of 1.8 per cent. between 2006 and 2014, whilst average earnings in the North West grew by a CAGR of 1.7 per cent. and Yorkshire and the Humber grew by a CAGR of 1.8 per cent., Scotland and the North East both grew by a CAGR of 2.4 per cent. over the same period. (*Source: Office for National Statistics*)



Source: Office for National Statistics.

UK residential property prices have continued to differ significantly by region, as shown in Exhibit 1.9. Between 2006 and 2014, average UK property prices increased by a CAGR of 3.9 per cent. Over the same period, London average property prices increased by a CAGR of 6.8 per cent., resulting in average house prices reaching £502,000. Property prices outside of London increased by a CAGR of 2.8 per cent., reaching an average of £234,000. In NAGE's core regions, the increase in property prices varied from 0.5 per cent. CAGR in the North East England to 3.4 per cent. CAGR in Scotland, resulting in average house prices ranging from £153,000 in North East England to £193,000 in Scotland. (*Source: Office for National Statistics*)



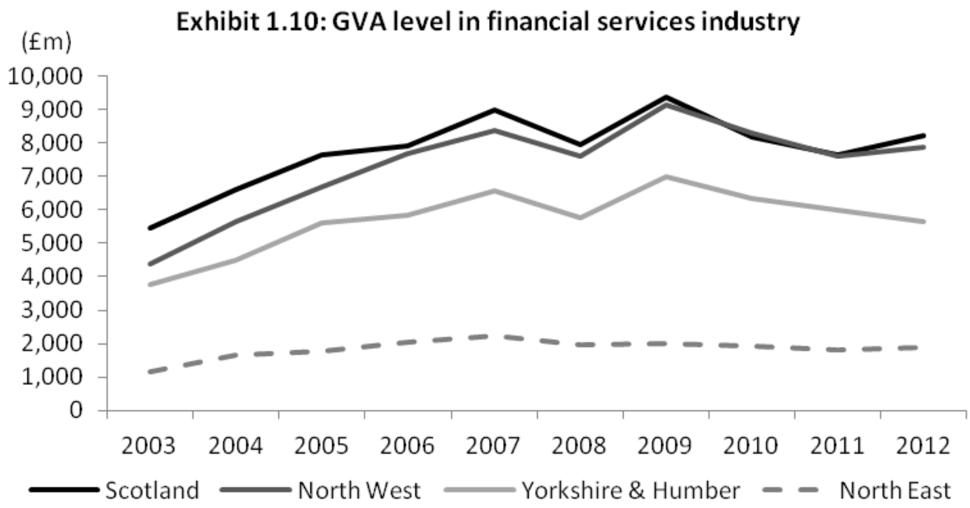
Source: Office for National Statistics.

The UK government is seeking to stimulate growth in a broad area around Manchester, spanning into NAGE's core regions, including Yorkshire and the Humber and the North West. As at June 2014, the combined metropolitan areas of Greater Manchester, Liverpool, Leeds and Sheffield were home to approximately 9 million people, a £154 billion economy and almost 3 million jobs.

1.1.2 *Regional financial sector importance*

The financial services industry is significant across NAGE's core regions, representing 4 per cent. of GVA in North East England to 6 per cent. of GVA in Scotland. The industry employs over half a million people in NAGE's core regions and provides a pool of experienced personnel for banks that operate in those regions. (*Source: TheCityUK*)

GVA growth in the financial services industry has been consistent across NAGE's core regions, and grew by 60 per cent. as a whole between 2003 and 2012. In 2012, total GVA of the financial services industry in the four regions was £24 billion, contributing 20 per cent. of the total UK financial services GVA. (*Source: Office for National Statistics*)

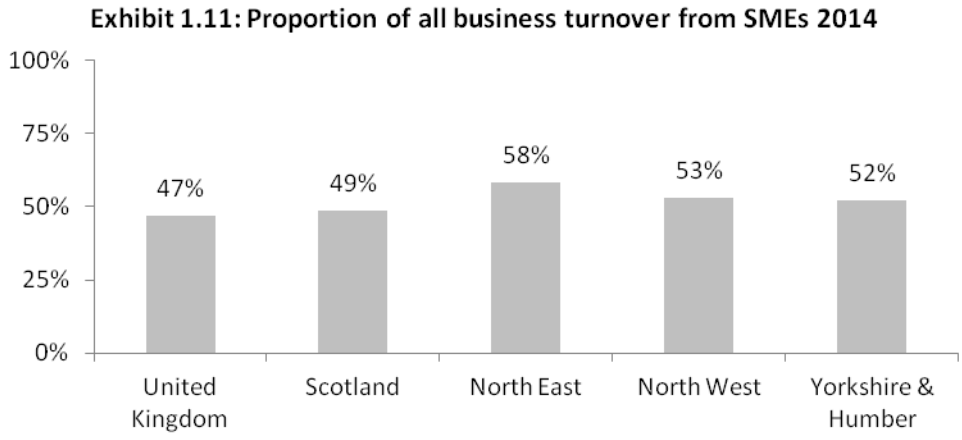


Source: Office for National Statistics.

1.1.3 *Regional Small and Medium size business importance*

Whilst the British Banking Association ("**BBA**") defines micro, small and medium-sized enterprises ("**SMEs**") as commercial businesses with an annual bank account debit turnover of up to £1 million, and the Department for Business Innovation and Skills ("**BIS**") considers SMEs as businesses which employ up to 250 employees, this section uses the Bank of England's definition as businesses with an annual turnover of up to £25 million.

SMEs represent a large part of the UK economy, including 99 per cent. of all businesses; 60 per cent. of all employees; and 47 per cent. of turnover. See "*Introduction to SME Banking*" below for further information. Private sector turnover from SMEs in NAGE's core regions is higher than the UK average, particularly in the North East where SMEs represent 58 per cent. of turnover compared to the UK average of 47 per cent. (*Source: Department for Business Innovation and Skills – Business population estimates for the UK and regions 2014: detailed tables*).

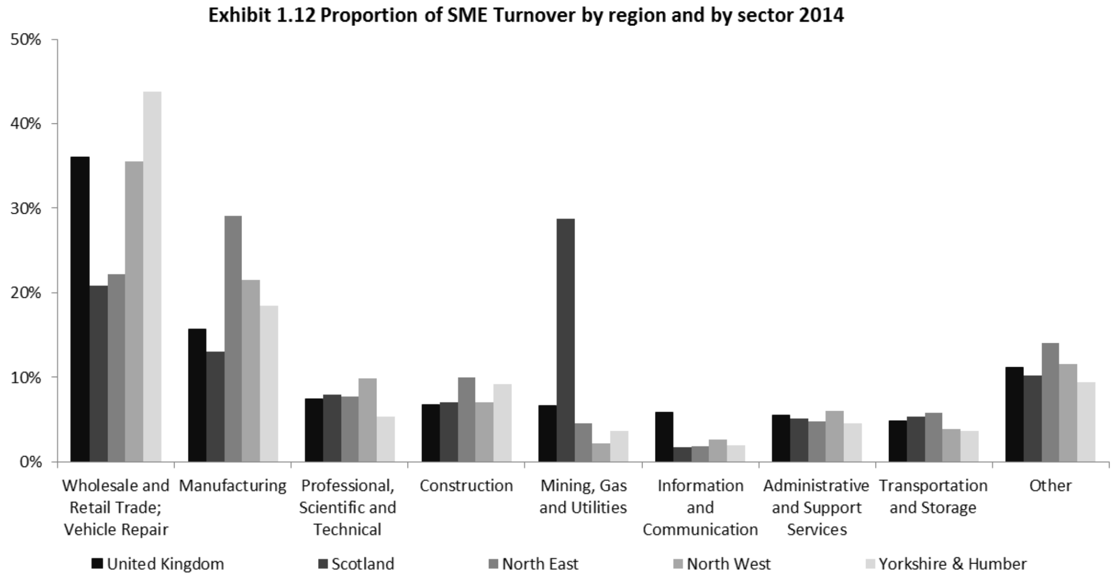


Source: UK Department for Business, Innovation and Skills; chart displays available data as at 24 November 2014

Since 2004, the number of SMEs has increased from 3.9 million to 5.2 million, despite difficult economic conditions and declining levels of lending from banks following the financial crisis. (*Source: UK Department for Business, Innovation and Skills – Business Population Estimates: 2014 statistical release*) There are positive indications of further growth as 16 per cent. of SMEs plan to increase staff in 2015 and 43 per cent. expect revenue growth. (*Source*: *FSB Voice of Small Business Survey 2013-14*).

A 2013 European Commission study found the UK to be among the most competitive environments for SMEs in the European Union, with a positive outlook for future growth. The UK scored particularly high in business environment, public procurement, and conditions for international business. (Source: *European Commission for Enterprise and Industry*) Recently, the UK government has introduced a range of measures to stimulate SME success. (*Source: House of Commons*) These include advice to boost exports, changes in public sector procurement to include more SMEs, improved broadband access and business rate relief. See "*Introduction to SME Banking*" below for further information.

SMEs are represented across all sectors of the economy. NAGE's core regions broadly reflect the wider UK economy. There are some regional differences in Scotland, where turnover from SMEs in mining and gas utilities is significantly higher than the UK average as a result of the North Sea oil and gas industry, and in the historically industrial North East and North West where manufacturing remains strong. (*Source: UK Department for Business, Innovation and Skills – Business Population Estimates*)



Source: UK Department for Business, Innovation and Skills.
Note: 'Other' comprises: 'Arts, Entertainment and Recreation'; 'Accommodation and Food Service Activities'; 'Human Health and Social Work Activities'; 'Real Estate Activities'; 'Agriculture, Forestry and Fishing'; 'Other Service Activities' and 'Education'. Chart displays available data as at 24 November 2014

1.2 ***Structure of the UK banking industry***

Banks and other lenders play a vital role in the UK economy. This is reflected in the type of customers they serve, ranging from the general public and small businesses to sophisticated corporations and investors. Banks' services are essential in facilitating day-to-day financial transactions as customers interact with their banks as the centre of non-cash transactions, such as direct debit payments and salary deposits. Their services are also essential in providing capital for short to long-term purposes, they organise foreign exchange and provide sophisticated financial products that help consumers and businesses plan for the future.

The main players in the UK banking market can be grouped into six broad categories:

- *Large national banks*: These banks have national coverage and a full retail bank offering including current accounts, mortgages, savings, credit cards, and other personal banking services. Due to consolidation over the last ten to fifteen years, there are currently only five large national banks in the UK banking sector (the "**Big Five**"); Barclays plc ("**Barclays**"), HSBC Bank plc ("**HSBC**"), Lloyds Banking Group, which includes the Lloyds Bank, Halifax and Bank of Scotland brands ("**Lloyds**"), Royal Bank of Scotland Group plc, which includes the RBS, NatWest and Ulster Bank brands ("**RBS**") and Santander UK plc ("**Santander**"). (*Source: Bank of England: Evolution of the UK banking system*)

- *Challenger banks*: The Independent Commission on Banking defines challenger banks as banks that are large enough to be a threat to incumbents and have a strong incentive to compete with them to increase market share. (*Source: Independent Commission on Banking*) Challenger banks can be grouped into three sub-categories: (i) mid-sized banks that are branch-led, full service banks with an established customer base with the ability to compete with the Big Five; (ii) small and specialised banks with total assets of under £20 billion that focus on differentiating themselves through either customer service and/or specific product offerings; and (iii) retailer banks where retailers typically leverage their large customer base to cross-sell financial products, including savings accounts, loans, mortgages, credit cards, and in some cases, personal current accounts ("**PCAs**").

- *Building societies:* These are usually smaller lending institutions which are owned by their members. These mainly offer mortgages and savings products, although many now provide a broader range of retail banking products, such as current accounts and credit cards.

- *Credit unions:* These are usually smaller lending institutions which are owned by their members. They typically serve those customers who are unable to access standard retail bank products through the established high street banks.

- *Monoline product providers:* These providers focus on the provision of specific products, such as credit cards, rather than a full range of retail banking services.

- *Other lenders*: These include payday lenders, online specialists, peer-to-peer lending facilitators, and specialist mortgage lenders.

The Big Five have 85 per cent. market share of the retail PCA market and 57 per cent. market share of the mortgage market. (*Source: Office for National Statistics*) In England and Wales, the Big Five accounted for 93 per cent. of business current accounts in 2013, while in Scotland three banks, RBS, Clydesdale Bank and Bank of Scotland, held 88 per cent. of SME business current accounts ("**BCAs**").

Many foreign banks are also active in the UK, typically serving multi-national companies which operate in the UK, but with activities across the globe.

1.2.1 *Increasing competition in UK Banking*

The UK government has emphasised the need to introduce more competition into the SME and retail banking market, in response to poor customer satisfaction. In a study conducted by YouGov as at April 2013, retail banking customers rated large banks, namely the Big Five, negatively for customer satisfaction. On the other hand, smaller and mid-sized banks enjoyed a much higher customer satisfaction score. Similarly, a study conducted into the SME banking market as at July 2014 revealed that only 13 per cent. of SMEs believe that their bank acts in their best interest (*source: A CMA and FCA market study – Banking services to small and medium sized enterprises*). The studies identify high levels of market concentration amongst the Big Five as one of the key drivers for dissatisfaction.

Many smaller and mid-sized banks have become popular with customers by focusing on strong customer service with minimal brand damage from the financial crisis. This has been complemented by greater interest in the banking sector from the business and investor community. In 2010, Metro Bank, a new bank, was awarded a full service banking licence. This was the first time a new full banking licence had been granted to a new High Street bank in over 100 years. (*Source: Metro Bank*) A number of banks are expected to launch IPOs by 2016 in addition to the IPOs of TSB, Virgin Money, OneSavings, Shawbrook and Aldermore, which have already taken place in the past 12 months.

(a) *The landscape of banks outside the Big Five*

Banks outside of the Big Five typically compete by providing a specialised offering to customers, either in terms of product range, service level, regional focus, pricing or a combination. These are outlined further below:

- *Product range focus:* banks that provide a subset of products to their customers. For example, banks such as Sainsbury's bank offer a set of savings, personal loan, credit card, travel money and general insurance products to customers. (*Source: Sainsbury's Bank*)

- *Service focus*: banks that seek to differentiate on the quality of their customer service. For example, Metro Bank emerged on the promise of customer-focused retail business, offering convenience and simplicity in the form of 7-day opening hours. (*Source: Metrobank*)

- *Regional focus*: banks with a long-standing UK banking history that largely focus on a subset of UK regions. NAGE is an example of a bank with a long-standing market position, focusing on the markets in Scotland and Northern England. Additionally, newly emerging banks and traditionally localised banks are expanding across different regions. For example, TSB has used a pre-existing network of former Lloyds TSB branches, while Bank of Scotland which has a regional concentration, now sit within Lloyds. (*Source: Bank of England*)

- *Pricing focus*: some smaller and mid-sized banks are also offering lower rates for customers compared to incumbents. This is particularly notable for fixed-term savings products, where some banks such as Charter Savings, are offering a superior interest rate as they seek to build up their deposit book.

(b) *Competing with the Big Five*

Although the brand reputation of the major banks has weakened, the Big Five continue to have a significant national presence and established customer base, allowing them to enjoy high volume, scale efficiencies and benefits from customer inertia. The market share for PCAs and BCAs has remained largely stable over the last five years, inhibiting the ability of smaller participants to compete effectively. (*Source: Office of Fair Trading - Letter to Chancellor, September 2013*)

Due to the continued dominance of the Big Five, smaller and mid-sized banks are encouraged to meet some or all of the requirements set out in a letter to the Chancellor from the Office of Fair Trading in September 2013 in order to become an effective competitor. The requirements include: a branch network for PCA and SME banking services; a wide breadth of products; a strong base of PCAs; an established brand and reputation; ability to generate and reinvest profits; ability to innovate and differentiate the offering and a strong management team. (*Source: Office of Fair Trading - Letter to Chancellor, September 2013*)

1.2.2 *Key trends in distribution*

(a) *Digitisation of the banking model*

The UK banking industry is experiencing a significant shift towards digitisation. Banking has become increasingly multi-channel, as digital channels such as online and mobile banking are increasingly complementing traditional customer channels such as branches and call centres.

Retail banking customers tend to use digital functionality for speed and convenience, while using human interaction at key decision points such as obtaining a mortgage or opening a current account. Digital functionality is typically used to conduct routine transactions and to purchase simple products such as savings accounts and credit cards. (*Source: Mintel – Deposit and Savings Accounts UK*) Internet banking remains the main driver of digital channel usage, with an average of 7 million log-ins per day, compared to 2.6 million mobile log-ins per day in the UK in 2014. (*Source: BBA – The Way We Bank Now*). Additionally, 81 per cent. of SME customers interact with their banks online, with 39 per cent. using online banking services on a daily basis in 2014. (*Source: BBA – Promoting Competition*).

Mobile payments systems were introduced by a group of banks in the UK in 2014. They launched a mobile payments service, where payments can be sent and received using a mobile number, called "Paym", which allows users to link their bank accounts to their mobile phones. Sixteen UK banks participate – including the Big Five, Clydesdale Bank and Yorkshire Bank – and as at February 2014 nearly 2 million UK customers signed up for the service. (*Source: Paym*)

In general, the rate of growth in customers using digital channels has been significantly faster than the rate of decline in the number regularly using branches. (*Source: BCG – Distribution 2020: The Next Big Journey for Retail Banks*)

Digitisation has enabled banks to reduce cost and improve efficiency. Banks are increasingly leveraging tools such as e-forms and digital workflow systems to automate servicing and fulfilment processes (*Source: McKinsey & Co – The Rise of the Digital Bank*). Digital data and analytics systems have increasingly been used to tailor and personalise product offerings to different customer segments and expand banks' share of wallet. (*Source: BCG – Winning Share of Wallet in Wholesale Banking, February 2014*)

Price comparison websites, also known as aggregator websites, have emerged as another channel through which consumers research and purchase retail banking products. In 2014, 20 per cent. of UK internet users used a price comparison website to compare savings account products, with 7 per cent. of those using the price comparison website to apply for a savings account. (*Source: Mintel – Web Aggregators in Financial Services UK, June 2014*)

(b) *Importance of branch network and visible footprint*

A strong branch network remains an important part of the banking model in both the retail and SME markets. 72 per cent. of retail customers use branches to access financial services, and over 67 million transactions are carried out each week in UK bank branches. Branches are particularly important in the sale of core customer products (*Source: BBA*), such as current accounts and mortgages. 41 per cent. of current account customers use their branch at least once per month (*Source: Mintel Packaged and Current Accounts UK, July 2014*), and 42 per cent. of customers prefer to arrange a mortgage face-to-face (*Mintel Mortgages UK, March 2014*). In the SME market, 47 per cent. of SME customers have an employee visit a branch at least once a month. (*Source: Mintel Packaged and Current Accounts UK, July 2014*)

The bricks-and-mortar presence of a branch network is an advantage that banks use in order to compete against purely digital payment providers. However, most major UK banks have started to repurpose their branches from being transaction centres into product showrooms and technologically enabled locations that facilitate customer engagement. Branch employees are being trained to not only assist customers with everyday transactions, but also to offer face-to-face advisory services.

(c) *Regional variations in NAGE's distribution channels*

Consumers' preferred channels for purchasing retail banking products varies by both product and region. On a national level, consumers prefer to apply online for products with a simpler application process, such as savings accounts and credit cards, while products with longer application processes, such as mortgages, are more frequently arranged in a branch. Consumers in NAGE's core regions are an exception to the national trend and tend to prefer branches to online channels to a greater extent than the average UK customer. (*Source: Mintel – Deposit and Savings Accounts, April 2014*)

According to a survey conducted in January 2014, the proportion of customers applying for savings accounts in a branch in NAGE's core regions was significantly higher than the UK average. In Yorkshire and the Humber, 56 per cent. of those surveyed applied for savings accounts in a branch compared to the UK average of 48 per cent. (*Source: Mintel Deposit and Savings Accounts UK*) Online channels were also less favoured in NAGE's core regions, with as few as 49 per cent. of residents in the North West using online channels to open a savings account compared to the UK average of 55 per cent. Similarly, 45 per cent. of UK customers surveyed in May 2014 prefer online channels to branches when applying for a credit card, compared to 41 percent of customers in Yorkshire and the Humber, and whilst 26 per cent. of UK customers opened a credit card account in a branch, 31 per cent. of customers in Yorkshire and the Humber preferred to apply in person. In a national survey conducted in November 2013, 35 per cent. of respondents preferred to arrange a personal loan face-to-face with a bank or loan provider, compared to 30 per cent. who preferred to arrange the loan directly online. However, in NAGE's core regions, 39 per cent. of those surveyed preferred to apply face-to-face, while 24 percent reported that they would apply for a bank loan online.

1.3 ***Banking sector financial statements***

1.3.1 *Revenue*

Revenue consists of net interest income and other operating income. Net interest income is primarily derived from loans, deposits, and other sources of funding. It is generated through the differential between the rate charged to borrowers and the cost of funds. Other operating income is primarily earned from customer fees and commissions.

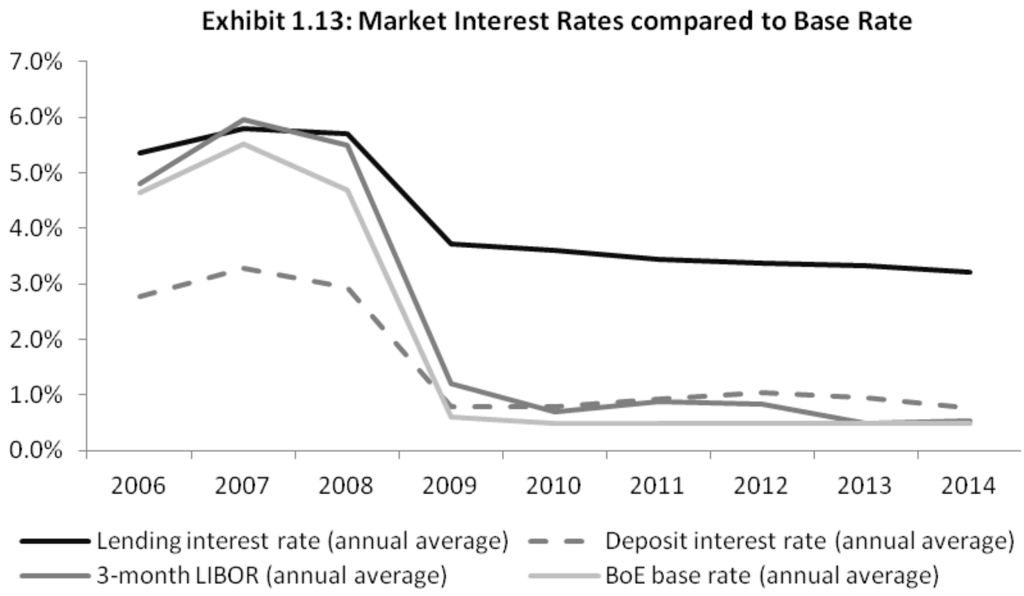
For retail-centric businesses, net interest income is the main driver of revenue, focusing on core lending and deposit products. Business banks offer more fee-based products, such as transaction banking or trade finance.

1.3.2 *Cost of funds*

Banks have four main sources of funding: (i) customer deposits; (ii) borrowing from the Bank of England; (iii) borrowing from other banks; and (iv) borrowing from other institutions (e.g. pension funds or insurance firms).

The cost of funding to a bank is a combination of the four sources. The cost differs across banks due to differences in weighting of each source by the banks and is not disclosed at the product level.

The base rate, set by the Bank of England, is one of the key determinants of all other market rates. Other market interest rates which track the Bank of England's base rate include both the monthly lending and deposit sterling weighted average interest rates of UK resident monetary financial institutions (excluding the Bank of England).



Source: Bank of England, British Bankers Association.

1.3.3 *Base rate used for this section*

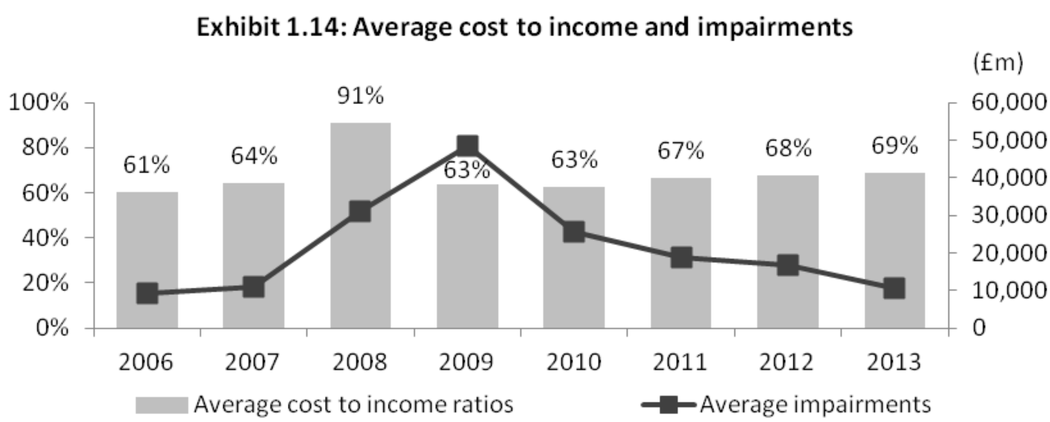
This section uses the base rate as a constant point of comparison for different product interest rates. Any individual bank's cost of funds will vary, depending on their internal allocation methodology, and cannot be readily stated on a product-by-product basis.

1.3.4 *Cost*

After calculating net interest income and other operating income, a bank incurs two costs: operating costs and impairments.

(i) The main components of operating costs are IT, property and salaries. The cost to income ratio measures the efficiency of a bank's operating model. Following a sharp increase in 2008, cost income ratios of major banks have remained relatively stable in the UK market, reflecting continued cost improvement to counteract downward pressure on revenue. (*Source: Bank of England*)

(ii) Impairments represent a provision against current and potential losses on the stated value of assets on a bank's balance sheet. Impairments rose steeply for UK financial institutions during the financial crisis. Between 2009 and 2014, the value of impairments has decreased to a pre-crisis level of £11 billion.



Source: Bank of England

1.3.5 *Profitability*

A bank's profit after tax is based on the sum of revenues earned (net interest income and other operating income) less operating costs, impairments, one-off charges, taxes and other provisions for future losses.

1.3.6 *Capital structure*

A bank's assets can be unsecured, for example, credit cards or secured, such as, mortgages. Banks apply two different risk weighting methods in calculating their total risk-weighted assets:

- *The Standardised Approach*, as followed by NAGE, uses standardised risk weightings in accordance with the European Union's Capital Requirements Directive. These are more explicit rules which aim to remove subjectivity from the risk weighting.

- *The Internal Ratings Based Approach* ("**IRB**") permits banks to use their own empirical models to best assess the appropriate risk weightings. Banks are permitted to use this approach in the UK, subject to approval from the PRA. The two IRB approaches to risk weighting, foundation and advanced, usually generate lower risk-weighted assets ("**RWAs**").

In the UK, the minimum capital required for each bank is established through discussion with the PRA, which sets each bank an individual capital guidance ("**ICG**"). The ICG is typically a multiple of the underlying required Tier 1 ratio. In the UK, all banks are required to meet a minimum 6 per cent. Tier 1 capital ratio, which is calculated as Tier 1 capital / RWAs. The major UK banks are required to meet a minimum of 7 per cent. (*Source: Bank of England*)

2. Retail Banking

2.1 *Summary of the retail banking market in the UK*

2.1.1 *The role of retail banks*

Retail banks offer a range of banking products which include PCAs, savings accounts, mortgages, personal loans, credit cards, and insurance and investment products. Banks offer these products through a number of bank-owned distribution channels such as branches, telephone and digital channels as well as through third party distribution channels such as mortgage intermediaries, known as "brokers".

Retail banks in the UK serve three main customer segments: (i) mass affluent customers typically customers who have investible assets between £50,000 and £1,000,000 ("**Mass Affluent Customers**") – above which they generally become private banking customers; (ii) retail banking customers in the UK who are mass market customers, with investible assets below £50,000; and (iii) customers with few to no assets, such as students and youth customers.

Traditionally, retail banks in the UK have operated a "full-service" model offering a broad suite of products to a diverse customer base. The major full-service banks have a large base of current account holders, a branch network of sufficient scale, as well as complementary channels. The combination of a large customer base, extensive channel reach and a broad product suite allows these banks to address the varying needs of their customers. For example, 58 per cent. of PCA holders also hold a savings account with their PCA provider. (*Source: Mintel – Consumers and Retail Banking*).

2.1.2 *Regional view on retail banking*

At a regional level, demand for retail banking products varies according to local economic and competitive conditions.

Strong employment growth in NAGE's core regions have contributed to increased demand for credit. The proportion of residents taking out personal loans in these regions increased by 13 per cent. between 2011 and 2013. Between 2006 and 2014, those four regions experienced year-on-year house price growth of 0.5 per cent. to 3.4 per cent., and in December 2013, approximately 20 per cent. of residents in these regions planned to take out a mortgage or re-mortgage their homes. (*Source: Mintel – Mortgages UK*)

Although the percentage of the total UK population which was classified as Mass Affluent Customers grew by only 0.11 per cent. per annum between 2004 and 2009, the growth rate experienced in the core regions was significantly higher from a 0.35 per cent. CAGR in Yorkshire to a 2.04 per cent. CAGR in Scotland.

Retail banking markets in Scotland and Yorkshire include a number of smaller participants whose presence in those regions is larger than their presence in the national market. In Scotland, the top four brands with the highest branch network concentrations are Bank of Scotland, RBS, TSB, and Clydesdale Bank. In Yorkshire, the top four brands by branch concentration are Yorkshire Bank, HSBC, NatWest, and Lloyds. For example, as at 31 December 2013, while Barclays had the largest network of branches in the UK, it had less than 30 branches in Scotland, while Bank of Scotland, RBS, TSB, and Clydesdale Bank each had more than 100 in Scotland. (*Source: SNL*)

2.1.3 *Distribution channels*

Consumers more frequently purchase simpler products online than in branches. For example, 42 per cent. of consumers surveyed in December 2013 prefer mortgage application processes, which are longer and more detailed, to be entirely face-to-face compared to 29 per cent. who prefer the process to be entirely online, whereas a higher percentage of customers surveyed applied for products with simpler application processes, such as savings accounts, online. (*Source: Mintel – Mortgages UK*) See "*Key trends in distribution – Regional variations in distribution channels*" above for further information.

Retail banking customers are also increasingly turning to online channels to service their accounts. 80 per cent. of PCA customers in the UK surveyed in May 2014 used online banking at least once per month to access their accounts, compared to 41 per cent. who used branch counter services. However, branches continue to be an important channel as 91 per cent. of PCA customers report using branch services at least once per year, compared to 86 per cent. who use online banking. (*Source: Mintel – Packaged and Current Accounts UK*). Furthermore, a survey conducted in June 2014 reported that 57 per cent. of banking customers agreed that branches were necessary for discussing banking issues. (*Source: BBA – Promoting Competition in the UK Banking Industry*)

2.1.4 *Customer sentiment*

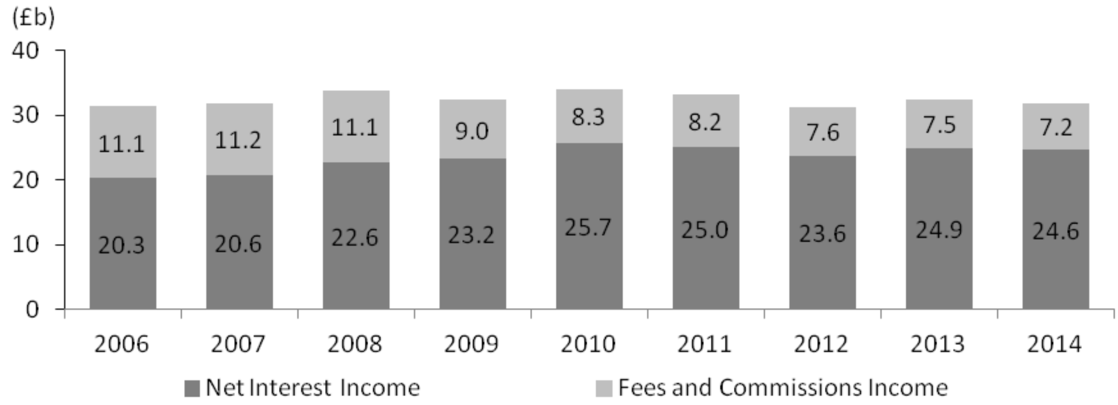
The financial crisis significantly impacted customer attitudes towards the banking sector and the way in which consumers interact with banks. Attitudes towards the banking sector vary between large and small banks. A 2013 YouGov survey of over 4,000 people found that 73 per cent. considered the banking sector to have a bad reputation, scoring lower than any of the other 25 industries included in the survey. This negative view is largely associated with the Big Five, which scored lowest in the survey. A July 2014 market report by the UK Competition and Markets Authority found an inverse relationship between the size of a retail bank's customer base and its customer satisfaction scores, with the five highest-scoring brands in customer satisfaction being amongst the UK's smaller institutions, including Clydesdale Bank and Yorkshire Bank.

Retail banks have experienced declining levels of customer retention. Between 2012 and 2014, the proportion of UK banking customers who had been with their bank for more than 10 years decreased from 72 per cent. to 59 per cent. Customer service quality is an important factor in customers' decisions to switch account providers. A May 2014 survey found that 20 per cent. of UK adults who changed current account providers in the past five years changed providers due to a better reputation for customer service from the new provider. (*Source: Mintel – Packaged and Current Accounts UK*). A similar proportion of 21 per cent. cited poor customer service from their previous provider as the factor that persuaded them to switch providers.

2.2 ***Retail Banking performance***

The profitability of a retail bank is determined by the relative levels of its income and expenses. The two primary streams of income for a retail bank are net interest income and other operating income. Fees and commissions income are the primary source of other operating income and is reflected in Exhibit 2.1 below. The primary costs are operating costs and impairments. Banks often look at impairment costs as a factor in determining profitability. Exhibit 2.1 below shows these revenue streams for the Big Five between 2006 and 2014.

Exhibit 2.1: Revenue components for the retail banking divisions of the 5 largest UK



Source: Annual reports

2.2.1 *Net interest income*

Net interest income for the Big Five rose steadily between 2006 and 2010, from £20.3 billion to £25.7 billion, before stabilising at around £25 billion. In 2014, net interest income accounted for 77 per cent. of total banking income for the Big Five.

2.2.2 *Fees and commissions income*

Retail banks charge customers fees for a variety of services, such as overdraft facilities, credit cards, and international transfers of funds. They also receive commissions from distributing products such as insurance. Taken together, these make up income from fees and commissions.

Exhibit 2.1 illustrates how both regulatory scrutiny and other market conditions have impacted fee and commission income in the retail divisions of the Big Five between 2007 and 2014, leading to a decline from £11.2 billion to £7.2 billion over this period.

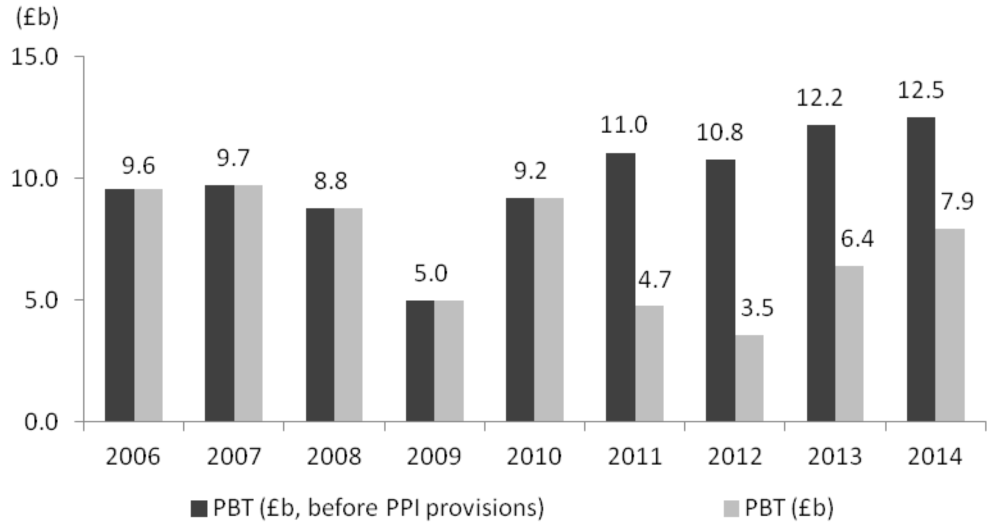
2.2.3 *Impairments*

The Big Five experienced rising impairments during the financial crisis. Impairments tend to be higher on unsecured assets than on secured assets since the bank is able to realise security of the asset in order to repay part of, or the entire, loan. Impairments have since returned to pre-crisis levels as unemployment has fallen and interest rates have remained low

2.2.4 *Profitability*

Exhibit 2.2 shows the underlying and reported profits of the Big Five. Underlying profitability fell sharply in 2009 as a consequence of the financial crisis, but has since rebounded, growing at a rate of 20.2 per cent. per annum between 2009 and 2014. However, fines and repayments for the mis-selling of payment protection insurance ("**PPI**") and interest rate hedging products ("**IRHP**") have impacted banks' profits, reducing 2014 headline profits of £12.5 billion to £7.9 billion. Between 2011 and 2014, PPI mis-selling and other conduct-related issues led to the Big Five making total provisions of £23.9 billion, equivalent to 51 per cent. of pre-tax profits. As a result, reported profits decreased at a CAGR of 3.6 per cent. between 2010 and 2014.

Exhibit 2.2: Calculated Profit Before Tax for the retail banking divisions of the 5 largest UK retail banks



Source: Annual reports

2.3 ***Key products: personal current accounts***

2.3.1 *Introduction*

A PCA is central to most retail customers' personal finances, and typically defines their primary relationship with a bank.

The PCA market can be divided into: (i) primary PCA, where the customer uses the PCA for everyday transactions, usually where there is a direct deposit of salary and the use of direct debits for regular bills; and (ii) secondary PCA, where the customer opens a second PCA with another provider. It is estimated that 32 per cent. of PCA holders in the UK have PCAs with more than one provider; this figure is 25 per cent. in the North East and Scotland, 30 per cent. in the North West and 32 per cent. in Yorkshire. (*Source: Mintel – Packaged and Current Accounts UK*)

Retail banks compete to be the primary PCA provider, since primary PCA customers are likely to hold further products, such as mortgages, credit cards and loans, and are generally more loyal customers. (*Source: CMA – Personal Current Accounts*) Due to competition, many UK banks have explicit strategies to generate 'main banking relationships', i.e. using the primary PCA as an anchor to secure multi-product holdings and multi-channel usage. (*Source: BCG - Retail Banking: Winning Strategies and Business Models Revisited*)

PCAs also provide a valuable source of stable, long-term funding. The cost for banks is typically lower than savings deposits or wholesale funding. (*Source: Office of Fair Trading – Review of Personal Current Account Market*)

2.3.2 *Competitive landscape*

PCA market concentration is expected to decrease as a consequence of three developments. The first is the divestment by Lloyds of 631 branches and their accounts into TSB Bank. TSB Bank was established as a separate business from Lloyds in September 2013, with more than 4.6 million former Lloyds customers and over £20 billion in both loans and customer deposits. TSB Bank became a stand-alone bank through an initial public offering in June 2014. A similar but smaller divestment is underway for RBS, where 314 branches have been divested to a consortium of investors in anticipation of a full high street re-branding towards SME and mid-corporate customers. The second development is the rise of new challenger banks, some of which have sought to capture market share from top PCA providers.

The third development was the UK Payments Council introduction of the Current Account Switching Service ("**CASS**") in September 2013. The intention was to increase competition amongst retail banks and support the entry of new banks into the PCA market. The scheme provides a guarantee that an account can be switched from one provider to another within seven working days. Currently, thirty-six banks and building societies participate, accounting for most of the UK PCA market, including Clydesdale Bank and Yorkshire Bank. In October 2014, the Financial Conduct Authority ("**FCA**") and Payment Systems Regulator announced that they intend to explore the introduction of full bank account portability in order to facilitate the CASS. UK Payments Council data indicates over an annual period ending 31 March 2015 there were 1,136,251 switches and since the new service launched in September 2013 it has successfully processed 1,758,301 switches.

As at May 2014, the top seven PCA providers and their estimated market shares of primary PCAs, defined as a customer's main current account, were Santander (15 per cent.), Barclays (14 per cent.), Lloyds (12 per cent.), Halifax (11 per cent.), NatWest (11 per cent.), HSBC (9 per cent.), and Nationwide (8 per cent.). Clydesdale Bank and Yorkshire Bank were each estimated to hold 1 per cent. of the UK primary PCA market. (*Source: Mintel Packaged and Current Accounts*)

2.3.3 *Key metrics*

There are approximately 80 million PCAs in the UK, of which 65 million are active. (*Source: CMA Personal Current Accounts Market Study*) As at 31 January 2015, there were £6.7 billion of outstanding PCA overdraft balances, a decrease of 9.5 per cent. since January 2014. (*Source: BBA – High Street Banking Statistics*)

2.3.4 *How banks make money from PCAs*

PCAs are a low cost source of funds for banks. Net interest income, overdraft balances, and fee and commission income from associated banking services make up the principal sources of income generated by PCAs.

Added value accounts, or 'Packaged Accounts', bundle additional products with the PCA for a fixed monthly fee. These products often include mobile phone insurance and auto breakdown coverage. (*Source: Office of Fair Trading – Review of the PCA Market*)

2.4 ***Key products: cash savings products***

2.4.1 *Introduction*

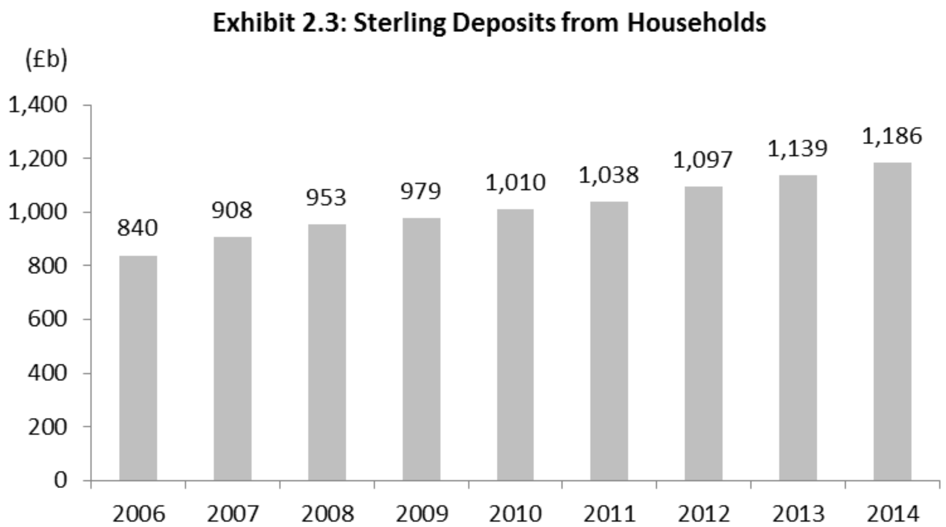
Cash savings products allow customers to deposit cash funds and to receive interest on those funds at rates which are typically higher than funds held in a PCA. There are two main types of cash saving products: fixed rate term deposits and variable rate savings accounts.

2.4.2 *Competitive landscape*

As at October 2014, 109 banks, building societies, and credit unions offered cash savings products in the UK, with the six largest providers holding approximately 68 per cent. of all cash savings balances. Estimates of market concentration show that while the cash savings products market has remained relatively concentrated for a number of years, the divesture of TSB Bank from Lloyds and the entrance of new providers such as Tesco Bank decreased market concentration in 2014. (*Source: Financial Conduct Authority - Cash savings market study report: Part I: Final findings Part II: Proposed remedies*)

2.4.3 *Key metrics*

As shown in Exhibit 2.3, total UK household cash savings products deposits stood at £1,186 billion as at 31 December 2014. During 2014, household cash savings products deposit balances increased at a rate of 4.4 per cent.

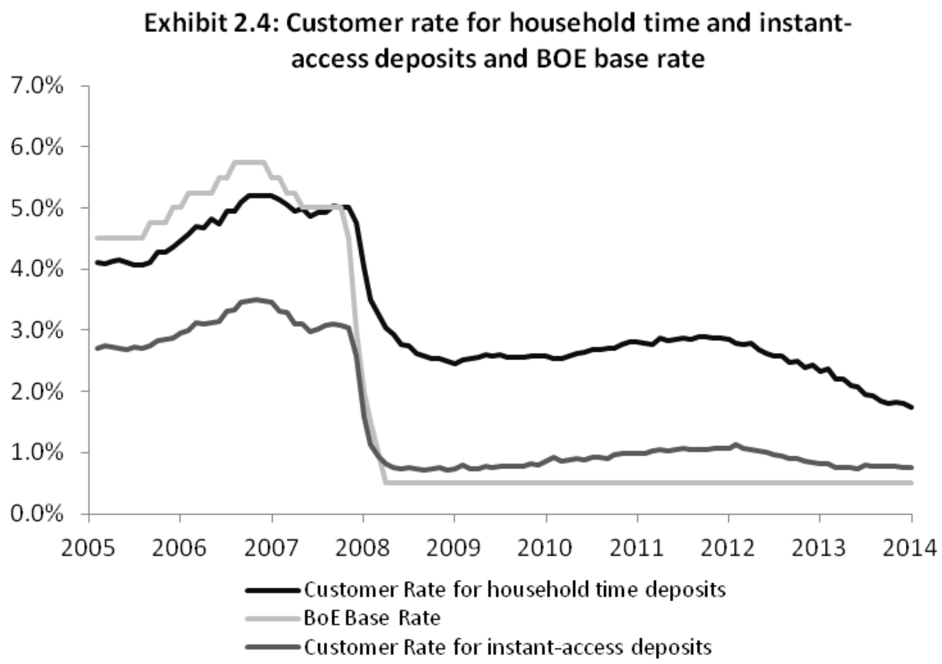


Source: Bank of England

Despite the fall in interest rates between 2008 and 2009, cash savings deposits increased steadily. It is estimated that in 2013, around £160 billion of instant-access savings deposits earned an interest rate equal to, or lower than, the Bank of England base rate of 0.5 per cent. Approximately £145 billion of these balances were held in accounts with more than £5,000.

2.4.4 *Cash savings products*

Exhibit 2.4 displays trends in the customer rates for time deposits (also known as 'term' deposits) and instant-access savings deposits, as well as the official rate set by the Bank of England. The gap between the interest rates paid on time deposits compared to instant-access deposits reflects the premium banks attach to time deposits, which are held for longer periods.



Source: Calculated from Bank of England

Between 2008 and 2009, the decline in the Bank of England base rate was sharper than the decline in interest rates offered for customers' deposits. This has resulted in savings deposits becoming a relatively more expensive source of funding compared to the official rate than before the financial crisis.

2.5 ***Key products: mortgages***

2.5.1 *Introduction*

The most common form of financing used by individuals in the UK to purchase residential property is a loan secured by using the property as collateral. There are three principal types of mortgage products:

- Variable rate mortgages have interest rates that broadly follow the Bank of England base rate but are determined by the lender and can change at any time;
- Fixed-rate mortgages offer a constant rate that typically lasts for a two to five-year period before reverting to a variable interest rate; and
- Tracker mortgages track the Bank of England base rate at a set margin.

As at 31 December 2014, 59 per cent. of total outstanding mortgage balances were subject to a variable rate while 41 per cent. were subject to a fixed rate. 33 per cent. of mortgage balances were subject to fixed rates in December 2013 and 28 per cent. as at 31 December 2012 (*Source: Financial Conduct Authority - Statistics on Mortgage Lending*), an increase suggesting mortgage customers are increasingly capitalising on low interest rates by purchasing or refinancing to fixed rate mortgages.

In addition to differentiating mortgages based on the interest rate, mortgage products can be further categorised by the type of repayment made by the customer:

- Capital repayment mortgages require the full value of the loan and the interest to be repaid by the end of the term;
- Interest-only mortgages require the borrower to repay only the interest on the loan; at the end of the term, the borrower still owes the full value of the original

loan. These mortgage products are therefore often dependent on rising house prices or other forms of repayment plans to pay back the capital repayment at the end of the term or a separate repayment vehicle; and

- Part capital repayment/part interest-only mortgages have only part of the mortgage payment being made towards the capital, with the remainder of the borrower's regular payment made towards the interest.

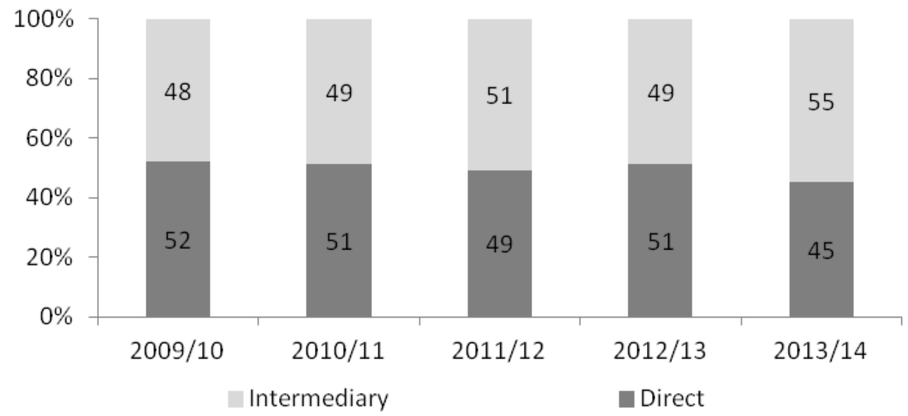
In 2013, the FCA required mortgage lenders to contact all borrowers with interest-only mortgages due to mature before the end of 2020 due to concerns about the borrowers' ability to repay the original loan at the end of the term. As a result, the Council of Mortgage Lenders reports that the number of interest-only mortgages fell 12 per cent. between 2012 and 2013 as borrowers converted to capital repayment mortgages.

2.5.2 *Competitive landscape*

The UK mortgage market has become increasingly competitive since 2009. The six largest lenders accounted for 72 per cent. of gross mortgage advances in 2013 compared to 86 per cent. in 2009. (*Source: Council of Mortgage Lenders*) The decrease in market share of the top six lenders, which includes the Big Five and Nationwide Building Society, is due to the increasing shares of smaller lenders which have entered the top ten. The ten largest lenders and their respective shares of gross advances are Lloyds (20.2 per cent.), Nationwide (15.3 per cent.), Santander (10.4 per cent.), Barclays (9.6 per cent.), HSBC (8.2 per cent.), RBS (8.1 per cent.), Yorkshire Building Society (3.9 per cent.), Coventry Building Society (3.3 per cent.), Virgin Money (3.2 per cent.), and Clydesdale Bank (1.8 per cent.). (*Source: Council of Mortgage Lenders*) The competitiveness of the UK mortgage market is reinforced by an estimate by the British Bankers' Association that 23 per cent. of current account customers had a mortgage from a lender other than the provider of their PCA. (*Source: BBA – Promoting Competition in Mortgage Lending*)

Intermediaries play a significant and growing role in the UK mortgage market. As shown in Exhibit 2.5, intermediaries accounted for 55 per cent. of mortgage sales in 2013/14, rising from 48 per cent. in 2009/10. As a result, intermediaries enable smaller banks to compete for mortgage business on a national scale.

Exhibit 2.5: Proportional distribution of regulated mortgage sales by channel



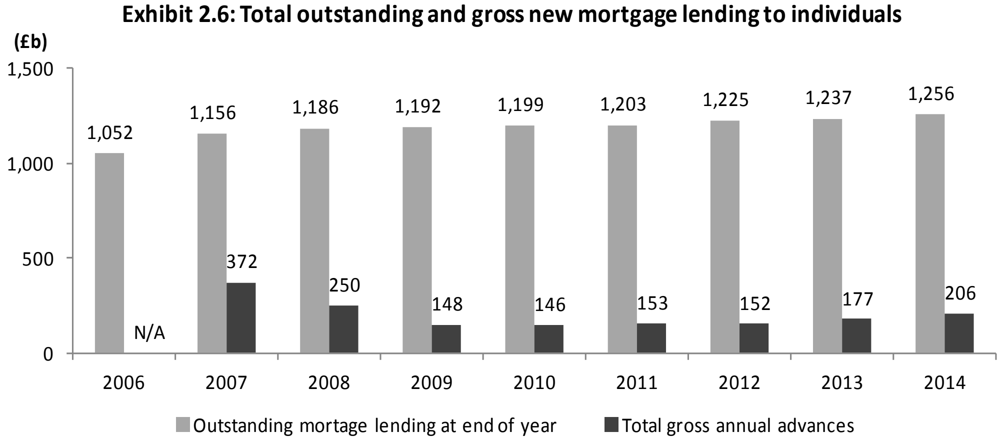
Source: Mintel (November 2014); Note: Data covers the period 1 April-31 March in each year

The increased proportion of intermediaries as a key channel in 2013-2014 can be explained by two factors. First, an increase in mortgage lending throughout 2013 and 2014, combined with an increasingly diverse range of mortgage products offered by lenders, has fuelled demand for the advisory services offered by brokers. Second, the 2014 Mortgage Market Review ("**MMR**") has prohibited non-advised mortgage sales. As a result, lenders without sufficient in-house advisory capabilities have turned to intermediaries to provide such services. (*Source: Mintel – Mortgages Intermediary Focus*)

2.5.3 *Key metrics*

The total value of outstanding mortgage balances in the UK was £1.3 trillion as at 31 December 2014, as shown in Exhibit 2.6. This figure has remained relatively stable over recent years, with a CAGR of 1.5 per cent. for the three years to 31 December 2014. Data from the Financial Services Authority ("**FSA**") and FCA also show that levels of net new mortgage lending, which measures gross new lending minus repayments, remained below £22 billion per annum between 2009 and 2013.

Exhibit 2.6: Total outstanding and gross new mortgage lending to individuals

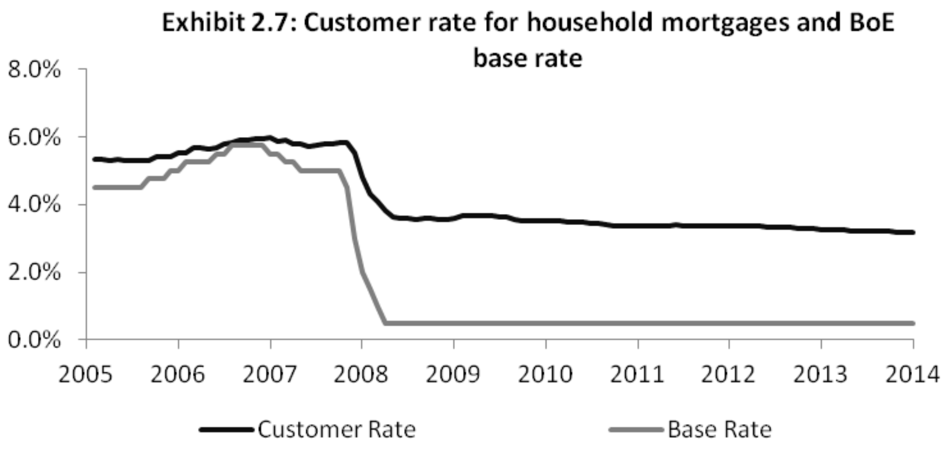


Source: Bank of England, Financial Conduct Authority mortgage lending statistics

The slowdown in growth of total mortgage stock in the UK following the financial crisis can be explained by two factors. First, levels of gross new lending remained relatively stable between 2009 and 2012, as shown in Exhibit 2.6. Second, the Bank of England reports that a fall in the official bank rate from 5 per cent. to 0.5 per cent. between October 2008 and March 2009, with the rate since remaining at 0.5 per cent., may have caused households to repay more of their mortgage principal. (*Source: Bank of England*) This increase in repayments would effectively counter-balance some of the gross new mortgage loans extended since 2009. (*Source: Prudential Regulation Authority and the Financial Conduct Authority - Mortgage Lenders and Administrators Statistics*)

2.5.4 *How banks make money from mortgages*

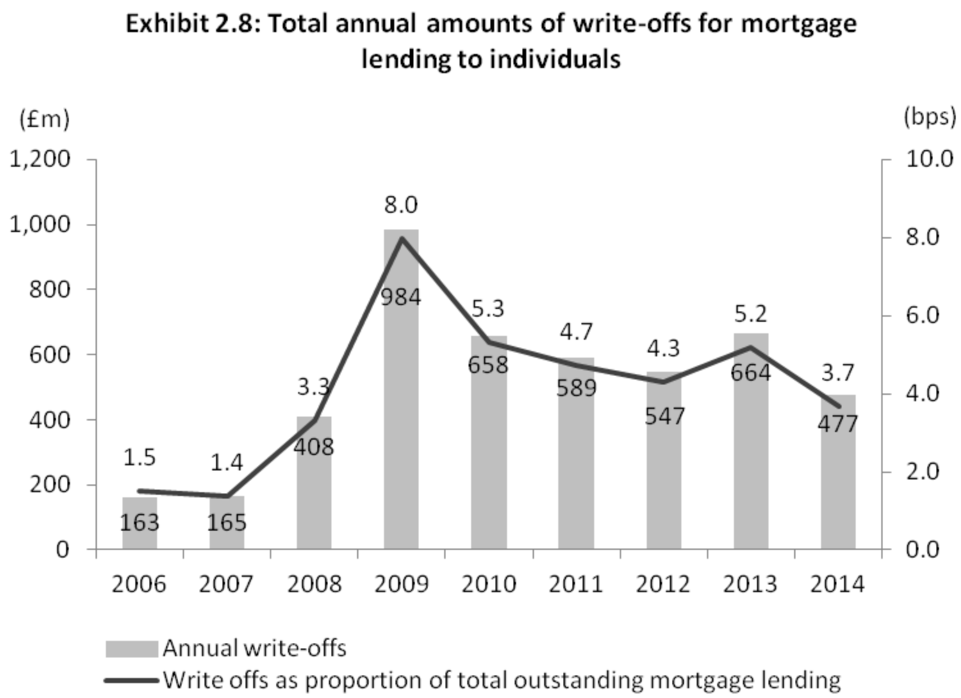
The key source of income for mortgage providers is the interest rate spread on mortgage loan balances. As shown in Exhibit 2.7, this spread has widened significantly since 2008 as the interest rate charged to customers has decreased at a significantly slower rate than the base rate, which is directly correlated to the funding cost for banks, suggesting an improvement in the overall profitability of mortgage lending. However this spread has been under pressure more recently as banks seek to grow their mortgage portfolios.



Source: Calculated from Bank of England data

During the financial crisis, a proportion of revenue from this increased spread has been used in addressing the significant impairment charges incurred on loans during this period. The total UK financial institutions' mortgage impairments are shown in Exhibit 2.8.

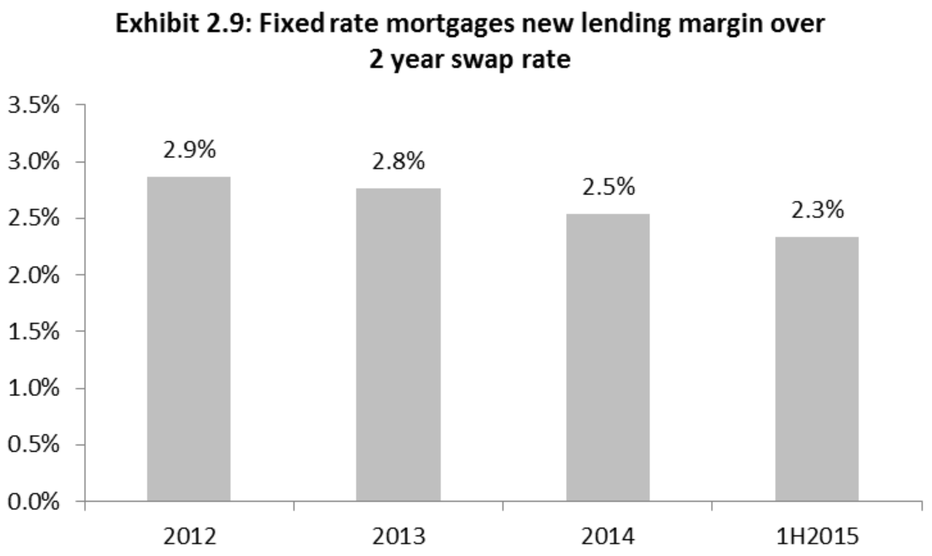
There has been an overall improvement in both the annual amount of mortgage loans written-off and outstanding mortgage lending between 2009 and 2014, reflecting improved macroeconomic conditions and a more risk-adverse approach to mortgage lending.



Source: Calculated from Bank of England data

2.5.5 *Fixed rate mortgages*

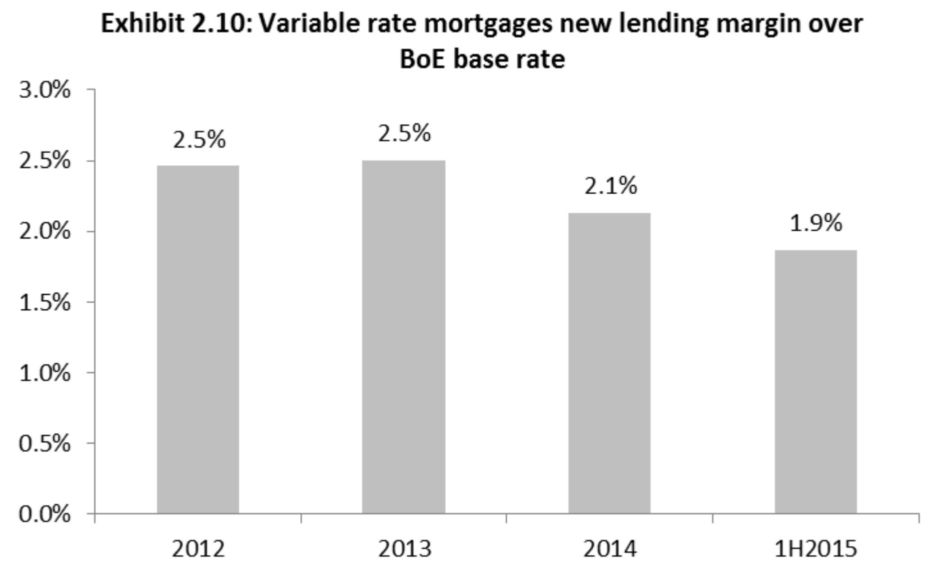
The market average margin on fixed rate mortgages in the UK has gradually declined over the period from FY12 to 1H15, as shown in Exhibit 2.9 below.



Source: Calculated from Bank of England mortgage statistics (FY12-1H15)

2.5.6 *Variable rate mortgages*

The market average margins on variable rate mortgages in the UK have also gradually declined between the period from FY13 to 1H15, as shown in Exhibit 2.10 below.



Source: Calculated from Bank of England mortgage statistics (FY12-1H15)

2.6 ***Key products: personal loans***

2.6.1 *Introduction*

Personal loans allow customers to borrow a sum of money for a specified period of time without providing any collateral. The interest rate varies with loan value and term, as well as customer credit quality. As at January 2015, the average interest rate charged by UK banks for a £5,000 personal loan was 9.0 per cent. and 4.8 per cent. for a £10,000 personal loan *(Source: Bank of England)*.

2.6.2 *Competitive landscape*

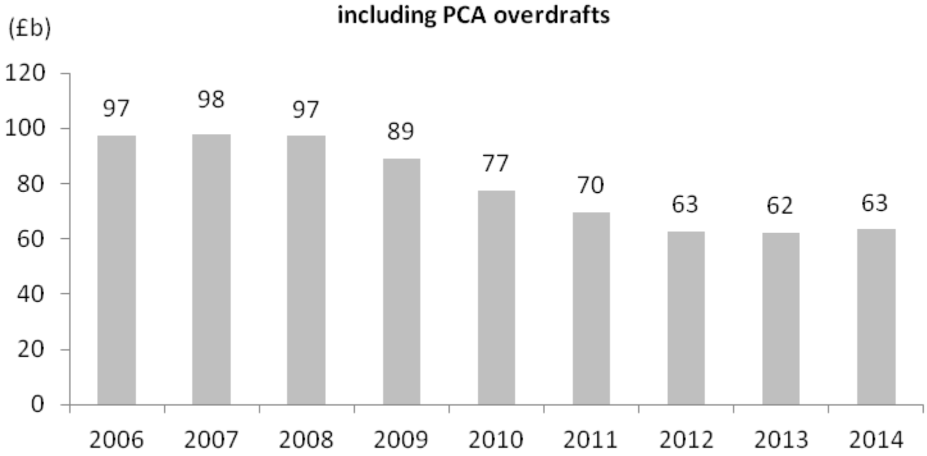
The UK personal loan market is relatively fragmented. The leading providers of personal loans, consisting of the Big Five, Clydesdale Bank, Yorkshire Bank, and Nationwide, account for approximately 60 per cent. of the personal loan market, with smaller lenders and specialist lenders accounting for the remainder. (*Source: BBA – Unsecured Personal Loans*)

42 per cent. of personal loan holders purchase the product from their PCA provider, therefore the PCA is an important gateway product.

2.6.3 *Key metrics*

The personal loan market can be measured in terms of total outstanding loan balances, as shown in Exhibit 2.11. Outstanding loan balances, including PCA overdrafts, dropped 35 per cent. from the average outstanding peak of £98 billion in 2007 to £63 billion in 2014.

Exhibit 2.11: Average outstanding personal lending to individuals including PCA overdrafts



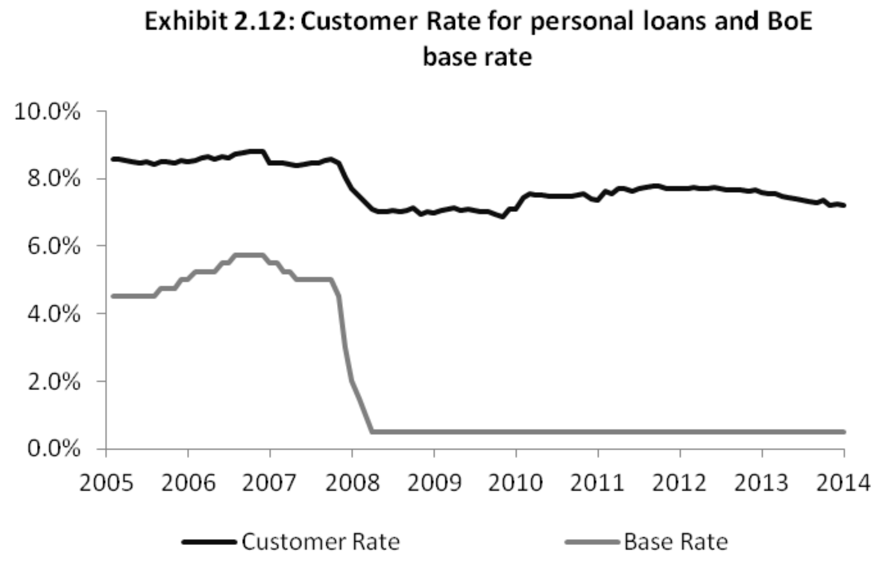
Source: Calculated from Bank of England data

The decline in outstanding personal loan balances in 2008-2013 can be explained by changes in both consumer and lender preferences. As consumers sought to shift from consumption to savings amidst an uncertain macroeconomic environment, their appetite for personal loans decreased. At the same time, banks tightened their lending criteria as they sought to reduce their credit losses and to reduce the size of their balance sheets.

2.6.4 *How banks make money from personal loans*

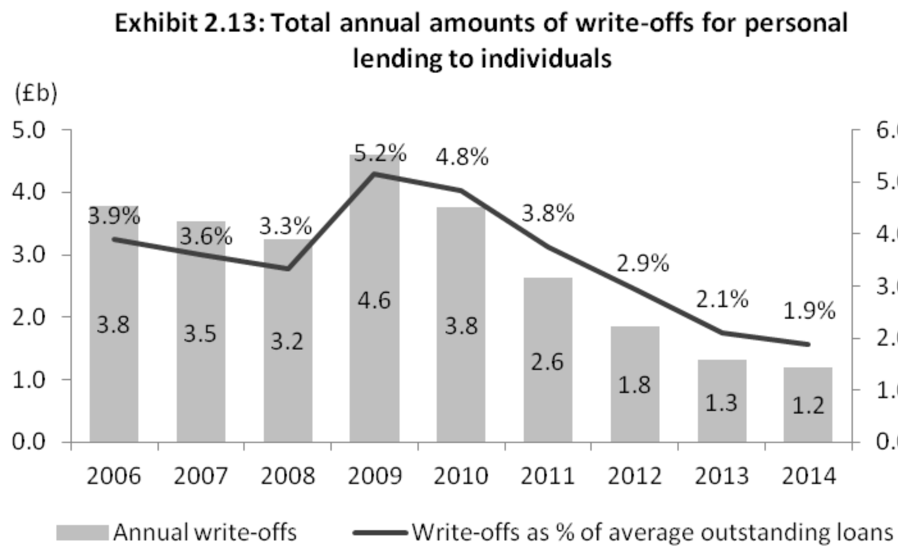
Unsecured personal loans are associated with higher risk as there is no corresponding collateral and therefore they have higher interest rates than mortgages. As shown in Exhibit 2.12, customer rates (interest rates charged to customers) for unsecured loans fell from 8.57 per cent. in September 2008 to 7.22 per cent. in December 2014. Given the drop in the Bank of England base rate (which is directly correlated to the funding cost for banks) from 5 per cent. to 0.5 per cent. over the same period, banks have, at times, experienced an increased interest spread on personal loans between 2008 and 2014.

Although now a less common source of income, personal loans also generate a small amount of fee income, predominantly from penalties for late payments and, to a lesser extent, fees for early repayment.



Source: Calculated from Bank of England data

Between 2008 and 2009, there was an increase in impairments on unsecured personal loans. The total amount of UK financial institutions' impairments is illustrated in Exhibit 2.13. Between 2009 and 2014, there has been a steady decline in both the annual amount of write-offs and their proportion of total outstanding personal loans. This reflects both improved macroeconomic conditions and the tightening of lending criteria by personal loan issuers.



Source: Calculated from Bank of England data

2.7 *Key products: credit cards*

2.7.1 *Introduction*

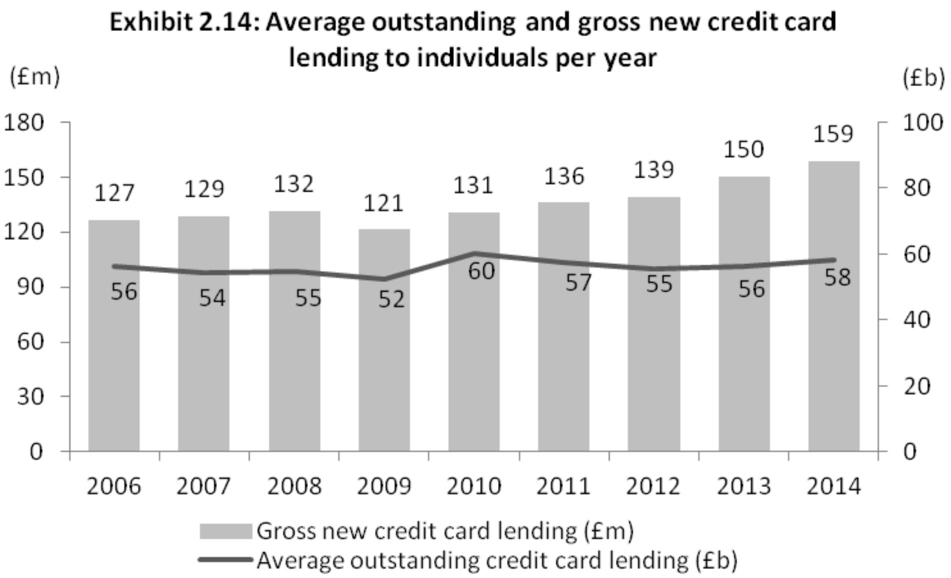
Credit cards provide customers with a means of executing transactions along with an unsecured revolving credit facility. The main stakeholders in the credit card business are the card issuer (i.e. the issuing bank), card scheme (i.e. clearers of card payments), acquirer (e.g. arrangers of card transaction settlement), and merchant (i.e. retailer).

2.7.2 *Competitive landscape*

The wide range of participants in the UK credit card market include high street banks, building societies, and monoline card issuers. Estimates from May 2014 show that five providers account for 53 per cent. of the UK credit card market: Barclays (15.7 per cent.), Lloyds (15.6 per cent.), HSBC (10.0 per cent.), RBS (6.3 per cent.), and MBNA/Virgin Money (5.5 per cent.). The remainder of the market is fragmented between monoline providers such as Capital One, card issuers such as American Express, and retailer banks such as Tesco Bank, M&S Bank, and Sainsbury's Bank. Market share also varies widely by region: 16 per cent. of card holders in Greater London have an American Express card compared to 8 per cent. of the whole of the UK, while in Yorkshire and the Humber, Yorkshire Bank has 4 per cent. share compared to 1 per cent. across the UK. (*Source: Mintel – Credit Cards*)

2.7.3 *Key metrics*

There are 59 million credit cards in issue in the UK, relating to 51 million accounts, of which 67 per cent. have outstanding balances. (*Source: BBA – Statistics High Street Banking*) In December 2014, average outstanding balances stood at £58 billion, as shown in Exhibit 2.14.



Source: Calculated from Bank of England data

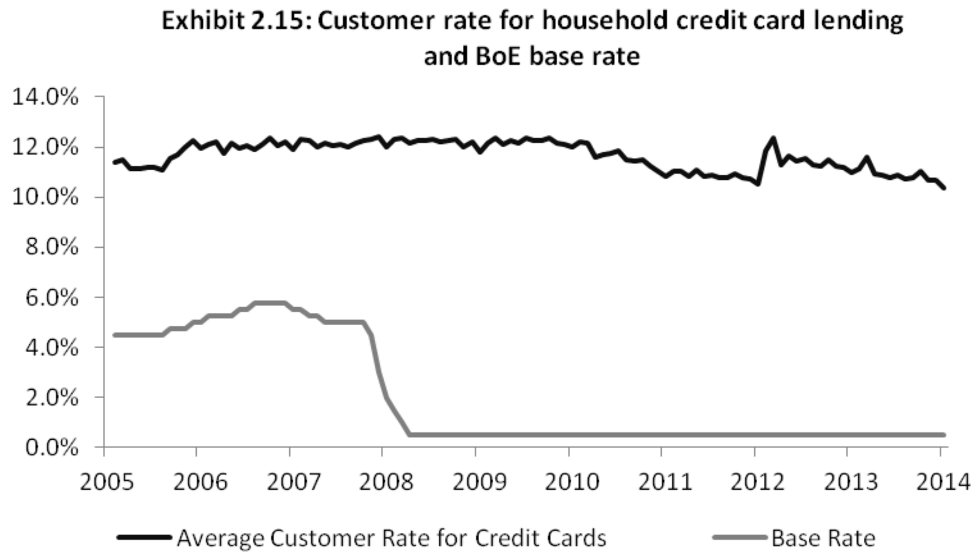
Consumers in the UK have greater appetite to take on credit as the economy recovers. Exhibit 2.14 shows the annual amount of gross new lending extended to credit card holders (in millions of GBP). While outstanding credit card lending reflects the amount of revolving balances on existing lines of credit, gross new lending reflects the expansion or contraction of lines of credit, driven by the number of credit cards issued and their respective credit limits.

Both outstanding and gross new credit card lending declined between 2008 and 2009 as banks sought to reduce their loan-to-deposit ratios and restrict capital commitments. However, new lending increased by a CAGR of 5 per cent. between 2010 and 2014 as providers re-entered the market to benefit from attractive margins and the improving economic environment.

2.7.4 *How banks make money from credit cards*

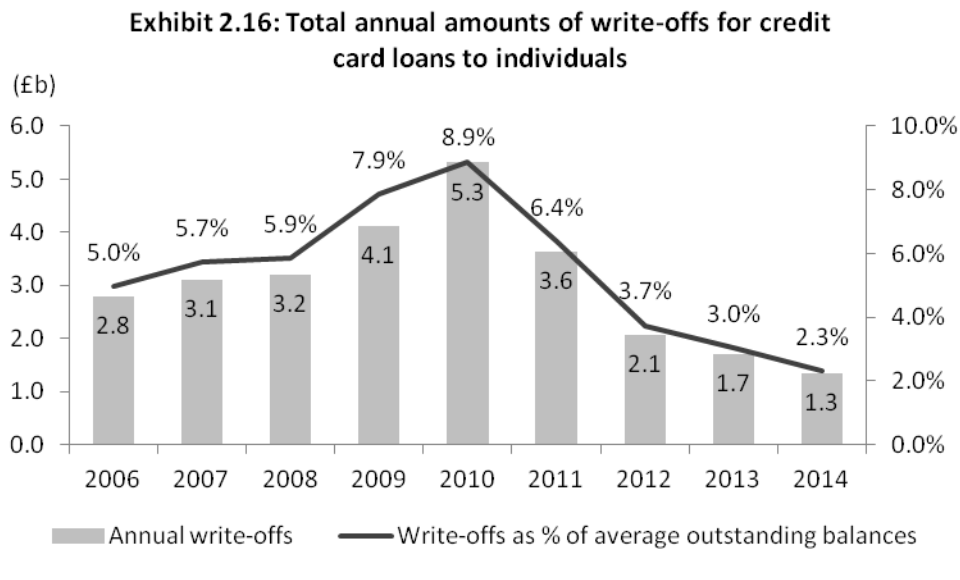
The primary source of income for credit cards is the spread between interest rates charged to customers and the funding cost for banks (which has fallen in correlation to the Bank of England base rate). In addition, issuers generate fees and commissions through interchange fees, late payment penalties, and card fees charged to consumers periodically.

Interest rate spreads on credit cards have increased as the average interest rate charged to customers on credit card balances fell from 11.9 per cent. in December 2007 to 10.4 per cent. in December 2014, at a slower rate of decline compared to the Bank of England base rate.



Source: Calculated from Bank of England data

During the financial crisis, banks incurred significant impairments on credit card loans. Impairments, as a percentage of total balances outstanding stood at nearly 9 per cent. of all credit card lending made in 2010. However, since 2010 there has been a steady decline in both the annual amount of write-offs and total outstanding credit card loans, reflecting improved macroeconomic conditions, as shown in Exhibit 2.16 below.



Source: Calculated from Bank of England data

3. Introduction To SME Banking

SMEs are a large and vital part of the UK economy, constituting an important target segment for many UK banks. The traditional relationship between SMEs and their banks have been affected by the financial crisis as banks have become more risk adverse and businesses look for alternative forms of credit. Bank lending to SMEs continues to fall and new forms of lending, will compete to regain the ground left behind by conventional bank financing. In addition to the liquidity squeeze, there has been a fall in the demand for borrowing from SMEs due to a combination of risk-aversion and the belief that lending is unavailable. (*Source: BBA*)

3.1 *The role of banks for SMEs*

Banks and other lenders provide financial products and services to organisations and businesses of all varieties and sizes. Customer needs in this segment vary by the size and type of businesses.

To address these needs, NAGE segments customers according to size and turnover:

- Micro, including sole proprietorships: NAGE defines these as businesses with no loans outstanding, with turnover less than £120,000. Many sole proprietorships and small businesses use PCAs for business purposes and therefore function similarly to a retail customer.

- Small: NAGE defines these as businesses with loans of up to £0.25 million, with turnover greater than £120,000 and up to £2 million.

- Commercial: NAGE defines these as businesses with loans of £0.25 million to £10 million, with turnover greater than £2 million.

There are many reasons why SMEs borrow. In 2014, 54 per cent. of loans were to ensure adequate working capital, 27 per cent. to buy equipment and 25 per cent. to inject working capital. (*Source: FSB – Voice of Small Business Report*) Products used by SMEs are principally current accounts, overdrafts, loans and credit cards.

Generally, banks generate a larger proportion of their revenue from fees in the commercial banking sector than in the retail sector.

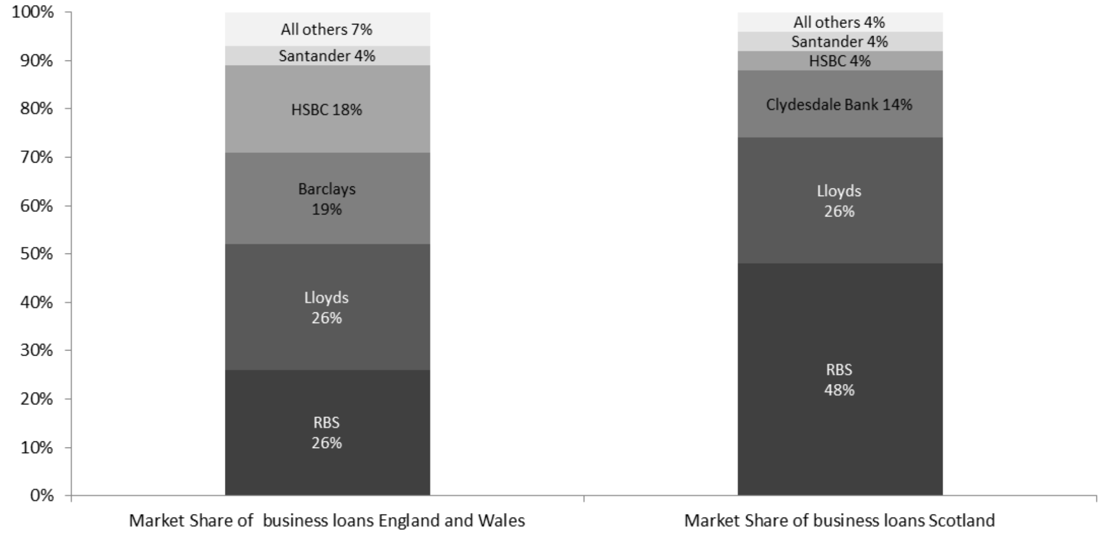
3.2 *Main market participants*

The market for SMEs generates annual revenue of over £2 billion for banks and other lenders in the UK. It is relatively concentrated, with the Big Five accounting for 93 per cent. of volume of business lending to SMEs in England and Wales in 2014. BCA market share is similarly concentrated, with the four largest banks accounting for 85 per cent. of main banking relationships. This concentration has been broadly stable for the last 14 years.

In Scotland, three banks (RBS, Lloyds and Clydesdale Bank) have accounted for 88 per cent. of lending to SMEs and accounted for 80 per cent. of SME BCAs in 2013. The market shares in England and Wales and Scotland have remained stable since 1999. (*Source: Competition and Markets Authority and Financial Conduct Authority – Banking Services to small and medium-sized enterprises*)

Although the UK market is generally stable, there have been successful entrants, such as Handelsbanken, which emphasises its branch network and local, face-to-face relationships. It now has 175 branches and £8.8 billion of business loans, the majority of which are to SMEs.

Exhibit 3.1: SME business loans market share 2013



Source: CMA FCA Banking Services to Small and Medium-Sized Enterprises July 2014

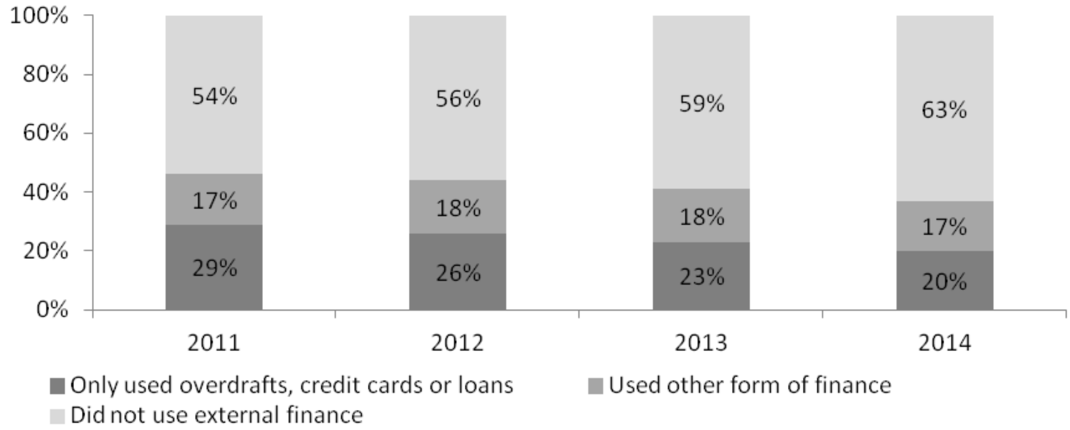
3.3 ***Access to finance***

The use of traditional banking products available to SMEs has declined. Overall, the use of *any* form of finance, referred to as "external finance", has declined in recent years across sectors, from 46 per cent. in 2011 to 37 per cent. in 2014. The decline in overdrafts, credit cards and loans is particularly significant. (*Source: BDRC Continental SME Finance Monitor Q4 2014*)

Economic pessimism during the years following the financial crisis was reflected in fewer investment opportunities for businesses, which held more of their cash in deposits. Despite signs of economic recovery, some SMEs wanting to borrow are discouraged by the difficulty of applying for loans, or a perception that they will not be approved. In Q4 2014, 79 per cent. of SME loans were approved, but only 33 per cent. of applicants assumed they would be successful. (*Source: BBA*)

Due to the perception of loans being harder to obtain, fewer SMEs turn to external sources of finance. The use of traditional banking products such as overdrafts, term loans and credit cards has declined from 39 per cent. to 29 per cent. between 2011 and 2014.

Exhibit 3.2: How SMEs use finance 2011-2014



Source: BDRC Continental SME Finance Monitor Q4 2014

3.4 ***Use of bank financing***

SMEs also use non-banking sources of finance. Informal sources include loans from friends and family or personal savings. Formal sources include vendor financing, amongst others and recent innovations such as peer-to-peer lending, driven by digital technology. Although these newer channels remain small, they are, however, growing. (*Source: BBA - Promoting competition Report*)

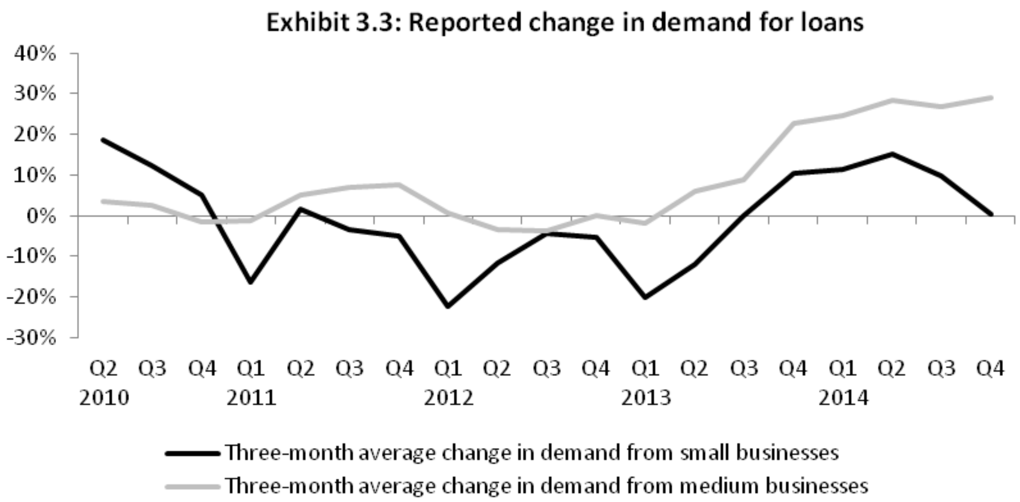
43 per cent. of SMEs in the UK are considered "permanent non-borrowers", having neither borrowed for 5 years nor looking to borrow currently. (*Source: BRDC SME Finance Monitor Q4 2014)* In a YouGov survey conducted in 2014, the most common reason cited from the options given for choosing not to borrow was the economic climate. Another potential contributing factor is a deficit of trust. A survey by the Federation of Small Businesses found that only 16 per cent. considered banks to "care about small businesses". Excessive charges were the largest source of concern for SMEs in relation to their bank.

3.5 ***Trends in banking for SMEs***

Although demand for finance has increased since 2013, lending has fallen continuously since 2011. This decline is in spite of the 2012 Funding for Lending Scheme, in which the Bank of England attempted to boost lending to households and companies by providing funding to banks and building societies at a lower cost.

3.5.1 *SME demand*

After a period of decline, demand for lending from medium sized enterprises has grown since Q2 2013. Demand from small businesses also grew until Q2 2014, since then it has declined. Unlike medium-sized businesses, small businesses have reported that their demand has mostly been met since 2011. (*Source: YouGov – SME Banking Report*)

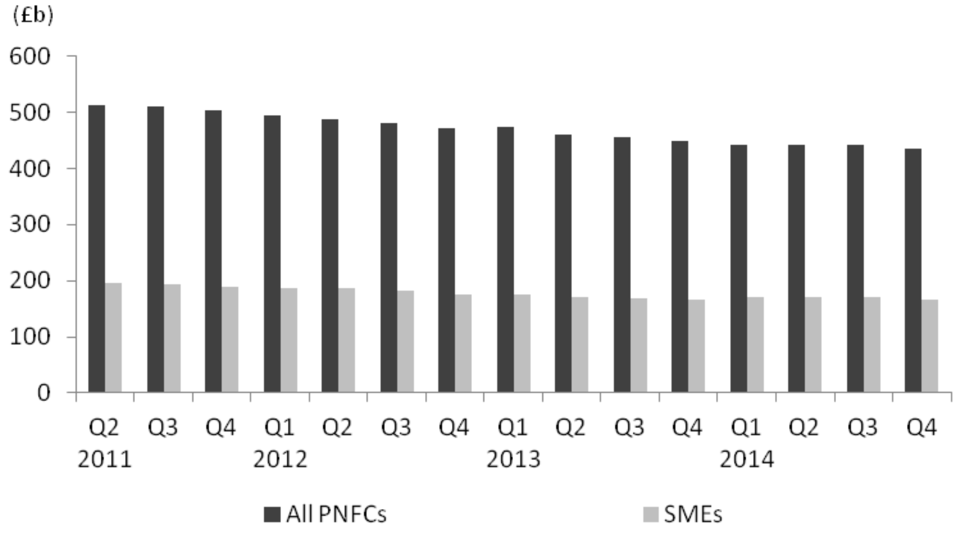


Source: Bank of England

3.5.2 *Lending to SMEs*

Lending to all private non-financial companies ("**PNFCs**") in the UK has declined since Q2 2011 by a total of 15 per cent. Lending to SMEs has also experienced a downward trend, as shown in Exhibit 3.4.

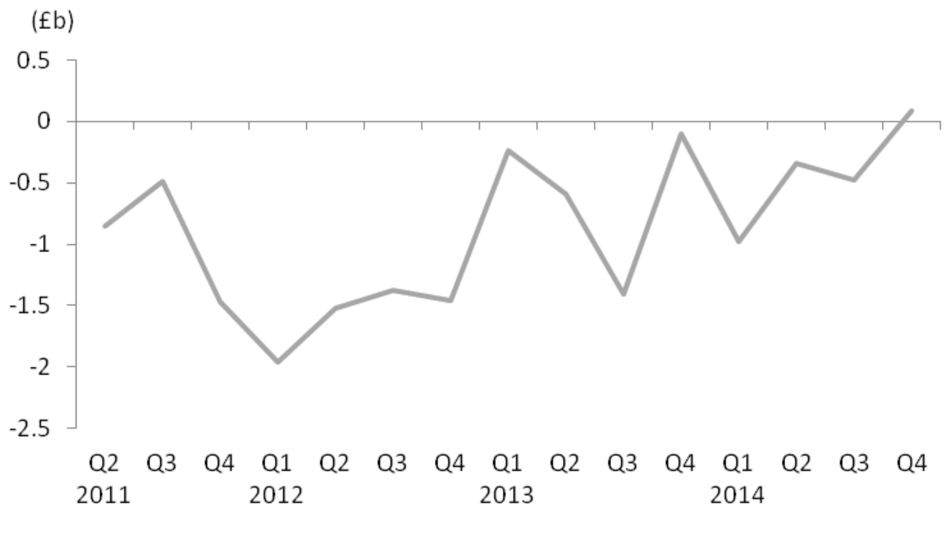
Exhibit 3.4: Total Outstanding Loans to UK PNFCs



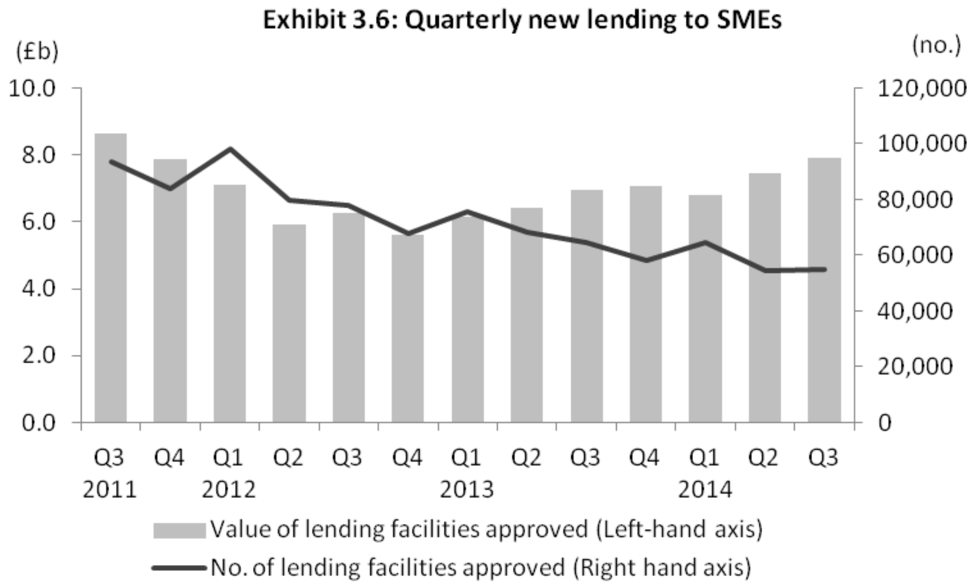
Source: Bank of England.

There are tentative signs of market recovery. First, the decline in loans outstanding slowed in the final three quarters of 2014, as shown in Exhibit 3.5. Secondly, although the approval rate for new borrowing facilities is still declining, total new lending to SMEs is now increasing, as shown in Exhibit 3.6, suggesting that the average new loan size is rising.

Exhibit 3.5: Quarterly changes in loans outstanding to SMEs

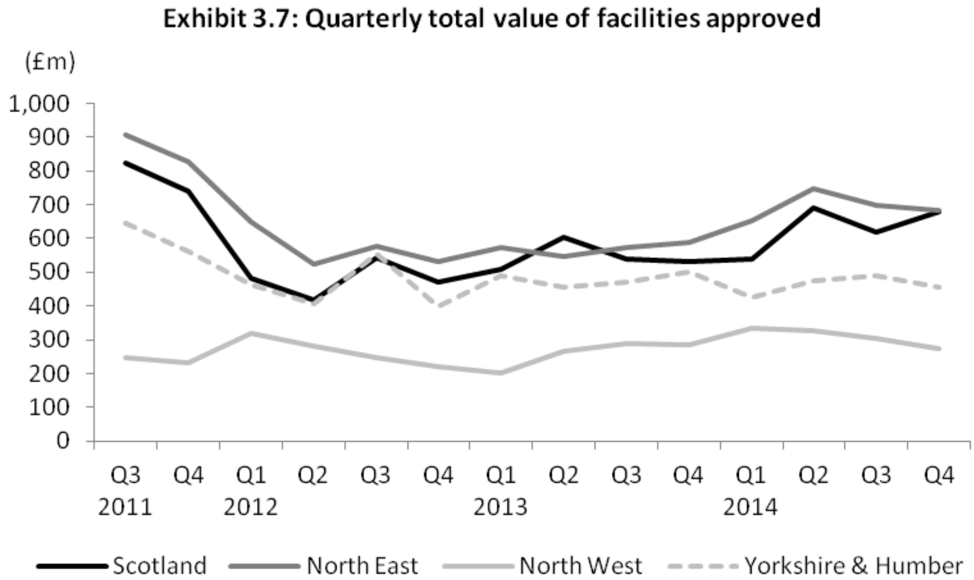


Source: Bank of England



Source: Bank of England

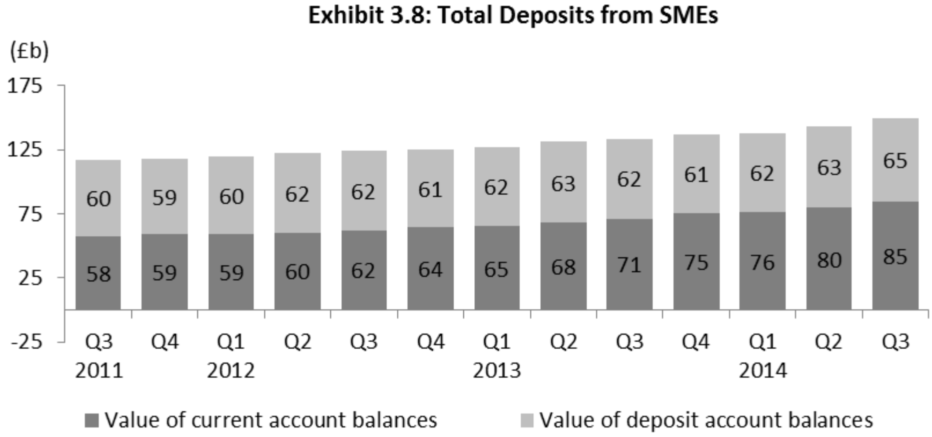
As shown in Exhibit 3.7, the core regions reflect tentative improvement in the value of new lending to SMEs. All regions except the North West experienced a considerable fall in lending in 2011. More positive trends in Scotland and the North East have emerged since 2011, with a less buoyant new lending market in Yorkshire and the North West.



Source: British Banking Association

3.5.3 *Deposits from SMEs*

During the challenging economic period between 2011 and 2014, deposits from both small and medium-sized businesses grew.



Source: British Banking Association

3.6 *Distribution channels*

The main distribution channels used by SMEs are branches, online channels and by telephone. (*Source: YouGov*) Relationship managers, who have an understanding of each business, provide a single point of contact for larger SMEs. (*Source: YouGov – SME Banking*) SME customers use multiple channels, preferring digital options for simple interactions and using personal interaction for more complex banking needs. (*Source: YouGov*)

Personal contact and branch banking are important to SMEs. The largest SMEs place significant value on personal service and face-to-face contact from banks. 54 per cent. of SME customers visit a branch at least once a month and SMEs' most preferred means of communication with a bank is over the telephone with a branch employee. 31 per cent. of SME customers in Northern England and 30 per cent. of customers in Scotland conduct business at a branch at least once a week. On average, SME customers in both regions consider branches will continue to be important to a greater extent than customers in other regions in the UK. (*Source: YouGov – SME Banking Data*)

A strong digital presence is important for SME customers and they make frequent use of online banking. 81 per cent. of SME customers interact with their banks online, with 39 per cent. on a daily basis. SMEs overwhelmingly consider digital banking to be the channel most likely to grow in importance in the next year. (*Source: YouGov – SME Banking Data*)

3.7 *Customer behaviour*

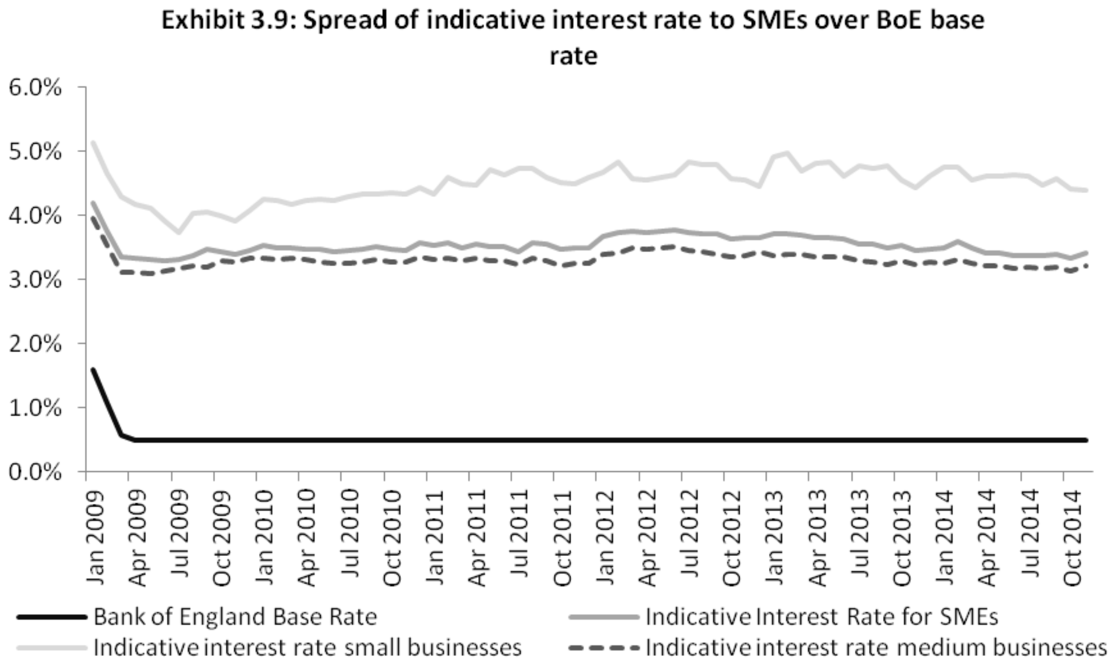
85 per cent. of SMEs prefer to receive their business current account banking services from a single provider. (*Source: YouGov – SME Banking Data*)

Satisfied customers are generally loyal to their banks, remaining with them for many years. The government and the banking regulator, however, may introduce greater competition to the SME banking market. When changing providers, SMEs are most concerned about price and the availability of free banking. SMEs also consider a good relationship and the ability to speak to an employee as the most important factors. (*Source: YouGov – SME Banking Data*)

There is considerable correlation between PCAs and BCAs. 31 per cent. of SMEs use a PCA as their main bank account and SMEs commonly open a BCA account with the bank they hold a PCA, benefitting banks with strong retail and SME propositions. (*Source: YouGov – SME Banking Data*)

3.8 ***Spreads on lending***

The spread between average interest rates for SME lending and the Bank of England base rate (which has a direct correlation to a bank's funding cost) has been steady since mid-2009 at an average of 3 per cent. Medium-sized enterprises have a lower spread at 2.8 per cent. while smaller enterprises are higher, at an average of 4 per cent.



Source: Bank of England

Spreads for SMEs are higher than for retail mortgages reflecting the more complex risk factors and higher cost to serve. A 2013 Bank of England study found that secured household loans in the retail sector have a rate of forbearance of approximately 5 to 8 per cent. of their total value, whereas SMEs had a rate of 14 per cent.

Research suggests that banks and other lenders perceive SMEs to be higher risk than they actually represent. A 2013 UK government study found that rejection rates for low and medium risk firms increased at a faster rate after 2009 than for high risk firms. (*Source: BIS Evaluating Changes in Bank Lending to UK SMEs*)

3.9 ***Asset and invoice finance***

Asset and invoice finance are fast-growing banking products. Unlike the BCA market, challenger banks have a considerable market share of these products, particularly in asset finance.

3.9.1 *Asset finance*

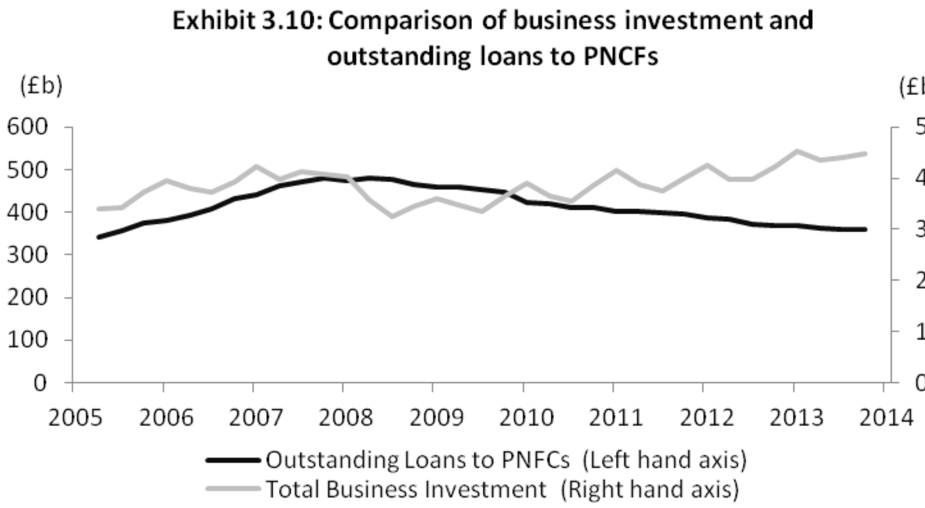
Asset finance typically involves a business paying a regular charge for the use of an asset over an agreed period of time. The most common types of asset finance are: (i) leasing, where the customer rents new equipment without owning the asset; and (ii) hire purchase, which allows the customer to buy equipment on credit.

3.9.2 *Invoice finance*

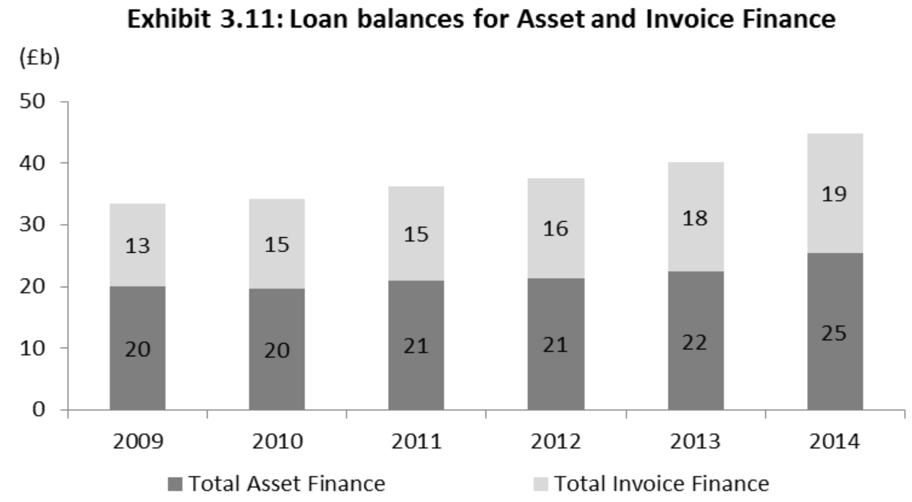
Invoice finance involves businesses raising cash against as yet unpaid customer invoices. The most common types of invoice finance are: (i) factoring, where the provider interacts with a business' customers to receive payments owed, takes over the sales ledger and manages the credit control whilst receiving a percentage of the value in return; and (ii) discounting where the provider maintains the sales ledger and invoice processing but does not directly interact with the business' customers. Invoice finance typically earns a greater proportion of its income from fees than does asset finance.

3.9.3 *Background to growth of asset and invoice finance*

Since 2009, lending to PNFCs has consistently fallen each year, as shown in Exhibit 3.10. BIS forecasts a cumulative credit funding gap, the gap in businesses' access to funds, of £84 billion to £191 billion between 2013 and 2018 (*Source: Department for Business Innovation and Skills Boosting Finance Options for Businesses*). In addition, UK business investment has been unpredictable and moderately seasonal each year. Alternative sources of financing such as asset and invoice finance have expanded over 2009 to 2014 growing by a CAGR of 5 per cent. and 8 per cent. Respectively as shown in Exhibit 3.11.



Source: Office of National Statistics, Bank of England;



Source: FLA and ABFA

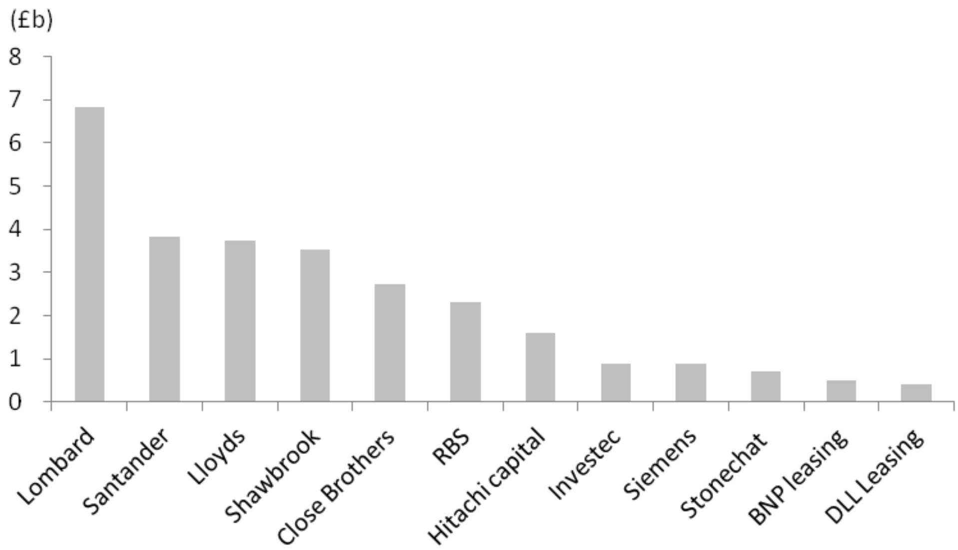
3.9.4 *Structure of the asset and invoice finance industry*

The asset and invoice finance industry comprises of three different types of participants:

- *Big Five high street banks*: these banks typically focus on larger business customers.
- *Original equipment manufacturers and vendors*: examples are General Electric and Siemens. They offer financing as part of their sales process and typically to large customers.
- *Challenger banks and niche specialists*: other banks such as Aldermore and Close Brothers, as well as specialists such as Bibby or Lombard. They focus on SME customers, and some on certain product types only.

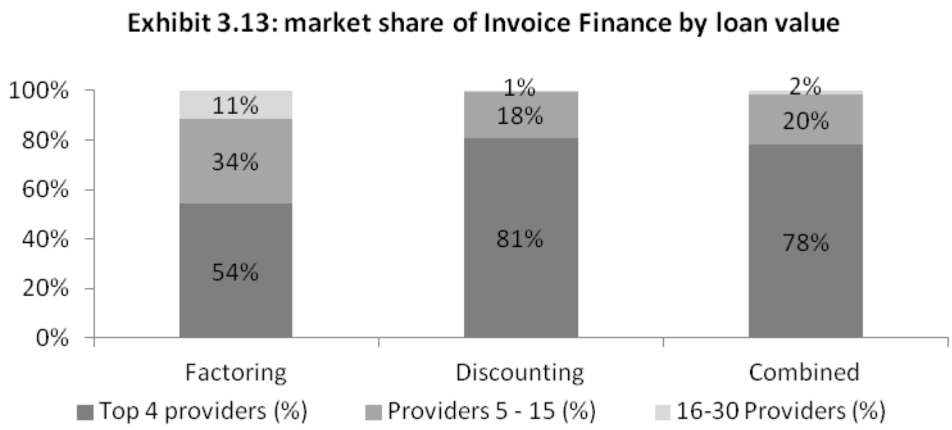
For asset finance, there are 66 companies registered with the Finance and Leasing Association ("**FLA**"). The market overall is relatively fragmented. By value of loan book, smaller banks outside the Big Five, have a greater prominence than in traditional lending. Below is an example set of asset finance loan book values as provided in the companies' annual reports.

Exhibit 3.12: Sample of Asset Finance loan books 2013



Source: Company Annual Reports. Chart shows data as in 2013 Annual Reports.

In contrast to asset finance, the Big Five have a leading market share for invoice finance. Of the 30 invoice finance providers registered with the Asset-Based Finance Association ("**ABFA**"), the top four banks of the Big Five who provide invoice financing (RBS, Lloyds, Barclays and HSBC) occupy 54 per cent. market share for factoring and 81 per cent. for discounting. Combined, they have 78 per cent. market share. In the overall market, the next 10 providers (including Santander with 1.5 per cent. of the market) have 20 per cent. market share, and the remaining providers have only 2 per cent. share. Some providers such as Clydesdale Bank and Yorkshire Bank only operate in the discounting market, of which they have a combined market share of 3 per cent., whilst other such as Pulse Cashflow Finance or Ashley Commercial Finance only operate in factoring. Spreads on invoice finance loans typically range from approximately 2.25 per cent. to 3.75 per cent.



Source: Business Money. Chart shows available data as at March/April 2014

3.9.5 *Asset finance market*

The market split of asset finance has evolved over the past 5 years, with business equipment becoming less significant, decreasing from 34 per cent. to 9 per cent., whilst plant and machinery from 7 per cent. to 22 per cent. and car finance, from 17 per cent. to 31 per cent., have both increased considerably. The category of commercial vehicles has retained a similar share, increasing from 21 per cent. to 24 per cent. (*Source: FLA Statistics 2009-2014*)

3.9.6 *Invoice finance market*

The number of invoice finance customers has remained relatively stable in recent years, witnessing a slight decline from 2006 to 2014.

By industry, the main market segments (manufacturing, distribution and services) have grown at a rate of 1 per cent. per annum since 2010.

When segmenting customers by turnover, there is a divergence in customer growth trends. Customers with turnover of less than £10 million have grown by 1 per cent. per annum since 2010, whereas customers with turnover of greater than £10 million grew at an annual rate of 9 per cent. This pattern of divergence in growth rates is also apparent in the balances since 2010. In total, average balances grew at 8 per cent. per annum from 2010 to 2014, as the existing customer base borrowed more heavily against their invoice assets. The larger contributors to the growth in the industry have been customers with high turnovers of greater than £10 million.

Definitions

"**ABFA**"	Asset-Based Finance Association
"**Barclays**"	Barclays plc
"**BBA**"	British Bankers Association
"**BCAs**"	business current accounts
"**BIS**"	the Department for Business Innovation and Skills
"**CAGR**"	compound annual growth rate
"**CASS**"	Current Account Switching Service
"**CMA**"	Competition and Markets Authority
"**FCA**"	Financial Conduct Authority
"**FLA**"	Finance and Leasing Association
"**FSA**"	Financial Services Authority
"**GVA**"	gross value added
"**HSBC**"	HSBC Bank plc
"**ICG**"	individual capital guidance
"**IRB**"	internal ratings based approach
"**IRHP**"	interest rate hedging products
"**Lloyds**"	Lloyds Banking Group, which includes the Lloyds Bank, Halifax and Bank of Scotland brands
"**MMR**"	Mortgage Market Review
"**NAGE**"	National Australia Group Europe Limited
"**PCAs**"	personal current accounts
"**PNFCs**"	private non-financial companies
"**PPI**"	payment protection insurance
"**RBS**"	Royal Bank of Scotland Group plc, which includes the RBS, NatWest and Ulster Bank brands
"**RWAs**"	risk weighed assets
"**Santander**"	Santander UK plc
"**SMEs**"	micro, small and medium-sized enterprises