MOODY'S

BankFocus

BANKFOCUS RESEARCH
17 JUNE, 2024

UK challenger banks: uneven performance in a sluggish market.

The UK challenger banks show diverse trends but on average compare favourably with their established high-street peers in terms of profitability and capitalisation. However, their asset quality indicators on average are below their established peers.

ABOUT

Moody's BankFocus is a solution that enables research and analysis for banks, for counterparty credit risk and portfolio analysis. The BankFocus research team provides ongoing analysis of the banking sector globally.

AUTHORS

Irakli Pipia
Director, BankFocus Research

Dongying He
Product Manager, BankFocus Research

Enoc Pinto Perez
Product Manager, BankFocus Research

CONTACT US

Americas
+1.212.553.1658
clientservices@moodys.com

Europe
+44.20.7772.5454
clientservices.emea@moodys.com

Asia (Excluding Japan)
+85.2.2916.1121
clientservices.asia@moodys.com

Japan
+81.3.5408.4100
clientservices.japan@moodys.com

SUMMARY

→ The **UK challenger banks grew their assets at a moderate pace** with the majority exceeding the high-street banks' CAGR at 1.1% since 2020. This indicates moderate organic growth opportunities in the UK lending market which has come under pressure due to the spike in interest rates since 2023.

→ The UK challenger banks reported **a wide range of RWA intensity** ratios from 14% to 51% as at end-2023. The risk content of their balance sheets compares unfavourably with the high-street average RWA intensity ratio at 26% as at end-2023.

→ The profitability indicators of the UK challenger banks varied during the last year, with four of them below the high-street peer average. **Shawbrook** and **Starling Bank** had the best profitability indicators, supported by superior net interest margins.

→ There was notable difference in asset quality metrics among the challenger banks. **Those with lower profitability reported better non-performing loan ratios** (e.g. Virgin money and TSB). On average, the challenger banks had less favourable asset quality ratios compared to the high-street banks' average.

→ The UK challenger banks' **CET1 ratios were in line with the high-street banks' average** ratio at 14% as at end-2023. However, despite similar regulatory capital ratios, their unadjusted non-regulatory leverage ratios varied across a wider range. This indicates differences in the asset composition of the challenger banks and, consequently, their RWA intensity.

→ Most challenger banks **hold less liquid assets** in proportion compared to the high-street banks. However, due to their dependency on longer-term secure funding the LCRs ratios of the challenger banks are on average better than those of the high-street peers.

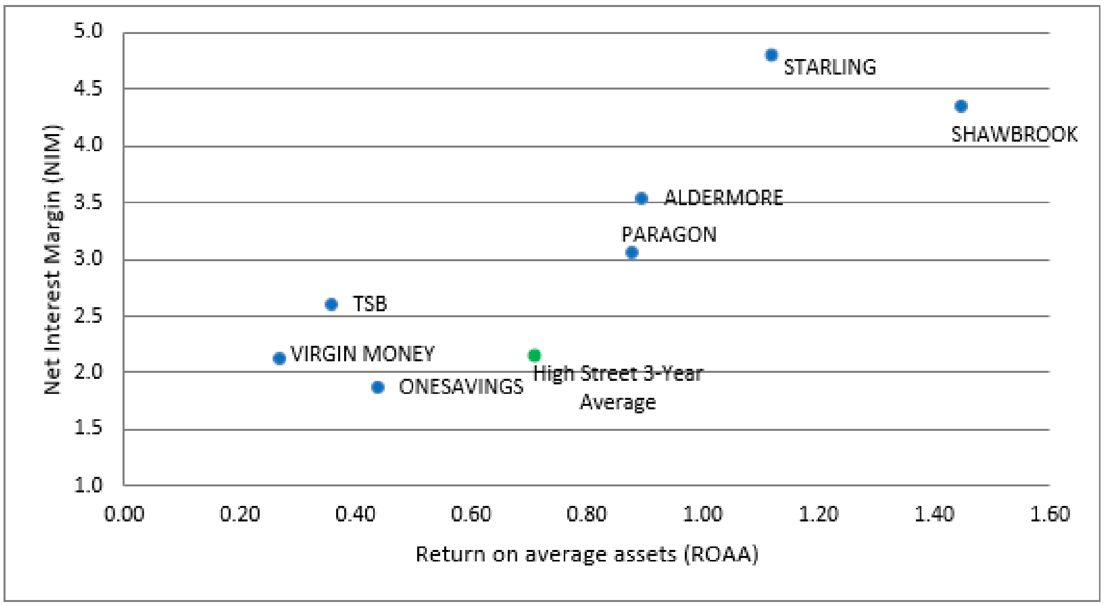


Table of contents

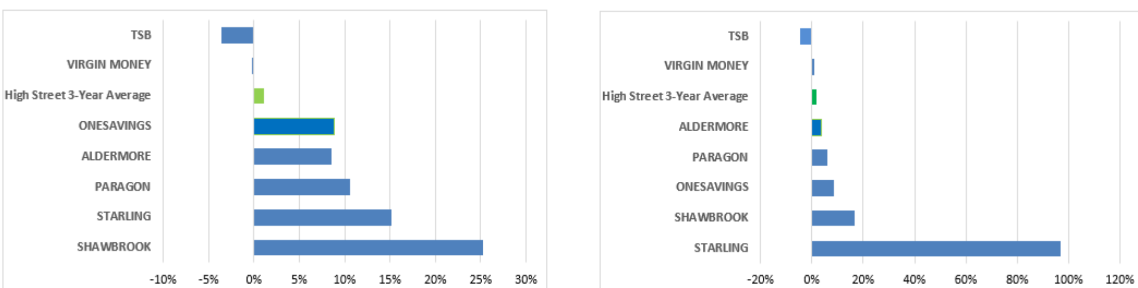
CONSTRAINED LENDING DYNAMICS RESULTS IN MODEST ASSET GROWTH TRENDS

In this report we examined the leading challenger banks in the UK and compared their latest financial metrics to established high-street banks in the UK (*further details on the peer group in Research Methodology pg. 13*).

The UK challenger banks' balance sheets on average grew at a moderate pace with the majority exceeding the high-street banks' CAGR at 1.1 % since 2020. The fastest growth was reported by **Shawbrook** which was partly due to acquisitions of smaller lenders over this period. On the other hand, **TSB** and **Virgin Money** showed stagnation in overall asset size due to contraction in their mortgage portfolios since 2020.

However, the growth rates of customer loans indicates even slower growth for this peer group. **Starling Bank** was leading the peers on this metric, albeit from a very low base (total loan book was GBP 54.2mn in 2019). The majority of the UK challenger banks grew their loans books at single digit CAGRs since 2020. This indicates constrained lending opportunities for organic growth as well as general market stagnation due to higher interest rate environment since 2023. The pressure from the significantly higher interest rates is also evidenced by the high-street banks' stagnation in loan growth with the average CAGR close to zero since 2020.

FIGURE 1 Total Assets and Gross Loans to Customers CAGR, YE 2020 to YE 2023*



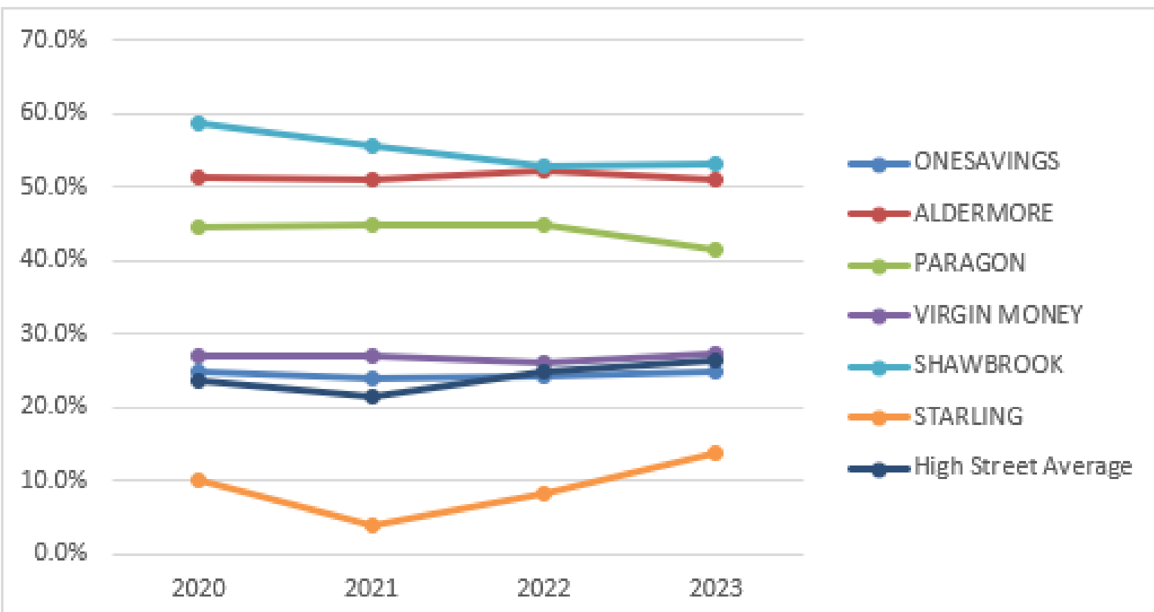
RWA INTENSITY IS ON AVERAGE HIGHER COMPARED TO THE HIGH-STREET BANKS

The UK challenger banks reported a wide range of RWA Intensity ratios from 14% to 51% as at end-2023. This compares less favorably with the high-street average ratio at 26% as at end-2023.

OneSavings and **Virgin Money** had their RWA intensity indicators aligned with the high-street banks' average. However, the rest of the UK challenger banks had notably higher RWA intensity ratios exceeding 40% as at end-2023.

Shawbrook had the highest RWA intensity among the group above 50%, due to its sizeable holdings of higher-risk weighted buy-to-let mortgage loans. In contrast, **Starling Bank** had the lowest, but increasing, RWA intensity below 15% due to a large portion of its assets in low-risk liquid instruments (c. liquid assets were 45% of total assets as at end-2023).

FIGURE 2 RWA Intensity (%), YE 2020 to 1HYE 2023



STARLING BANK AND SHAWBROOK HAVE BETTER PROFITABILITY INDICATORS

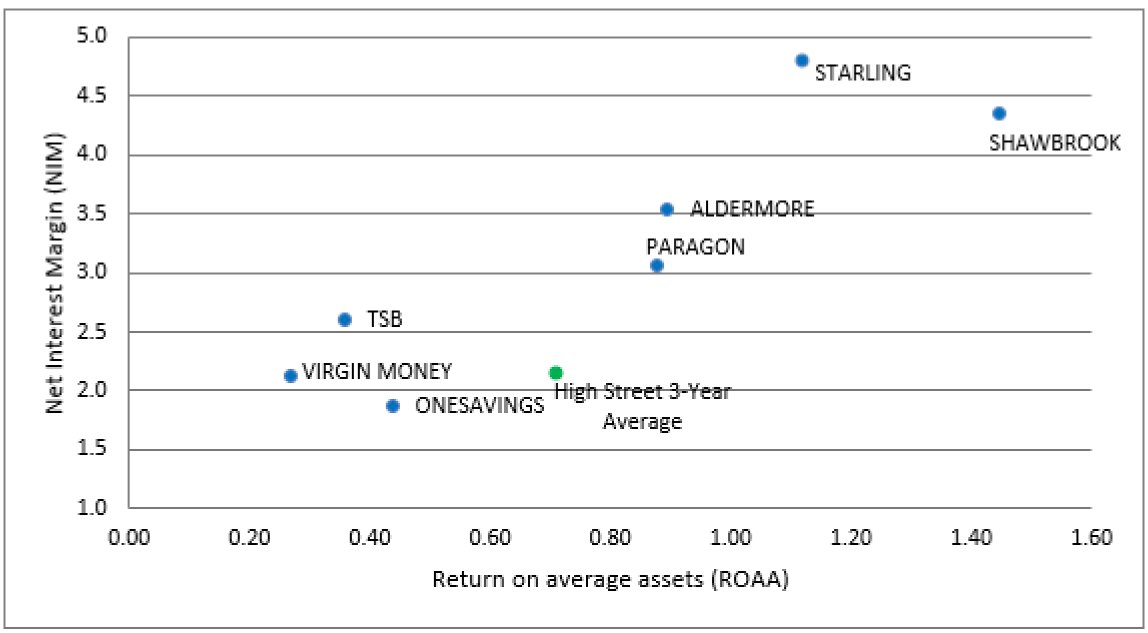
The profitability ratios of the UK challenger banks varied during the last year, with four of them above the high-street peer average. **Shawbrook** and **Starling Bank** had the best profitability indicators, supported by superior net interest margins at around 4.5%. **Aldermore** and **Paragon** were also above the high-street banks' profitability average and comparable to each other.

TSB and **Virgin Money** had the weakest profitability indicators compared to the peers as well relative to the high-street banks' average. This was due to lower interest margins of their lending portfolios.

All challenger banks were highly dependent on Net Interest Income as their fees and commissions represented only small part of Operating Revenues (Appendix II). This indicates lower revenue diversification and sensitivity to the interest rate environment compared to the high-street banks.

FIGURE 3 ROAA and Net Interest Margin (NIM), YE 2023

.



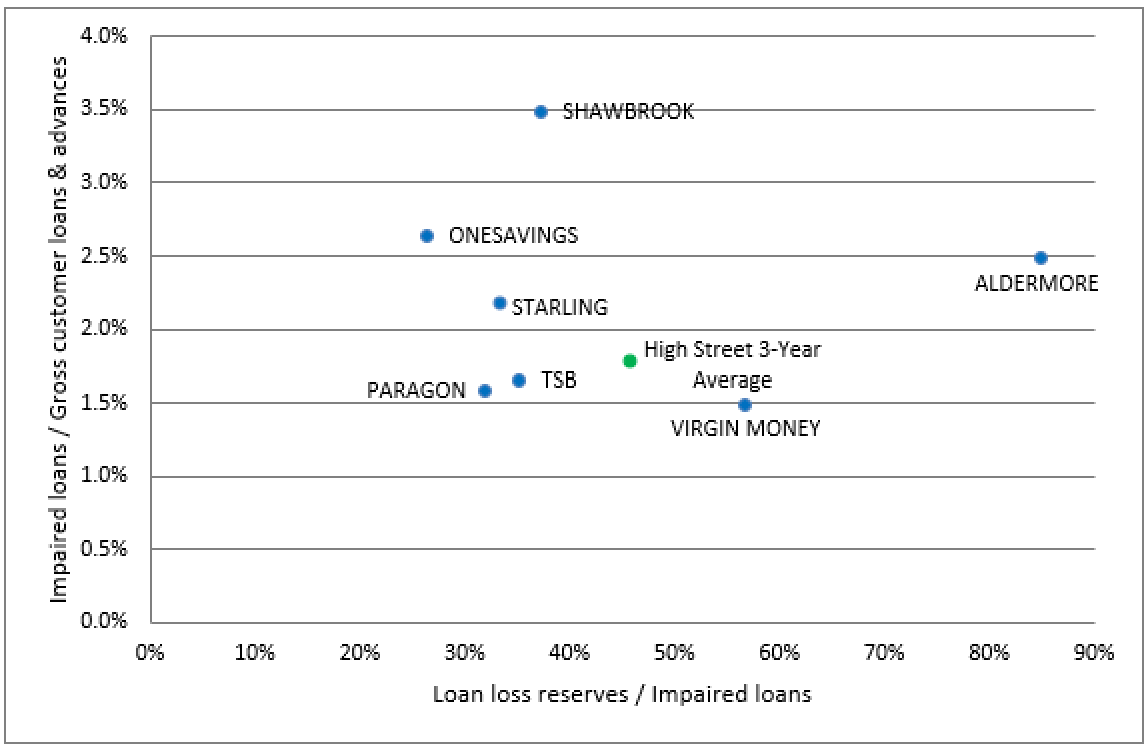
HOWEVER, LOWER PROFITABILITY IS MITIGATED BY BETTER ASSETS QUALITY

There was notable difference in asset quality metrics among the challenger banks peer group. The lower profitability of **TSB** and **Virgin Money** reflects their risk-averse lending strategies and resulted in better non-performing loan ratios. On average, however, the challenger banks had less favourable asset quality ratios compared to the high-street banks' average.

Shawbrook, one of the most profitable challenger banks, had the weakest asset quality metrics which also was also indicated by its higher RWA intensity as noted above.

Loan loss coverage ratios of the majority of challenger banks were below the high-street banks' average at 45%. This relatively modest coverage ratios reflected dominance of secured lending and reliance on mortgage collateral. **Aldermore** had the highest loan loss coverage ratio exceeding 80% which mitigated its relatively higher non-performing asset ratio at 2.5%. **OneSavings** had a similar non-performing loan ratio with considerably lower provisioning coverage as at end-2023.

FIGURE 4 Impaired Loans / Gross loans and Loan Loss Reserves / Impaired Loans, YE 2023

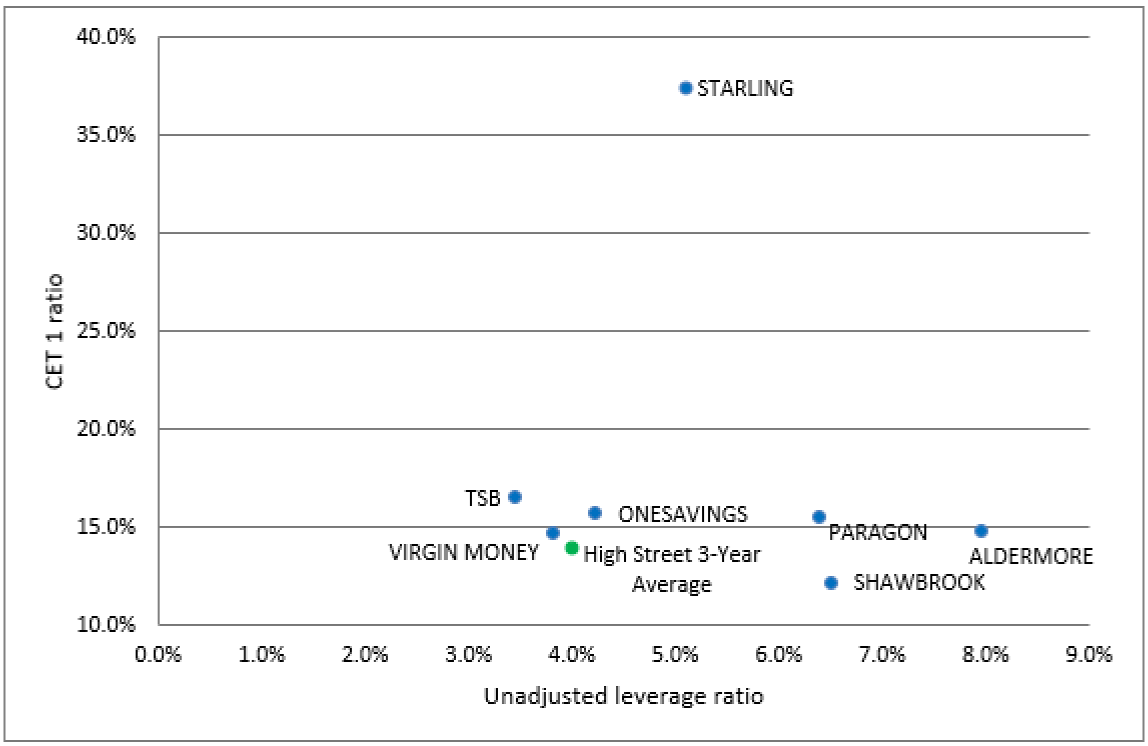


UNADJUSTED LEVERAGE RATIOS AND REGULATORY CET1 PAINT CONTRASTING PICTURES

The UK challenger banks' CET1 ratios were in line with the high-street banks' average ratio at 14% (excluding Nationwide). **Starling Bank** had the highest regulatory ratio which was due to low RWA intensity and higher proportion of liquid assets in its balance sheet.

However, despite similar regulatory capital ratios, the unadjusted non-regulatory leverage ratios were across a wider range for the challenger banks. **TSB** and **Virgin Money** had the lowest leverage ratios, with **Aldermore** leading the peers, despite its moderate regulatory CET1 ratio. **Starling Bank** had a more modest leverage ratio at 5.1% despite its very high regulatory CET1 ratio.

FIGURE 5 CET1 and Unadjusted Leverage Ratio, YE 2023

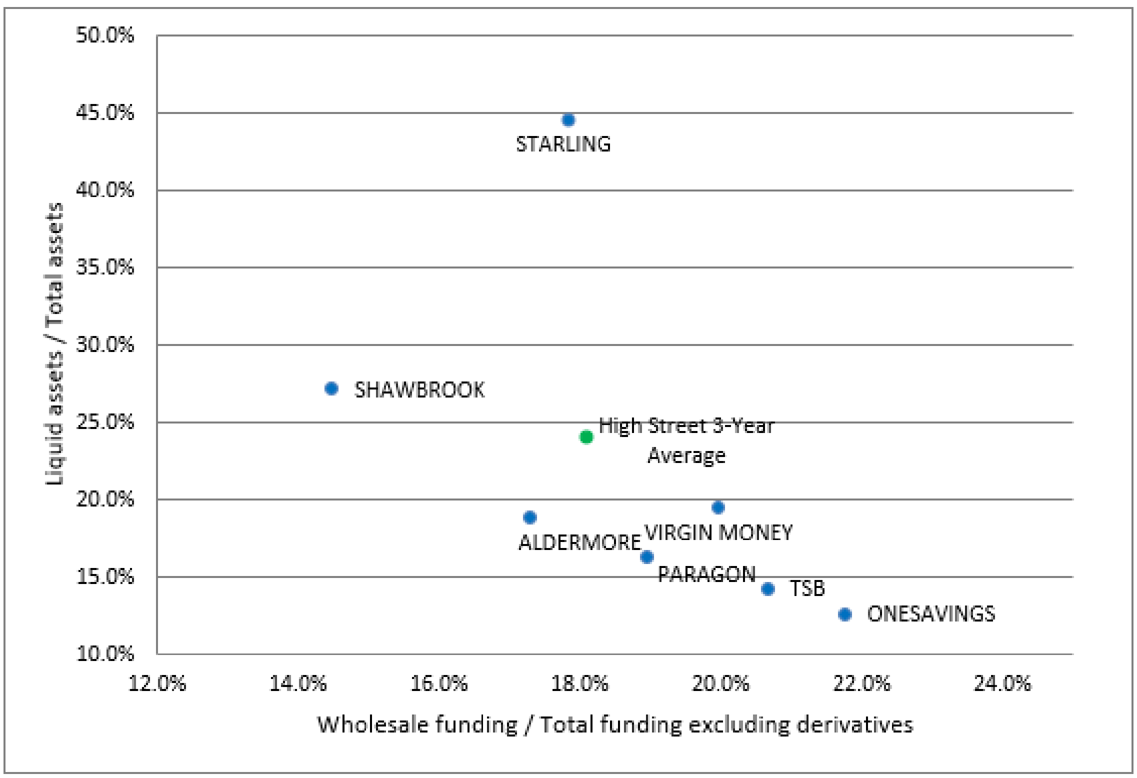


LOW REFINANCING RISK AS WHOLESALE FUNDING DEPENDENCE IS MODERATE

The liquidity position of the challenger banks reflected different strategies of managing their refinancing risk. While **Shawbrook** and **Starling Bank** and banks kept larger proportion of their assets in liquid instruments, **OneSavings** and **TSB** had the same ratio below 15% of total assets. However, most challenger banks compared unfavorably to the high-street banks' average liquid asset ratio of at 24% .

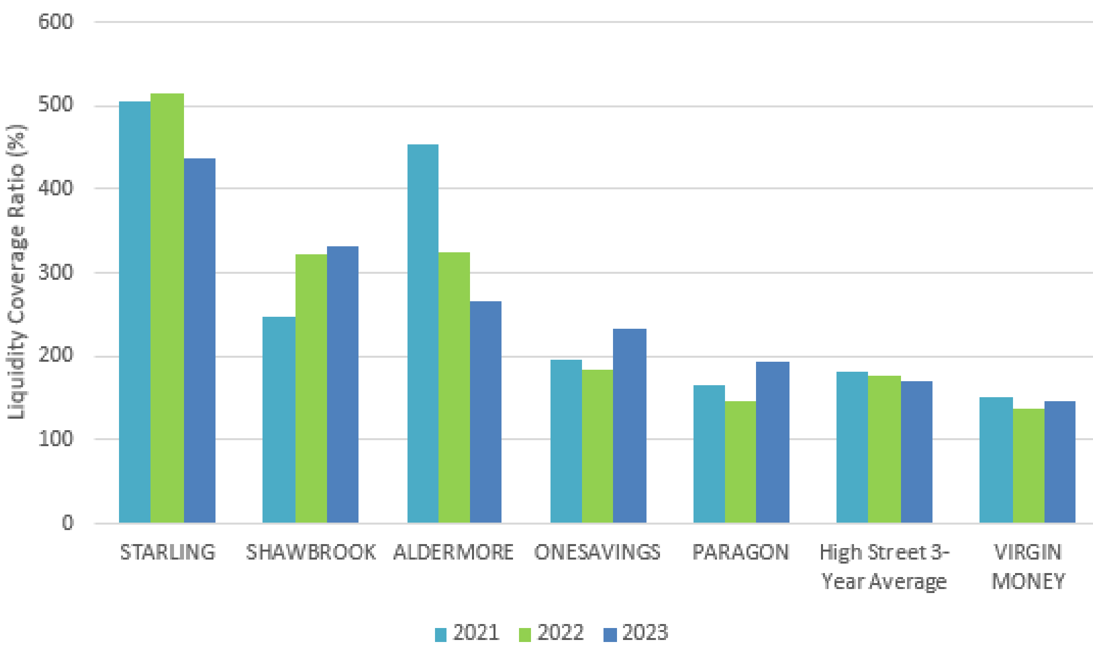
Dependence on wholesale funding was more uniform among the challenger banks, ranging from 17% to 22% of total liabilities (excluding **Shawbrook**). The latter was an outlier with the least dependence on wholesale funding at 15% of wholesale liabilities as at end-2023. Their wholesale funding dependence on average was higher than the high-street banks' average ratio at 18%. However, we expect that the nature of the challenger banks' wholesale liabilities to be skewed towards longer-term secured funding, thus reducing short-term refinancing risk.

FIGURE 6 Liquid Assets / Total Assets vs Wholesale Funding / Total Funding Excl. Derivatives, YE 2023



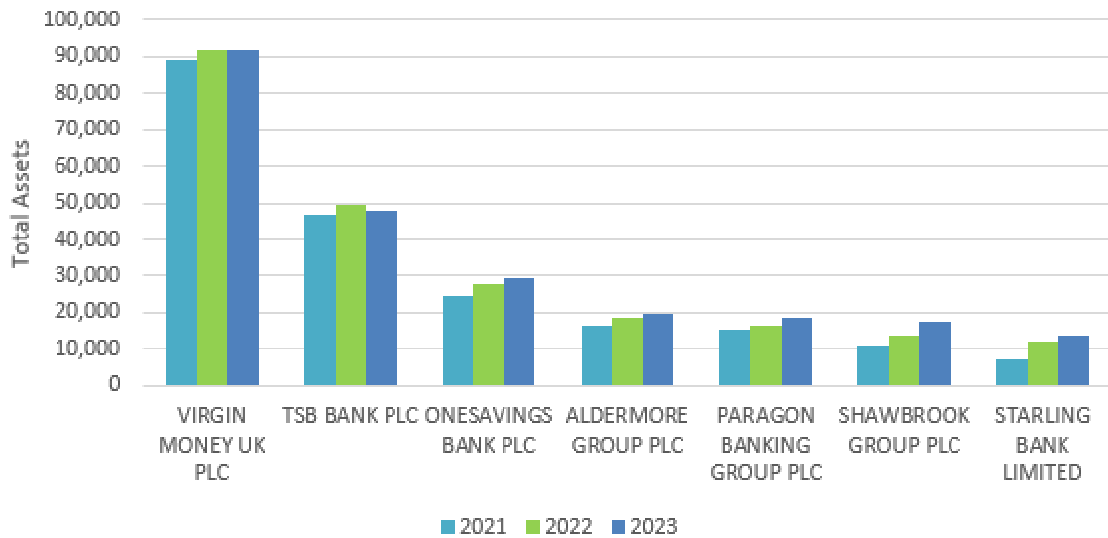
Overall, these liquidity and funding ratios suggest a manageable short-term refinancing risk among the challenger banks, which is also evidenced by high Liquidity Coverage Ratios (LCR). Except **Virgin Money**, all challenger banks had LCR ratios above the high-street banks' average as at end-2023.

FIGURE 7 Figure 7 Basel III Liquidity Coverage Ratio (LCR) (as reported), YE 2020 to YE 2023

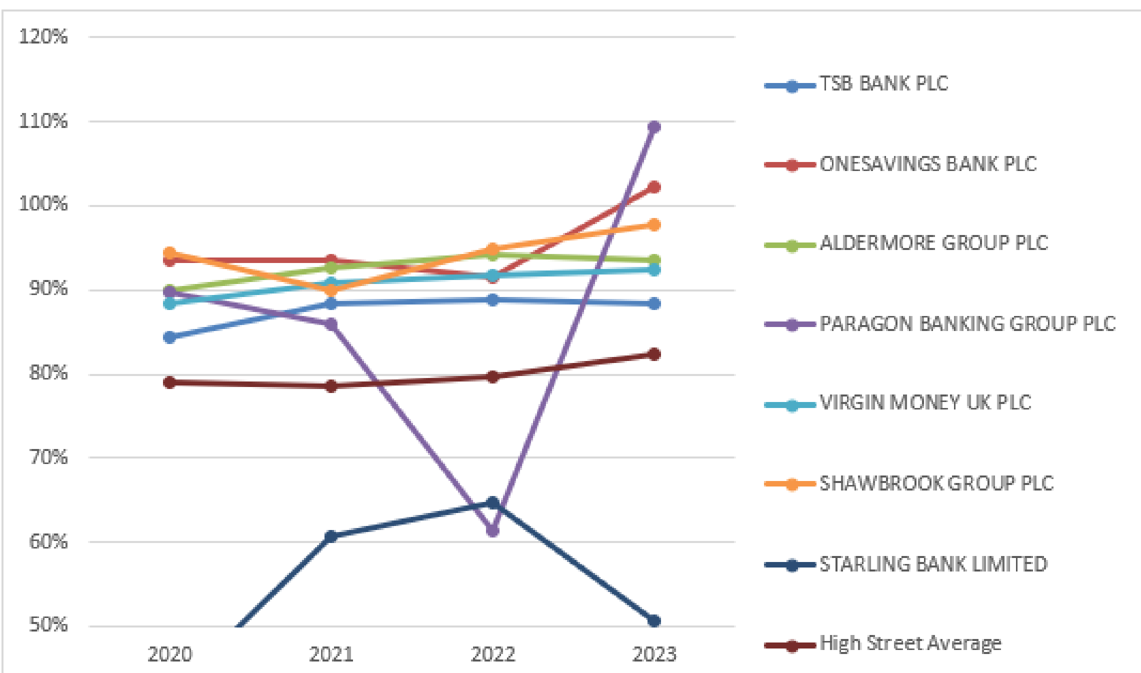


APPENDIX

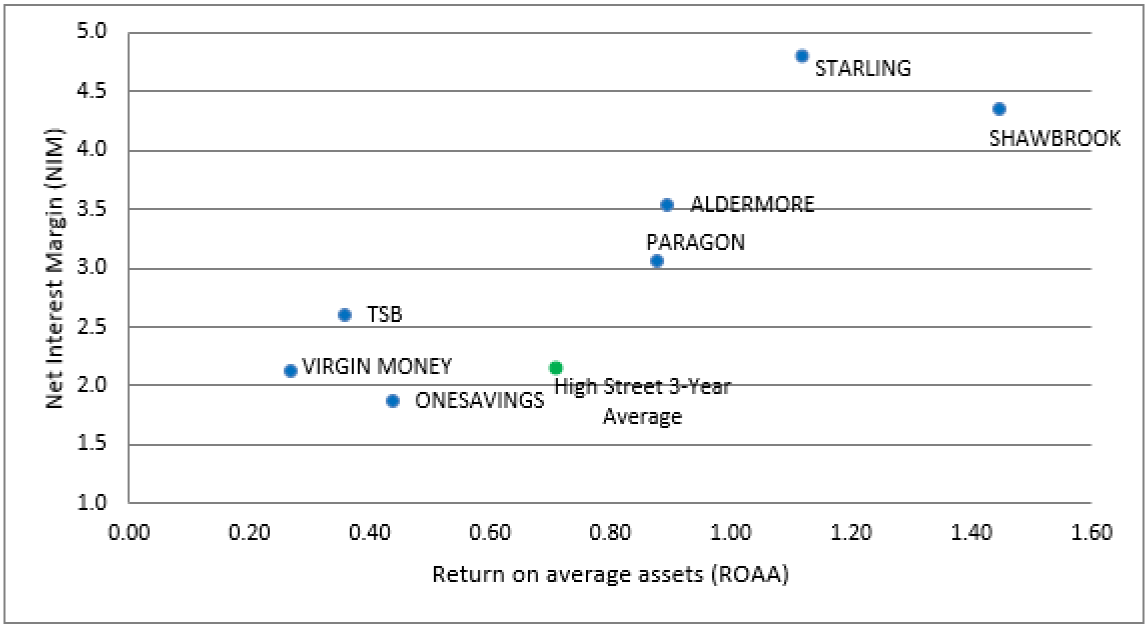
Appendix I: Total Assets, YE 2021 to YE 2023.



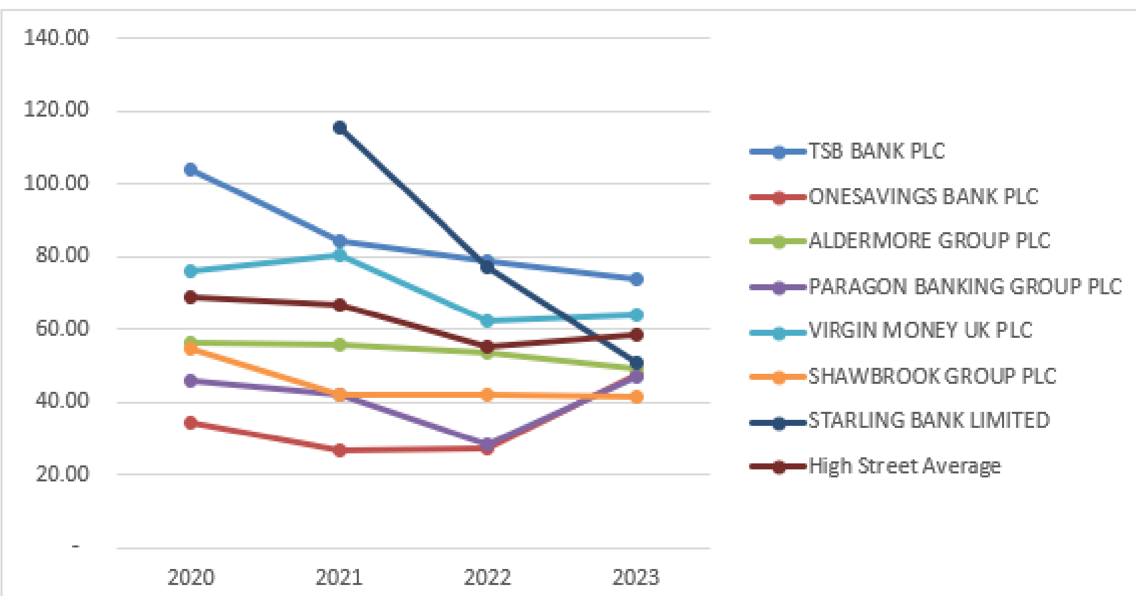
Appendix II: Net Interest Income / Operating Revenue, YE 2020 to YE 2023



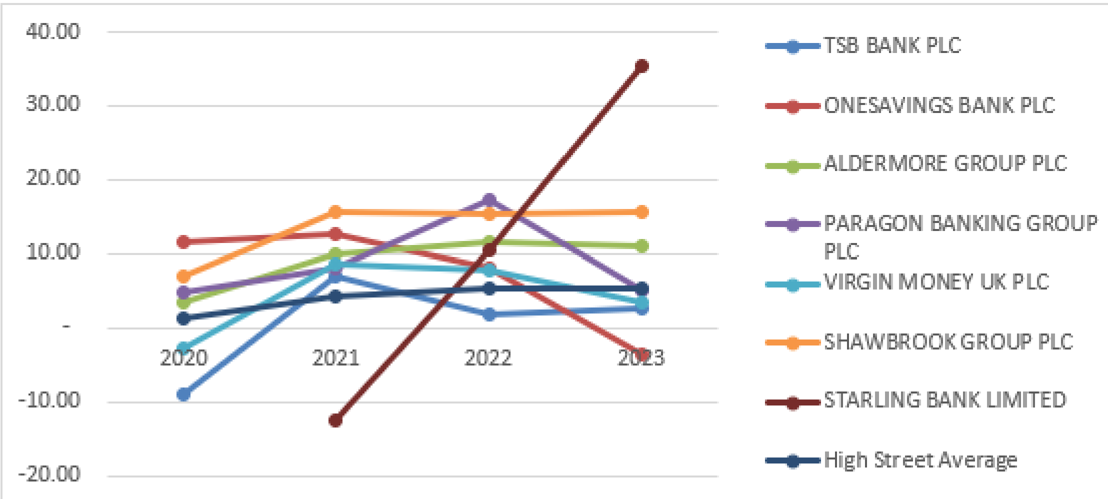
Appendix III: ROAE and Recurring Earning Power, YE 2023



Appendix IV: Cost to Income (Efficiency) Ratio, YE 2020 to YE 2023



Appendix V: Average CET1 Capital Generation (Net Income - Dividends / Total Equity),
YE 2020 to YE 2023



Research methodology and scope

Using BankFocus search steps we analyzed the following financial factors: Asset Quality, Profitability, Capitalization, Liquidity and Funding for the period of financial end-2020 to end-2023.

Principal Ratio definitions

For more detailed definitions refer to BankFocus Global detailed format – data and ratio definitions in the Help section of Popular guides, Financial data.

We analysed the following UK banks:

Challenger banks: TSB BANK PLC, ONESAVINGS BANK PLC, ALDERMORE GROUP PLC, PARAGON BANKING GROUP PLC, VIRGIN MONEY UK PLC, SHAWBROOK GROUP PLC

High Street Banks: LLOYDS BANK PLC, NATIONAL WESTMINSTER BANK PLC – NATWEST, HSBC UK BANK PLC, BARCLAYS BANK UK PLC, NATIONWIDE BUILDING SOCIETY, SANTANDER UK PLC