

# RBS INDEPENDENT LENDING REVIEW

25 NOVEMBER 2013

## FOREWORD

The role of the banks in lending to SMEs has long been the subject of concern and debate in the UK and the issue has assumed particular significance in the wake of the financial crisis. The contraction in lending to the SME sector gave rise to concern among politicians, the public and not least SMEs themselves. At RBS lending to SMEs contracted faster than at the other banks as it faced the challenge of surviving the crisis. While RBS is still the leading lender to UK SMEs, it has inevitably become a lightning rod for discontent and complaint.

It was against this background that Sir Philip Hampton, Chairman of RBS Group, asked me and Oliver Wyman to conduct an independent review into RBS's SME lending.

The review made clear that RBS has achieved a huge amount since the crisis, first to stabilise the situation and then to make many necessary changes to the business. RBS has rebalanced its asset mix, remedied prudential and commercial standards, and invested in infrastructure to build a platform for sustainable growth in the future. Despite these successes, however, it is clear that RBS has not yet met the expectations many observers have of it.

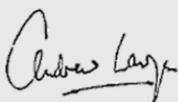
Therefore, the key questions that we faced were: is there more RBS can do to lend to SMEs? Is it realistic to expect the bank to lend more when the requirement for prudence appears to necessitate cutbacks in lending? Can RBS find ways of escaping from the legacy of the past? And are the problems at RBS symptomatic of deeper issues that need to be confronted?

This Review has found that the answer to all four questions is "yes". There is much for RBS to do, and they have committed to undertake that. There are also broader issues that need addressing.

RBS's decision to undertake this Review was a brave approach to identifying the root causes of the mismatch between the bank's intentions and its actual ability to deliver. In order for this report to have credibility, RBS recognised the need for it to be carried out independently. RBS has been scrupulous in respecting this and I am grateful for the openness with which the bank has approached this exercise. In addition to many meetings with the Board and staff of the bank, in the field as well as head office, I have also met a wide variety of stakeholders. These include Government and Public Authorities, Business Associations and of course SMEs themselves and their representatives.

I hope that the Review and the recommendations we lay out will serve several purposes: making the public aware of the issues that RBS needs to address; illustrating the complexity of the task facing the bank and the many areas which have to be joined up coherently; and separating fact from fiction in the broader debate. RBS has much to do, and I hope that this Review will help them better achieve their goals.

There are also broader issues that need to be addressed which go beyond RBS and which I believe need to be tackled collectively by financial providers and the Authorities. The SME area is of such significance for the economy that it surprises me how little attention has been paid to rectifying some simple shortcomings that continue to hamper the sector: the inadequacy of comparative data; a lack of understanding about the suitability of different financial products; and the implications of new regulatory initiatives for lending. The UK Authorities should take the lead in putting in place the necessary mechanisms to address these shortcomings involving engagement between the Authorities and the industry. I hope they will.



Sir Andrew Large, Chairman, Independent Lending Review

## DOCUMENT STRUCTURE

This document details the findings, supporting evidence and key recommendations from the Independent Lending Review of RBS's lending standards and practices in the Small and Medium Enterprise (SME) market. It follows the Summary and Recommendations document which was published on 1<sup>st</sup> November 2013.

The structure of this document is as follows:

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## REPORT QUALIFICATIONS/ASSUMPTIONS & LIMITING CONDITIONS

**No liability shall be assumed to any third party in respect of this report or any actions taken or decisions made as a consequence of the results, advice or recommendations set forth herein.**

The opinions expressed herein are valid only for the purpose stated herein and as of the date hereof. This report does not provide an opinion regarding the fairness of any transaction to any party. Information furnished by others, upon which all or portions of this report are based, is believed to be reliable but has not been verified. No warranty is given as to the accuracy of such information. Public information and industry and statistical data are from sources that have been deemed to be reliable; however, no representation as to the accuracy or completeness of such information is given and such information has been accepted without further verification. No responsibility is taken for changes in market conditions or laws or regulations and no obligation is assumed to revise this report to reflect changes, events or conditions, which occur subsequent to the date hereof.

# 1. KEY MESSAGES

- RBS has succeeded in delivering a number of critical changes to its SME business since the onset of the crisis. It has re-balanced and stabilised the balance sheet, improved economic viability and invested in a platform to create sustainable growth for both RBS and its SME customers
- In contrast to 2008, RBS's profile is now consistent with that of a market leading SME business, whose share of lending is broadly in line with its share of customer relationships
- Nonetheless, for some time RBS has not succeeded in supporting the SME sector in a way that meets either its own financial targets, or the expectations of customers and external stakeholders:
  - RBS's market share of the stock of lending has fallen steeply from 2010 to today, and it will continue to fall below the levels expected given its share of customer relationships
  - Much of this decline is associated with the legacy of the 2008 crisis, which engulfed RBS, requiring the run off of unwanted assets regarded as "Non Core" to the continuing business, and a reduced concentration of lending to the Commercial Real Estate sector
  - However, RBS's share of the flow of gross new lending to industry sectors beyond Commercial Real Estate has also fallen steeply, and beyond the levels expected
- Furthermore, a perception has arisen among some SME customers that RBS is unwilling to lend. In fact, a recent survey showed that 30% of SMEs disagreed with the statement that RBS was "open for lending". There is a belief amongst some that RBS has been withdrawing support from existing customers and has become impersonal and unresponsive to their needs:
  - Other SMEs and commentators have made more extreme accusations about RBS's handling of relationships with customers (particularly with respect to customers facing difficulties or distress). The bad publicity this generates has the potential to damage RBS's reputation in the SME market
  - Stakeholders are confused as to how much RBS is actually lending, the reasons behind any changes in that amount, and whether those changes are a good or a bad thing
- RBS had, in fact, planned to grow volumes of SME lending in its ongoing or "Core" business from 2009. To achieve this it made the requisite capital available. However, the planned lending volumes were not met, resulting in under deployment of the capital set aside. In reality, these planned lending volumes were inconsistent with the bigger picture constraints and challenges to which the Group was subject. For example:
  - Concentration limits that, in particular, restricted Commercial Real Estate lending, as they led to the imposition of higher credit standards in this segment, which resulted in RBS turning away some lending to the sector which would otherwise be attractive
  - The necessity to focus on the amount and cost of funding resulted in:
    - Lending being given lower priority behind gathering deposits (and risk management) up until 2012
    - A shortening of the term of lending, which in turn has resulted in an increase in the proportional volume of repayments. This makes maintaining the stock of outstanding lending more difficult

- Internal upheavals were caused by the need to carve out the unwanted Non Core business as well as the business required to be divested by the European Commission (EC):
  - The consequent fragmentation of responsibility for the SME business has contributed to the difficulty that RBS has had in managing SME lending and also stakeholder expectations, as it made it difficult for outsiders to assess the performance of RBS's ongoing SME business
  - For example, it is unclear to stakeholders how much of the decline in RBS's SME lending is due to the objectives that have been set, the strategy deployed or the operations in place: these all differ across the ongoing Core SME business and other areas of the Group, such as the Non Core business, in which SME operations occur
- RBS faces a number of operational challenges, particularly in the initial interaction with customers looking to borrow. Although a significant falloff is to be expected, one in four SMEs that approach the ongoing business end up borrowing from it. This is marginally less than competitors achieve and primarily occurs before a formal lending application is made:
  - Lending standards are in line with the prudential standards set by the Regulators. However, risk aversion has been observed by both Relationship Managers who assemble applications on behalf of customers, and Credit Officers who sign-off on them, in the *application* of these standards. This means that otherwise acceptable lending opportunities are being missed
  - RBS's approach to business development is heavily reliant on Relationship Managers, who for various reasons are unable to devote sufficient time (and less than before 2008) to customers. Other factors affecting the productivity of staff in relation to lending volumes have included:
    - Credit skills of Relationship Managers, which had been neglected in the run up to 2008, are varied and in some instances still too low. This can leave good potential lending opportunities unfulfilled
    - Interaction of Relationship Managers and Credit Officers is often less than ideal
  - Productivity of customer facing staff is impacted by the time-consuming process for getting loans successfully approved:
    - Processes to achieve a lending decision are not user-friendly, and take longer to complete than those of competitors
    - Policies have been implemented in a way that some staff found difficult to understand
    - The ongoing SME business has had difficulty in finding the best way to deploy its people and investment budget so as to originate and win the lending opportunities that are available to it
- RBS also faces challenges in the way it addresses legacy issues from the crisis. For example, RBS has been active in renegotiating lending facilities with existing customers. RBS has also changed the way it manages its relationship with customers that it believes have shown signs of financial deterioration or distress. A small minority of customers who have experienced this have made serious allegations about the actions that RBS has taken. There is a risk that awareness of this will discourage some borrowers from approaching RBS to discuss new borrowing needs. It may also contribute to a perception that RBS is reluctant to lend despite its recent communication efforts
- RBS has started addressing a number of these issues, particularly as they relate to the ongoing SME business. They have been focusing on:
  - Building its business development capabilities
  - Simplifying and streamlining the framework by which lending decisions are shaped
  - Improving the skills of Relationship Managers
  - Stressing the overall primacy of the lending objectives

- The conclusion is that further progress is required for RBS to remove impediments to lending and better meet stakeholder expectations. Accordingly, nine initiatives are recommended which would help RBS meet its objectives in the SME market as well as customer and stakeholder expectations:
  - Two overarching recommendations to establish a coherent and realistic set of objectives for the SME business, with clear lines of responsibility for delivering them
  - One recommendation to instigate an inquiry into allegations about the way that RBS has treated customers in financial difficulty
  - Four recommendations for the ongoing SME business to improve the origination and conversion of lending opportunities
  - One recommendation to improve customer communication
  - One recommendation for the Authorities, including the Regulators, to work with providers of finance to establish an engagement process both to identify common problems related to financing SMEs and to develop solutions, an initiative in which RBS can play a leading role
- Finally, it is important that metrics and indicators are agreed to measure progress in achieving these improvements

## 2. REMIT AND APPROACH

### 2.1 REMIT

**The Chairman of RBS commissioned an Independent Lending Review of RBS's<sup>1</sup> lending standards and practices in the Small and Medium Enterprise (SME) market:** Two broad objectives were set for the Review, as per the Terms of Reference:<sup>2</sup>

- To identify steps that RBS can take to enhance its support to SMEs and the economic recovery whilst maintaining safe and sound lending practices
- To promote a common understanding of the way in which the bank makes its judgements and decisions on SME lending

**Consultation was a key element of the Review:** In undertaking the Review, a wide consultation process has been conducted so that views from inside and outside RBS are well represented. Every effort has been made to ensure that findings have an objective basis, and that conclusions are formed independently of RBS and other stakeholders.

**In light of the consultation, the remit of the Review has been restated as being to:**

- Deliver recommendations on how RBS could: increase support and lending to the SME sector in the UK while maintaining appropriate levels of prudence and conduct; improve the quality of both its strategic and operational decision making; and communicate better to stakeholders and customers regarding all of the above
- Deliver recommendations on how Government, Regulators and the commercial banking community can work together to meet the financing needs of SMEs better, given their importance to the economy in the UK, and thereby support economic recovery

**The Review has focused on SMEs with a turnover of £25 MM or less:** For the purposes of this review, an SME has been defined as a business with an annual turnover of £25 MM or less. This definition is in line with that used by the Bank of England (BoE) in its reporting on lending to SMEs, and is also consistent with RBS's internal definition and organisational structure.

No comment is made on specific competition issues in the Report.<sup>3</sup> However, these are referenced as part of an analysis of broader financing issues.

### 2.2 APPROACH

**Multiple information sources were used to inform the Review:** The findings and recommendations made within the Review have been underpinned by the development of a comprehensive evidence base. This has been supported by the delivery of 17 streams of work. These are described at a summary level in the below table, and in greater detail in Appendix D.

<sup>1</sup> For the purposes of this report, and unless otherwise stated, "RBS" includes the NatWest, Lombard, RBS and RBS Invoice Finance brands under which RBS lends to UK SMEs. Other RBS brands, such as Ulster Bank and Coutts, were excluded from the scope of this Review.

<sup>2</sup> The full Terms of Reference can be found in Appendix A.

<sup>3</sup> Competition issues in the SME banking market are currently being examined by the Office of Fair Trading

**Table 1: Workstreams undertaken as part of the Independent Lending Review<sup>4</sup>**

<b>Workblock</b>	<b>Workstream</b>	<b>Description of workstream</b>
Stakeholder consultation	SMEs	Consultation with existing, potential and former SME customers via public website, customer survey and supplementary case studies
	Market stakeholders	Interviews with key market stakeholders, including Government, Regulators and Business Associations
	RBS stakeholders	Interviews and consultation with RBS management and staff
Secondary research	SME surveys	Evaluation of third party SME surveys
	Additional research	Review of third party opinions and data, plus a detailed summary of the regulatory operating environment
SME lending volume analysis	Market data	Sizing of the overall SME lending market, exploring trends over time
	RBS data	Analysis of RBS's lending to UK SMEs, considered within the market context
Appeals and complaints	Appeals	Review of appeals processes and analysis of trends in number of customer appeals
	Complaints	Analysis of trends in volume and type of customer complaints
Credit standards	Policy review	Analysis of RBS's policy thresholds against both its existing loan book and a sample of recent applications
	Loan applications' review	Detailed review of sample of loan applications (referred to as "credit files")
Pricing and economics	Pricing	Analysis of RBS's pricing levels and processes
	Economics	Analysis of the profitability of SME lending for RBS and the market as a whole
Market affordability		Estimation of the level of bank debt that the SME sector can prudently support, based on an affordability analysis
RBS's strategic and operational decisions		Review of RBS's key strategic and operational decisions between 2008 and 2013, and the constraints within which they were taken
RBS's lending framework		Description of the framework that RBS uses to deploy credit to SMEs and manage existing customer relationships, including customers with deteriorating financial positions
The end-to-end lending process		Analysis of the four key stages of the lending process (Pre-contact; Initial engagement; Application, approval and appeal; Completion, contracting and draw down), comparing RBS against the market at each stage

**A wide consultation exercise has been conducted:** The Review has consulted widely so that views from outside of RBS are well represented. Perspectives have been gathered from customers and other market stakeholders with an interest in RBS's support of and lending to UK SMEs, in addition to seeking the views of the bank's staff and management. As well as speaking directly to representatives of each group, a consultation website was opened and surveys of both customers and staff were conducted. The Review has sought to separate "noise" from issues of substance, and to balance competing points of view, however strongly held.

<sup>4</sup> Please see Appendix D for further details.

**The basis for analysis of RBS’s market share is consistent with Bank of England and British Bankers’ Association reporting:** Analysis of RBS’s lending to SMEs in the UK presented in this Review covers all lending under the RBS, NatWest and Lombard brands, including both Core and Non Core assets.<sup>5,6</sup> Other RBS brands, such as Ulster Bank and Coutts, were excluded from the scope of this Review.<sup>7</sup> Assets transferred to the “Rainbow” divestment vehicle have been included as part of the Core assets in this analysis.<sup>8</sup> The Review’s assessment of RBS’s lending to SMEs is therefore broadly consistent with the data reported to external stakeholders (such as the Bank of England and British Bankers’ Association (BBA)) and with customer perceptions gathered by surveys (which are not generally aligned with the bank’s internal organisation and structure).

**The assessment of RBS’s practices has centred on “ongoing” SME lending businesses:** In the assessment of RBS’s priorities and the recommendations made, attention is focussed on RBS’s “ongoing” SME lending business, which is housed within the Business & Commercial Banking (B&C) unit. Specific assessments have not been made of the lending standards and practices in place within the divested Rainbow business, although the Rainbow business is included in the market share analysis, as outlined above.

**RBS data and information have been cross-checked to ensure accuracy and completeness:** Full access has been obtained to RBS information, employees and customers. Anonymised information received from the bank includes database records of the bank’s lending activities to SMEs since 2008 (including, for example, applications and complaints); documentation that communicates how the bank’s objectives, strategy and policies have evolved over time; and a sample of over 100 individual credit files that were selected independently by us.<sup>9</sup> The accuracy and completeness of data and information sources has been confirmed in Governance Committees specifically established for the Independent Lending Review. Multiple information sources have been used wherever possible (including market data from the BoE and BBA, industry surveys and third party reports) to ensure that there has not been an over-reliance on information received from RBS.

**A formal governance process was established:** A formal governance process was established to ensure that the Review was undertaken in accordance with the Terms of Reference, that data protection and customer confidentiality were enforced, and that competitively sensitive information was not cited. The key forums were (see Appendix B for further details):

- Senior Oversight Committee: Chaired by Sir Andrew Large, with the remit of monitoring the Review’s progress against its Terms of Reference, addressing any issues arising, overseeing the processes used to execute the Review, ensuring data protection and customer privacy, and reviewing the final report
- Technical Advisory Group: Chaired by the Chief Risk Officer (CRO) of the Corporate Banking Division (CBD), it was established to provide a forum for structured RBS input as to accuracy and context whilst maintaining the Review’s independence, to assist the Review team in acquiring any relevant information, and to ensure the appropriate treatment and interpretation of such information

<sup>5</sup> RBS Invoice Finance has not been included in market share analysis because it is not comparable with market SME data reporting definitions (e.g. the Bank of England).

<sup>6</sup> Assets can be interpreted here as the money that a bank is owed. For example, when a bank advances funds to customers (i.e. lends them money), this loan or overdraft is an asset on the bank’s balance sheet.

<sup>7</sup> The full terms of Reference can be found in Appendix A.

<sup>8</sup> See Table 2 for a description of the key RBS organisational structures for SME lending.

<sup>9</sup> See Appendix C and Appendix D for a comprehensive list of the information used.

## 2.3 REPORT STRUCTURE

The remainder of the report is structured into five major sections.

**Section 3 provides context on the UK SME market and outlines the general issues relating to SME financing in the UK:** Section 3.1 recognises the importance of SMEs to the UK economy, and the key areas that invite controversy. This is set in the context of observed trends in lending to SMEs over time, including the impact of the financial crisis. In Section 3.2, the root causes of general SME market issues are examined.

**Section 4 assesses the overall level of lending and support that RBS has offered to UK SMEs:** Section 4.1 outlines the key trends in RBS's lending to SMEs since 2008. Section 4.2 describes the objectives that the bank set itself in 2009. Section 4.3 then details outcomes that RBS has achieved post crisis in the context of these objectives, and conclusions are drawn as to how successful or not RBS has been in meeting these objectives.

**Section 5 lays out the results of the in-depth diagnosis:** This diagnosis focusses on the key issues that have impacted RBS's efforts to lend to and support UK SMEs, and the extent to which they have already been addressed. This comprehensive analysis covers multiple dimensions: objectives and standards; organisation; strategy and business model; people; process (including business development, lending, and managing customer relationships); and communication. Conclusions are drawn about the root causes of the issues that RBS faces, based on the evidence available.

**Section 6 makes a series of recommendations for RBS:** The recommendations made draw upon the findings and conclusions of the diagnosis in Sections 4 and 5. Nine initiatives are recommended which would help RBS meet its objectives in the SME market as well as customer and stakeholder expectations.

**Section 7 offers perspectives on how to assess the success of the initiatives once implemented:** In Section 7, perspectives are offered both in terms of how to judge RBS's lending to SMEs, as well as indicators that the industry as a whole is moving to meet the needs of SMEs better.

To facilitate reading of this document, a high-level description of the activities of the key RBS divisions, business units and sub-units which serve SMEs is outlined in the table below.

**Table 2: Description of key RBS organisational structures for SME lending, demonstrating degree of fragmentation**

	<b>Business Area</b>	<b>Description</b>	<b>Core or Non Core</b>	<b>Retained or Divested</b>	<b>Designated profit centre</b>	<b>Reports to</b>	<b>Role in RBS's SME banking business</b>
Core ongoing SME business	Corporate Banking Division (CBD)	Manages Business & Commercial Banking (B&C), Corporate & Institutional Banking (CIB), and Customer Solutions Group (CSG)	Core	Retained	CBD	CEO	This is the Division responsible for UK Corporate Banking and UK SME Banking. It includes two of the core ongoing areas of UK SME activity namely Business & Commercial Banking and Customer Solutions Group
	Business & Commercial (B&C)	Segmented into three separate sub-units: Business Banking (BB) (<£2 MM turnover SMEs), Commercial Banking (CB) (£2–25 MM turnover SMEs) and Specialised Relationship Management (SRM) B&C maintains teams of Real Estate Finance (REF) specialists dedicated to the Commercial Real Estate (CRE) sector	Core	Retained	B&C	CBD	Provision of RBS's primary services to SME relationships, via current accounts, deposit taking and lending products B&C is the "engine" of future SME growth and the major part of the SME relationship banking business that RBS has retained
	Specialised Relationship Management	Sub-unit within B&C tasked to support customers that are starting to have financial or trading difficulties	Core	Retained	B&C	B&C	Early stage management of SME customers experiencing difficult trading conditions, with no mandate to restructure lending contracts or recover on underlying assets
	Customer Solutions Group (CSG)	Comprises Lombard (Asset Finance), RBS Invoice Finance (RBSIF), Transaction Services and Mentor (SME Advisory)	Core	Retained	CSG	CBD	Provision of specific services to SME customer relationships (including invoice financing and asset based lending)
Other businesses with SME activities	Non Core Division (NCD)	Created in 2009 to rebalance RBS Group's risk profile post crisis and enable clean implementation of its strategy for the ongoing Core business At inception, it comprised distressed assets and those considered to be the most unattractively priced (predominantly Real Estate Finance)	Non Core	Retained	NCD	Head of Restructuring and Risk	Run off SME lending assets not considered part of Core book The Non Core Division has responsibility for assets, rather than customer relationships
	Global Restructuring Group (GRG)	Manages business customers in financial distress (of >£1 MM turnover) from across RBS Group, including CIB, B&C and CSG customers	Both	Both	Internal P&L <sup>10</sup>	Head of Restructuring and Risk	Manage distressed SME customers, with a mandate both to (where possible) turnaround SMEs back to B&C "Mainstream" (via restructuring of lending contracts) and protect shareholder value through the recovery of underlying assets
	Rainbow (Divestment)	Business to be divested under EC mandate, based on Williams & Glynn network	Core	Divested	CBD	CEO	Full provision of Rainbow's primary services to SME relationships
	Ulster Bank	Retail and corporate bank serving customers in Republic of Ireland (ROI) and Northern Ireland (NI) Operates as separate legal entity within RBS Group	Both	Retained	Ulster Bank	CEO	Ulster Bank Corporate Markets division serves banking needs of SME and corporate customers Ulster Bank is out of scope of this Review

<sup>10</sup> Assets and income managed by GRG remain on the balance sheet and P&L of the originating unit. The GRG P&L is constructed on the basis of Management Information.

# 3. ANALYSIS OF GENERAL SME FINANCING ISSUES AND THEIR ROOT CAUSES

## 3.1 SME MARKET CONTEXT

**SMEs are important to the economy:** The success of the SME sector is important to all developed economies. In the UK, SMEs account for approximately 60% of private sector employment and 50% of private sector turnover.<sup>11</sup> A healthy and vibrant SME sector has a major contribution to play in supporting high, sustainable growth within a domestic economy, including fostering innovation and introducing new techniques.

**UK SMEs remain dependent upon banks for the majority of their external financing:** SMEs require multiple forms of financing. In most developed economies, bank lending remains the most important component of debt financing for the SME sector. In the UK, despite recent growth by non-bank financing providers such as lessors, invoice discounters, and peer-to-peer lenders, SMEs rely on banks for 80% of all credit.<sup>12</sup>

**Bank lending to SMEs has long been an important area for policy makers...:** The issue of how best to finance SMEs, and the question of what role banks should play in this, is not new. Following the recession in the early 1990's, the Bank of England explicitly monitored this area, issuing an annual report between 1993 and 2004 entitled "Finance for Small Firms". In the last of these, the BoE noted that "a strong relationship between small firms and finance providers is an essential ingredient for promoting enterprise and growth. To innovate and expand, small firms depend upon reliable access to external finance. Ensuring that there is an efficient intermediation of funds to small firms, based on a good understanding of risks and returns, is thus an important public policy objective".<sup>13</sup>

**...But many key issues remain unresolved, and continue to invite controversy:** Since the most recent financial crisis began in late 2008, overall bank lending to UK SMEs has declined by nearly a quarter from its peak. As shown below, banks were previously lending more than was prudent to SMEs, but are now lending too little. This dramatic reversal in lending volumes not only disappoints potential borrowers, but also many politicians and commentators who hope that a resurgent SME sector will promote economic growth and employment. SMEs regularly voice their dissatisfaction and have lost some of their trust with the banks. Many stakeholders have concluded that the banking system has failed to deliver.

**Pre-crisis practices created unrealistic expectations amongst SMEs:** In the run up to the financial crisis, the distinction between the need for equity versus debt financing became blurred. Banks lent without sufficient discipline, and SMEs were able to borrow cheaply and easily instead of raising equity. This was particularly true for lending to the Commercial Real Estate sector, and for lending secured by property. Much necessary change has taken place to address these issues. However, the experience and perceptions of SMEs have yet to catch up, and the resulting mismatch of expectations between SMEs and banks is a cause of confusion and controversy often reflected in the public commentaries on the issue.

**Bank lending to UK SMEs grew rapidly in the five years preceding the financial crisis of 2008...:** According to the Bank of England, the stock of bank lending<sup>14</sup> to all UK businesses (including both SMEs and corporates<sup>15</sup>) doubled from ~£330 BN in Q2 2004 to a peak of ~£660 BN in Q2 2009. Although comprehensive datasets focused specifically on the SME lending market were not available before June 2011, analysis undertaken as part of this Review suggests that the total stock of bank lending to UK SMEs peaked at ~£220 BN in Q1 2009.

<sup>11</sup> Department for Business Innovation & Skills, Business Population Estimates (BPE) for the UK and Regions 2012, October 2012.

<sup>12</sup> The Confederation of British Industry, Ripe for the picking: a guide to alternative sources of finance, 2013.

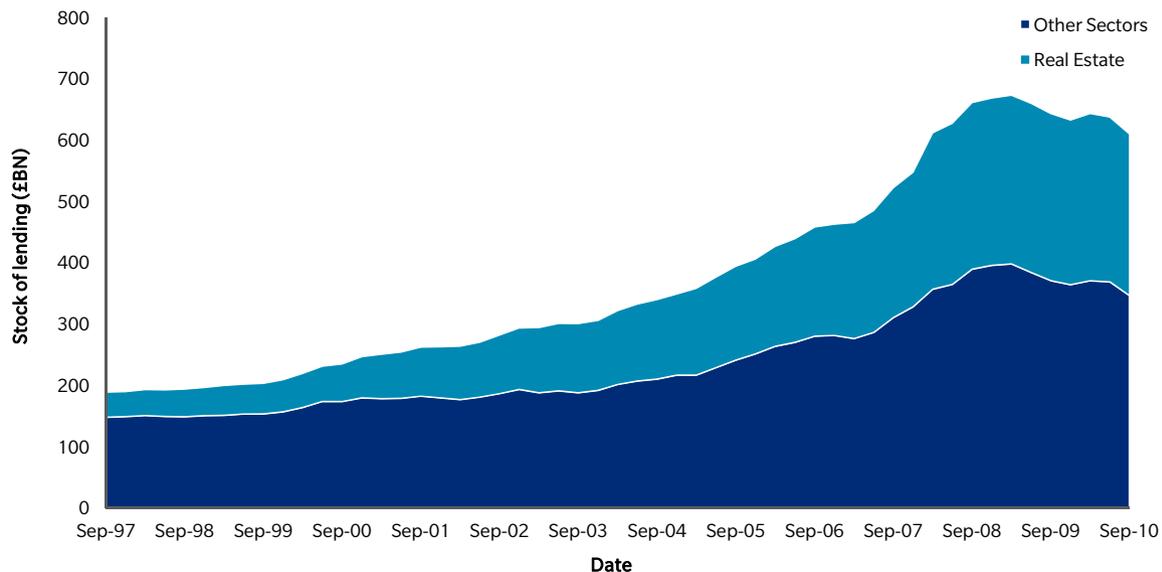
<sup>13</sup> Bank of England, Finance for Small Firms – An Eleventh Report, April 2004.

<sup>14</sup> The "stock" of bank lending is a measure of its outstanding balances (i.e. total lending). See Box 4 for further explanation.

<sup>15</sup> SMEs are defined in this Report as businesses with an annual turnover of up to £25 MM. Corporates represent businesses with a turnover of greater than £25 MM.

**...Fuelled by an abundance of cheap wholesale funding:** The major UK banks competed heavily with both foreign banks and non-bank financial institutions to lend to SMEs in the period between 2004 and 2009. The abundance of cheap wholesale funding meant that financial institutions were able to grow their balance sheets rapidly, subject to the regulatory constraints in place at the time. Margins were depressed further and credit standards were loosened as competition amongst lenders increased.

**Figure 1: Stock of lending to UK companies, September 1997 – September 2010**



Source: Bank of England

1. Measurement of the quarterly amounts outstanding of UK resident monetary financial institutions' sterling net lending
2. Includes lending to both SMEs and larger corporates
3. Real Estate represents those companies undertaking the buying, selling and renting of real estate, and construction companies
4. Companies in insurance, pension funds and financial intermediaries, and individuals and unit trusts have been excluded

**Lending to the Commercial Real Estate sector was the major driver of growth of bank balance sheets...:**

Figure 1 shows that, by 2009, approximately 40% of the stock of lending<sup>16</sup> held by the Major British Banking Groups (MBBG)<sup>17</sup> to UK SMEs and corporates was to the Commercial Real Estate sector. Most of the Commercial Real Estate lending (particularly in the corporate sector) was to professional real estate developers and investors, whose business is based on building, buying, managing or selling income-producing real estate.

**...But property was often also at the heart of lending to non-real estate companies in the SME sector:** With the cost of borrowing held low, many SME customers began to use debt rather than equity to finance their business plans. Property held on or off the balance sheet was often used as collateral on the basis of rising property prices. The property used as collateral was often central to the activities of the SME (for example, owner-occupied factory or office space). However in some cases, SME business owners were tempted to speculate on the property market *per se*, effectively diversifying into property development or investment.

**Banks were lending too much to SMEs in 2007–9...:** It is estimated that the market peak in the total stock of bank lending to UK SMEs in Q2 2009 exceeded the levels of lending which prudently should have been in place by ~£25–30 BN (down from an excess of ~£50–60 BN in 2007, before the fall in base rates). From post-crisis events, it is now clear that much of this over-lending was driven by lax credit standards and pricing that did not sufficiently reflect the risks being faced, particularly in relation to the Commercial Real Estate sector. Since 2009

<sup>16</sup> See Box 4 for explanation of the difference between lending stocks and flows.

<sup>17</sup> The Major British Banking Groups comprise the banking groups of Abbey, Alliance & Leicester, Barclays, Bradford & Bingley, HBOS, HSBC Bank, Lloyds TSB, Northern Rock and The Royal Bank of Scotland.

Regulatory Authorities<sup>18</sup> have required banks to raise prudential standards to enhance financial stability.<sup>19</sup> These result in stricter lending criteria for both new and existing SME borrowers.

**...But banks are now not lending enough to SMEs:** Since this peak in lending, the total stock of bank lending to SMEs has declined 23% to £170 BN. Most (although not all) banks have seen their stock of lending fall, and several smaller and foreign banks have exited the market entirely. As a result, the share of the stock of bank lending held by the major high street banks has increased. It is estimated the total stock of bank lending is now ~£30–35 BN below a prudent level. This is due to the continuing and extended period of very low base rates, which increases the amount of bank debt that the SME sector can prudently support at a time when the total stock of bank lending has fallen. See Box 1 for further details.

### Box 1: Market affordability of SME debt

Not only did banks lend aggressively to SMEs in the run up to the crisis, but they have also cut back significantly on new lending to SMEs since the crisis, reducing their total stock of lending to the sector. Given this boom and bust cycle, it is difficult to say whether the bank sector is over-lending or under-lending at any given time. How much bank lending would constitute a sustainable, or sensible, amount for both banks and SMEs?

Prudent lending to a business depends on three factors:

- *Affordability:* banks require SMEs to have the cashflow or other sources of funds sufficient to meet regular contractual repayments of interest and principal, taking into account future changes to key parameters, including base rates
- *Leverage:* banks want owners to have enough equity in their business to bear the risks inherent in their business and weather difficult trading periods without creditors suffering losses
- *Collateral:* banks seek to mitigate their own risk by securing a claim on the business's tangible and intangible assets which, in the case of SMEs, is often property

Of these, affordability is of primary importance, and is a point of focus for both the prudential and conduct authorities in their oversight of the industry.

During a downturn, not only are a firm's assets likely to lose value, thereby worsening its leverage and collateral positions, but also its cashflow may be reduced or at least become more uncertain. In short, a prudent business should aim to borrow less during a downturn, to reflect its own weakened financial position.

Equally, the amount that a bank charges an SME borrower for its loans should be a function of base rates (and expectations of future base rate changes), the cost of funding for the bank, the expected loss on the loan, the operational cost of selling and servicing it and the cost of the capital employed to make the loan. All of these factors also vary over time, affecting the cost of borrowing for the SME.

Typically, for example, central banks lower base rates in a downturn (as the Bank of England did aggressively in 2008–09) and this in turn lowers the cost of borrowing for the SME. This makes borrowing more affordable, offsetting the effect that the downturn might have had on a borrower's own cashflow.

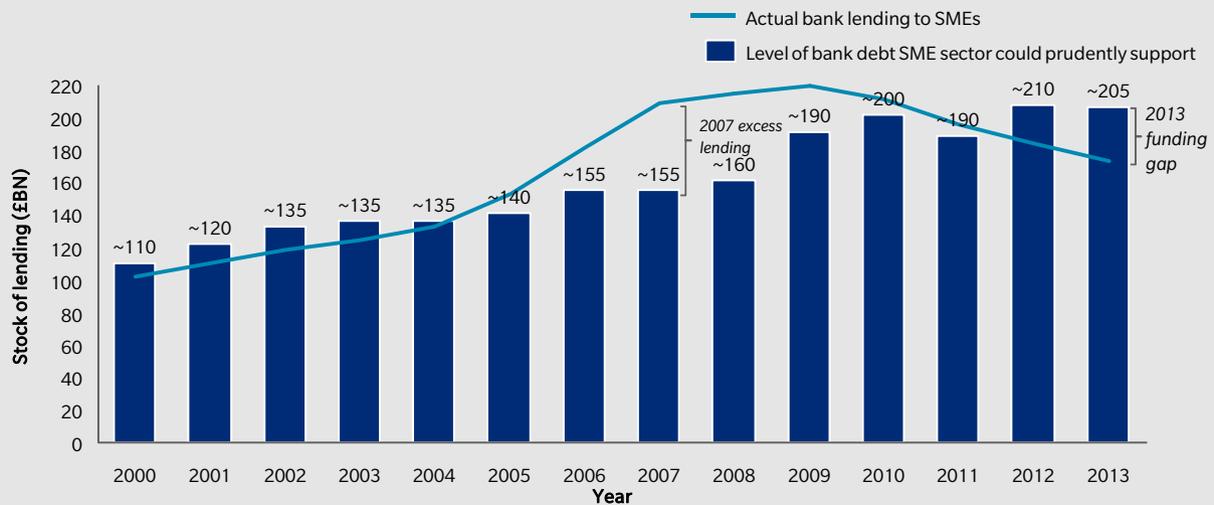
<sup>18</sup> The Financial Services Authority (FSA), pre-April 2013, and since April 2013 the Prudential Regulation Authority (PRA).

<sup>19</sup> In addition Regulators have increased standards relating to conduct to improve customer outcomes (pre-April 2013, the FSA, and since April 2013, the Financial Conduct Authority (FCA)).

Both the cashflow available to the SME sector and the cost of borrowing can be modelled, at an aggregate level, over time. In combination, these two elements can be used to calculate the *maximum* amount of bank debt that the SME sector could prudently support at a given price. This calculation takes into account the potential for base rates to rise in the future at any point in time. It does so by assuming both that only two thirds of the available cashflow is used to service debt repayments and that those debt repayments include a 3% price “buffer” on top of current base rates.

When the results of this calculation are compared to the *actual* amount of bank debt that the SME sector has historically borrowed over time, it is clear that actual borrowing fluctuates at around 50% of the sector’s maximum capacity to borrow. Indeed, the amount borrowed by the sector in 2003–04 (i.e. just before the boom started) was around 50% of its maximum capacity. It is therefore assumed that if the SME sector is borrowing up to 50% of its maximum capacity, it is borrowing prudently and sustainably.

**Figure 2: Estimated UK SME debt capacity compared with actual bank lending to UK SMEs, 2000–2013**



Source: Department for Business Innovation & Skills; Bank of England; British Bankers’ Association; Orbis; Oliver Wyman analysis  
 1. SME lending stocks are extrapolated backwards from 2011 using a range of sources including BBA Small Business Survey data, and BoE PNFC data, due to a lack of published data  
 2. Stocks are measured as yearly averages  
 3. Level of bank debt that total market could prudently support is based on Debt Service Cover (by Net Cash Flows) of 1.5, and pricing at economic cost

Using this model, it is estimated that in 2007 the amount being lent to SMEs exceeded their capacity to support that debt sustainably by ~£50–60 BN, and that falling interest rates in 2009 (which increase borrowers’ capacity) reduced this excess lending to ~£25–30 BN. Using the same model, it is estimated that the contraction in bank lending since 2009 has overshot: aggregate bank lending to SMEs is now ~£30–35 BN below the capacity for debt that SMEs could support sustainably.

**Banks have also evolved the SME service model:** In conjunction with decreased lending volumes, banks have continued to evolve the service model used to meet SME demand. In order to reduce costs post crisis, banks have generally shifted away from a Relationship Management model for all business customers, towards more centralised coverage for certain customer groups. Whilst this is a continuation of a trend that has been occurring for the past 20 years, it has still left a number of SMEs with a perceived “service deficit”.

**As a result of these market changes, there are three overarching themes of discontent apparent within the SME sector:** The consultation exercise highlighted three themes of discontent from SMEs. First, there is a perception that banks are not willing to lend to SMEs seeking finance. Second, some customers believe that banks are not maintaining support for their existing borrowers. Third, there is general dissatisfaction with the way that banks serve SME customers, with a perceived depersonalisation of service and disengagement from the needs of customers.

## 3.2 ROOT CAUSES

**There are many factors which affect overall market trends in lending to SMEs:** There are many reasons why the overall amount of bank lending to the SME market might have undershot best estimates of SMEs' ability to borrow sustainably. Some of these factors are idiosyncratic: they relate to the particular situation of individual lenders, and are therefore within the control of those lenders. Section 5 explores the factors which are specific to RBS. Other factors are common to all lenders, and are not within the control of any individual institution.

**Demand has been lower relative to the past due to SME caution and lack of confidence:** *Demand* for financing from SMEs is affected, among other things, by the state of the macro-economic environment, the amount of spare production capacity that SMEs are able to draw on, their confidence to invest in further productive capacity and their willingness to take on debt to finance that investment. Given recent improvements in the economic landscape, there is reason to believe that demand may increase.

**Supply is also constrained as a result of the current market structure:** The finance industry's *supply* of financing to SMEs is influenced by the amount of capital that Regulators and markets require banks to hold against SME lending, the cost at which banks can borrow, the competitive structure of the SME banking market which sets the margins and the availability of alternative sources of external finance for SMEs, including equity.

**There are three critical supply-side issues that are common to the industry and require attention:** This Report does not attempt to weigh the relative importance of these different determinants of demand and supply against one another. However, the following important supply-side issues are common to all involved in the financing of SMEs:

- The understanding, awareness and availability of alternative finance
- The impact of regulation on lending volumes
- The availability and quality of SME data

**A new approach to tackling these three issues is required:** Initiatives such as the Government's Business Bank go some way towards recognising their importance, and have started to take steps to tackle areas of market failure. In particular, the Business Bank is playing a leading role in supporting the development of the alternative finance market, bringing together the management of the Government's existing business finance schemes, and looking to increase awareness of the support and advice available to those needing specialist support. However, a more inclusive engagement approach is required, involving the different stakeholders with an interest in the SME market, aimed at identifying and resolving common issues. *See Recommendation 9 (Section 6) for a recommendation for the Authorities and providers of finance to resolve these issues.*

### 3.2.1 UNDERSTANDING, AWARENESS AND AVAILABILITY OF ALTERNATIVE FINANCE

**The financing needs of the SME sector are extremely diverse...:** SMEs are a very disparate population, ranging from "micro" firms offering a single product or service in a local area to relatively large businesses, serving a broad and diversified customer base. Established SMEs have a track record of success, but the approximately 500,000 businesses which start-up each year<sup>20</sup> do not. Some are looking to finance growth, others are seeking working capital. As a result, the range of financing needs within the SME sector is extremely diverse.

<sup>20</sup> Companies House (Department for Business, Innovation & Skills), Statistical tables on companies' registration activities, 2013.

**...And bank debt is often not the ideal source of finance:** It is difficult for banks to prudently and economically satisfy such a varied set of financing needs. To be prudent, banks must be primarily lenders of senior debt: as regulated entities, the vast majority of the assets on their balance sheets must be low risk. To be economic, banks must find ways to achieve economies of scale and scope given the diversity of service, risk and product requirements across the SME sector. The result is that banks can only be expected to satisfy one area of the financing needs of SMEs because bank debt is not always the most appropriate financing mechanism.

**There is insufficient understanding amongst SMEs of the types of finance they may require:** Complaints about banks' reluctance to lend are, to some extent, a result of the general lack of recognition that start-up, high risk or high growth firms, with their uncertain future cash-flows, are often not well suited to senior bank debt financing. This is in part a result of the expectations that were set in the pre-crisis period, when banks lent without sufficient discipline. It is also in part caused by the limited educational support available on this topic. Some individual organisations (such as the Confederation of British Industry (CBI), with their publication "Ripe for the picking: a guide to alternative sources of finance") have begun to provide educational support on this issue. However, there are no commonly agreed goals or standards across the industry. For example, the level of working capital that a business should hold is one of the most important strategic decisions that the owner of an SME has to make (see Box 2), and yet there is little guidance available to SMEs in this regard.

**There is insufficient awareness amongst SMEs of the potential providers of alternative finance:** Data from the SME Finance Monitor suggests that less than a fifth of SMEs surveyed were aware of the taskforce banks' initiatives to improve access to alternative providers of finance (such as Asset based Finance, Business Angel Finance or Community Development Finance). Furthermore, only approximately one quarter were aware of each of the government-sponsored lending schemes such as the Funding for Lending Scheme (FLS) and the Enterprise Finance Guarantee (EFG).<sup>21</sup> Such limited awareness of potential alternatives to traditional bank lending is a key driver of imperfect financing outcomes for the SME sector. *Recommendation 9 (see Section 6) aims to address this issue.*

**There is insufficient availability of non-bank sources of SME finance in the UK market:** Beyond awareness of alternative providers of finance, the *availability* of alternative finance is also an issue. For example, the CBI estimate that just 3% of UK SMEs use equity finance, below the EU average of 7% and much less significant than in countries like Denmark and Sweden, where equity investment accounts for 46% and 31% of SME financing respectively.<sup>22</sup> Banks do provide some sources of alternative finance (e.g. RBS provide leasing, invoice financing and trade finance products), but in general provide limited non-senior debt finance. For example, RBS does not provide equity or other non-senior debt finance to SME customers, other than in specific circumstances for financially distressed customers.

## **Box 2: Debt or equity finance?**

Many forms of finance can be relevant for SMEs. In the broadest terms, SMEs can access two key sources of business finance: debt or equity.

Debt finance requires a steady income stream to meet interest payments, and often requires "collateral" to be provided, against which the loan is secured. Providers of debt financing face a risk that borrowers will not pay them back in full. If borrowers do pay them back in full, they receive a fixed return as agreed at the outset of the loan, with no further upside from outperformance. Providers of debt finance are therefore only willing to bear a certain level of risk when financing businesses.

<sup>21</sup> SME Finance Monitor, YEQ2 2013 National Survey, August 2013.

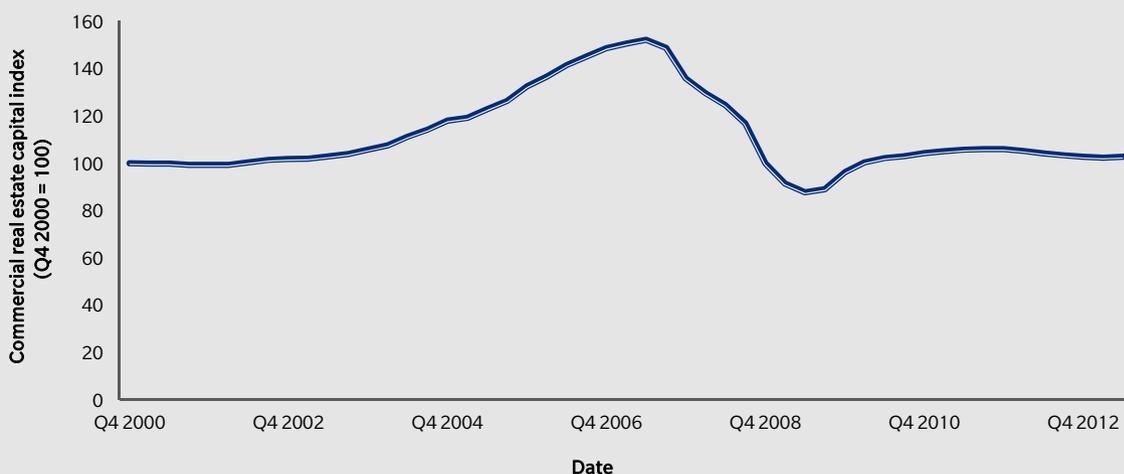
<sup>22</sup> The Confederation of British Industry, Ripe for the picking: a guide to alternative sources of finance, 2013.

Equity finance does not demand the meeting of regular interest repayments. Equity investors are instead exposed to potential open-ended capital growth (i.e. they have unlimited upside potential, unlike a debt financier), but may equally lose some, or all, of their investment. Equity finance is therefore better suited to higher risk situations.

Businesses with limited certainty over future cashflow or short or non-existent track-records of delivering profits typically carry more risk (particularly if they have no assets to offer as security) and therefore are less suited to high levels of debt financing. However, even businesses that have a good track record may not be as suited to debt finance as they may think.

For example, in the run-up to the recent financial crisis, rising property prices were used to justify high levels of debt where an injection of equity would often have been more appropriate. The collapse of Commercial Real Estate capital values, particularly outside London and the South East of England, has wiped out much of the equity that was on SME balance sheets pre crisis. Many SMEs who borrowed against properties valued at the peak of the market have found themselves with loans that they are struggling to refinance, as the value of the property has decreased so much. Banks are no longer prepared to finance at high Loan To Value (LTV) ratios, and expectations of SMEs therefore need to be re-set.

**Figure 3: Commercial Real Estate capital growth index, Q4 2000–Q2 2013**



Source: UK IPD Quarterly Portfolio Capital Growth Index – All Property  
1. Data is not seasonally adjusted

Working capital provides another good example. For the purposes of this Report, working capital is defined as equity used to finance the operational needs of the business. The level of working capital that a firm holds is one of the most important strategic decisions that it has to make. SME owners that invest equity into their businesses to cover seasonal peaks and troughs can be more confident that the business will survive, as the business will not have any problems with liquidity. However, this safety comes at a cost: short term borrowing would normally be cheaper than the “cost” of equity to fund the troughs.

Banks looking to lend prudently, as well as SME owners looking to borrow prudently, should do so with a full understanding of the risks and trade-offs such as those outlined above. This requires a higher quality dialogue between the lender and borrower than that which has been the norm in the market to date.

### 3.2.2 IMPACT OF REGULATION ON LENDING VOLUMES

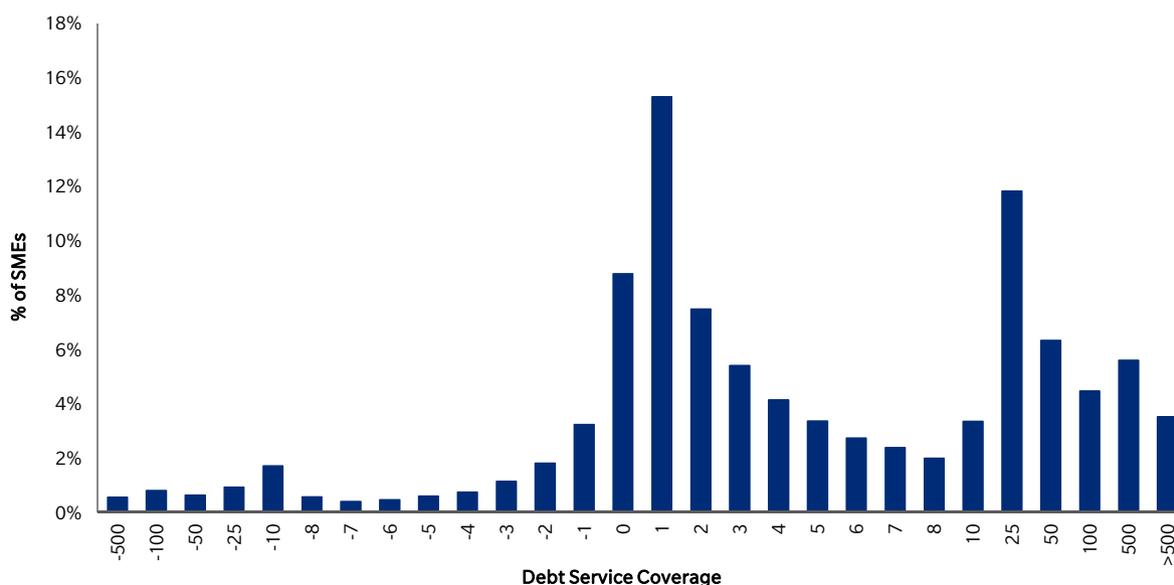
**The amount that banks can sustainably lend is a function of how affordable that lending is:** The Review uses its affordability analysis (see Box 1) to assess the extent to which actual bank lending exceeds or falls short of the amount that the SME sector can sustainably *afford* to borrow. To assess affordability, the analysis uses assumptions for both the cost of borrowing and for the average Debt Service Coverage (DSC) ratio which the sector maintains.

**An increase in the average Debt Service Coverage ratio required by banks reduces the capacity of the SME sector to borrow...:** Debt Service Coverage is the ratio between a business’s cashflow and its debt repayments (comprising both interest and capital), and is therefore a measure of affordability. A Debt Service Coverage ratio of 1.0x means that all of the business’s cashflow is being used to support debt repayments. A coverage ratio of 2.0x means that only half of the business’s cashflow is being used to support debt repayments. Consequently, if banks were to become more prudent in their lending, requiring SMEs to demonstrate a higher Debt Service Coverage ratio, then – assuming a fixed amount of cashflow – the capacity of the SME sector to borrow will reduce.

**...And an increase in the cost of borrowing also reduces the capacity of the SME sector to borrow:** Similarly, if banks were to increase the average price being charged for lending to SMEs (for example, as a result of increase in base rates), then debt repayments made by the SMEs will also increase. Again assuming a fixed amount of cashflow, then either the Debt Service Coverage ratio will be reduced or the absolute amount debt being serviced will need to fall to maintain a stable Debt Service Coverage ratio.

**Today, returns on capital for lending to SMEs are below “hurdle” and DSC ratios are relatively low...:** Borrowing is clearly more affordable for SMEs today than it was pre-crisis. This is a primarily because of the historically low level of base rates. However, banks have yet to fully re-price their lending to SMEs to reflect the increases in their own capital and funding costs, and are therefore not making a “hurdle” return on capital (the return expected by shareholders) from lending to SMEs. It is estimated that lending to SMEs currently generates an average return on capital of 3-7% for the banking industry (see Box 3). At the same time, it is estimated that nearly half of all SME borrowers today have low or negative Debt Service Coverage ratios (see Figure 4 below).

**Figure 4: Distribution of Debt Service Coverage ratios for the SME sector**



Source: Orbis; RBS internal data; Oliver Wyman analysis

1. Based on data for ~75,000 UK firms with turnover <£25MM

2. Debt Service Cover calculated using Net Cash Flows and typical facility price

3. Net Cash Flow and loan size obtained from Orbis; maturity based on RBS portfolio average given business unit and sector

**...And it is reasonable to expect regulation to encourage banks to increase both average prices and DSC ratios over time:** Today's pricing for SME lending and DSC ratios of borrowers across the SME sector may not be sufficient to meet the prudential and conduct standards that regulators expect banks to be lending against. Since the crisis, Regulators have increased prudential and conduct standards to enhance financial stability and improve customer outcomes. These are desirable objectives. As a result, it is reasonable to expect that banks will therefore need to apply stricter affordability criteria than they do today in order to meet those standards. Prudential regulators will want to be assured that the price charged by banks for lending provides a hurdle return on capital, to ensure long term viability of the business. Conduct regulators will also want to see hurdle returns on lending, to ensure that lending is not cross-subsidised by other products (thereby impeding healthy competition). They will also want to be reassured that the Debt Service Coverage ratios applied by the industry mean that those prices remain affordable by SME borrowers. For these reasons, other things being equal, it is anticipated that a higher level of prudence being demanded by supervisors will lead to a reduction in the capacity of the SME sector to borrow.

**Stricter affordability criteria would reduce the capacity of SMEs to borrow, and impact lending volumes:**

The affordability analysis set out in Box 1 was undertaken on the basis that banks lent to SMEs with a Debt Service Coverage ratio of 1.5x (i.e. two thirds of SME cashflow is used to service debt repayments). The analysis also assumed that the cost of borrowing for SMEs reflected a price for debt which gave the lending banks a hurdle return on capital. Figure 5 below shows how the results of the analysis would change if different assumptions are used. For example, if banks were to apply *less* prudent standards and lent to SMEs with an average Debt Service Coverage ratio of 1.0x (rather than 1.5x), and priced below the cost of capital (rather than at the cost of capital), it is estimated that SME capacity to borrow would increase by ~10% (or ~£25 BN). Equally, if banks were to apply *more* prudent standards and lent to SMEs with an average Debt Service Coverage ratio of 2.0x pricing to provide a hurdle return on capital, it is estimated that the capacity of the SME sector to borrow would reduce by ~5% (or ~£10BN).

**Figure 5: Impact affordability criteria on SME capacity to borrow, 2013**

*Estimated debt capacity (£ BN) under different price and Debt Service Coverage assumptions*

		Debt Service Coverage (based on Net Cash Flow)		
		1x	1.5x	2x
Increase in cost of borrowing	-1.5%	~230	~220	~205
	0%	~220	~205 <sup>1</sup>	~195
	1.5%	~205	~195	~185

Key	
	Less prudent: Actual prices and Debt Service Coverage = 1
	More prudent: Pricing at economic cost and Debt Service Coverage = 1.5

Source: Department for Business Innovation & Skills; Bank of England; British Bankers' Association; Orbis; Oliver Wyman analysis  
 1. Base case represents a prudent debt capacity under which the price of lending reflects the full cost of its provision, and companies take on debt at a Debt Service Coverage of 1.5

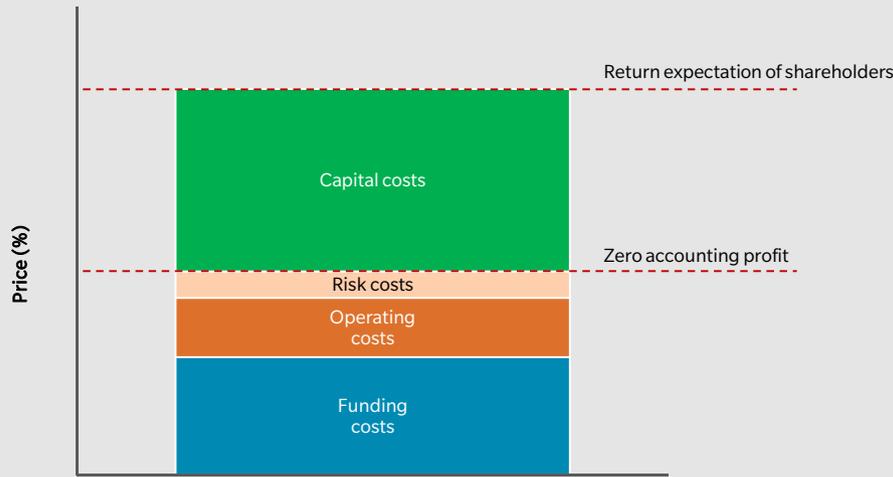
**The impact of regulation on the affordability of SME borrowing (and therefore the sector's capacity to borrow) is not yet well understood:** To date, the focus of the public debate has been on the ability of banks to lend prudently, given the need to have sufficient capital available under the new rules to support lending to the SME sector. The capacity of the SME sector to borrow on a sustainable basis has received less attention, despite being an obvious constraint on how much banks should lend, despite having direct links to the price at which banks supply debt (i.e. the cost of borrowing) and the discipline with which affordability is assessed. See *Recommendation 9 (Section 6) for a recommendation for the Authorities and providers of finance to resolve this issue.*

### Box 3: Economics of SME lending

This box examines the economics (i.e. profitability) of lending to SMEs by banks. SME lending is considered here as a standalone product, and the analysis does not include returns earned on the provision of other products to SMEs (such as deposits and transaction services). For simplicity of explanation, “traditional” variable rate lending at a margin over BoE base rate<sup>23</sup> is used as a general illustration for the overall economics of SME lending<sup>24</sup>.

Broadly speaking, the cost of borrowing for SMEs (i.e. the interest rate charged by the bank) reflects four components that banks take into consideration when setting their prices.<sup>25</sup>

**Figure 6: Illustrative breakdown of the cost of borrowing for SMEs, 2013**



Source: Bank of England *Trends in Lending*; Orbis; Oliver Wyman analysis  
1. Indicative economic cost for new variable rate loans originated in 2013  
2. Bank of England base rate is not included in the funding cost

1. **Funding costs:** The incremental cost (over base rate) to a bank of securing the funds that can then be lent to SME customers. Banks obtain funds from a range of different sources, including deposits from customers and debt from wholesale markets
2. **Operating costs:** The operating cost associated with supplying, servicing and managing a bank’s lending to SMEs (e.g. salaries, branches and IT systems)
3. **Risk costs:** The loss that the bank expects to face if the borrower defaults, taking into account the likelihood of that default actually occurring. Customers that are deemed more likely to default, or facilities that are unsecured, have higher risk costs. Risk costs are estimated by the bank based on borrower and facility characteristics. It is important to note that risk costs represent an expectation of average losses through an economic cycle, rather than accounting losses in any given period
4. **Return on capital:** Regulators stipulate a framework for calculating the minimum amount of capital that a bank must hold against lending commitments. Shareholders then have an expectation of the return that will be made on that capital. These expectations are sometimes expressed as the “hurdle rate” of return, and known as the “cost of capital”

<sup>23</sup> For an individual variable rate loan over BoE base rate, the price (i.e. interest rate) that the customer pays varies directly with changes in the BoE base rate (i.e. a 1% increase in the BoE base rate increases the interest rate paid by the customer by 1%).

<sup>24</sup> In addition, no adjustment is made to factor in the impact on profitability of fixed rate lending, asset based lending, invoice finance, overdrafts or other forms of SME lending. Fees associated with lending have also not been included.

<sup>25</sup> The following descriptions are a simplified view, intended to provide an illustrative explanation of lending economics.

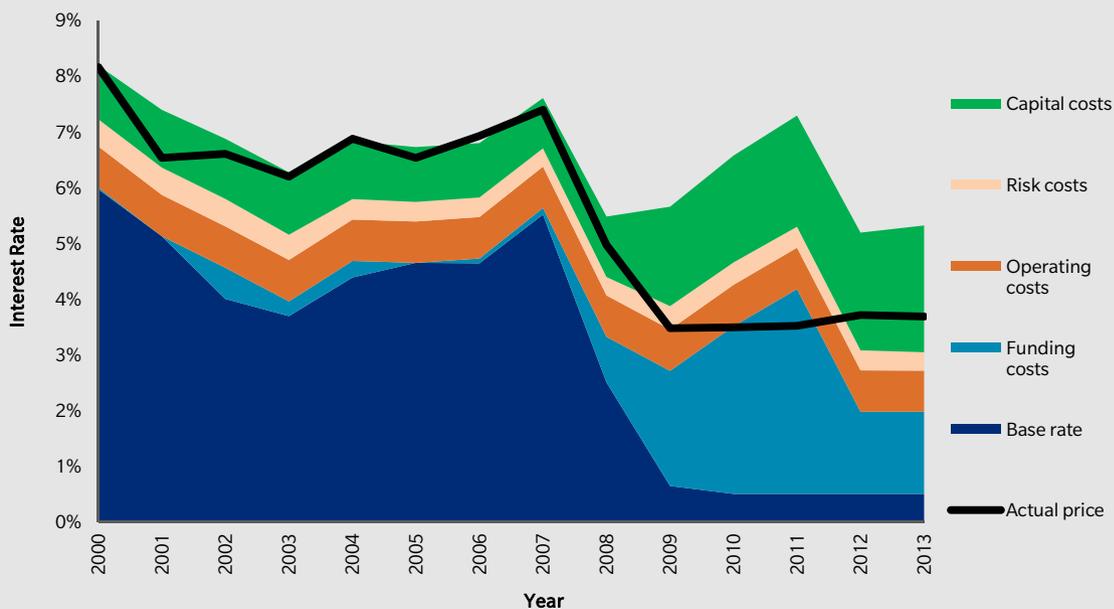
The interest margin that a bank makes from lending is the difference between the interest charged to the customer and the bank's funding costs. A bank begins to make a profit (i.e. at least breaks even) when this interest margin is greater than the sum of risk and operating costs. Where the bank's interest margin exceeds these costs, lending therefore generates a positive return on capital. If the return on capital is sufficient to meet the hurdle rate (i.e. the cost of capital), lending is generating a return commensurate with shareholder expectations.

The cost of borrowing for SMEs varies over time based on base rates and market funding costs, expectations for losses through the cycle, the efficiency of banking operations and the regulatory requirements for banks to hold capital. As a result of the financial crisis, these costs have changed significantly:

1. **Funding costs:** The severe market stress caused by the financial crisis made it significantly more difficult for banks to access funding. At the same time, banks adjusted the mix of different funding sources that they used. The combined impact of these has caused a substantial increase in funding costs
2. **Operating costs:** Banks have sought to reduce the cost to serve SME customers, but there has not yet been a substantial shift in operating costs since the financial crisis
3. **Risk costs:** The financial crisis revealed that banks had under-estimated the likelihood of borrowers defaulting on their repayment obligations. Banks have since adjusted their estimates of expected losses accordingly, but also tightened their lending criteria to reduce the expected losses they are exposed to
4. **Return on capital:** Following the financial crisis, regulatory capital requirements were increased significantly. These regulatory changes have increased the amount of capital that banks are required to hold per unit of lending, thus increasing overall cost of capital (even if the hurdle rate of return on that capital has remained the same)

Figure 7 estimates the economics of lending by banks to UK SMEs over time. In this chart, the "actual price" represents the average cost of borrowing for the SME customer (i.e. the average interest rate charged by the bank). The incremental funding costs of the banks are also broken out from the BoE base rate.

**Figure 7: Average economics of UK SME lending for banks, 2000–2013**



Source: Bank of England *Trends in Lending*; Oliver Wyman analysis

1. Actual price is measured by the Bank of England as the industry median price at which new variable rate loan facilities were originated. It is shown here as the full price paid by the customer (i.e. the base rate plus the interest margin charged by the bank)

Between 2000 and 2007, the interest rate charged by the banks generated a return on capital broadly in line with the hurdle rate expected by shareholders, given the regulatory capital requirements of the time.

From 2007, the interest rate charged to customers fell as the BoE base rate was reduced sharply, although this reduction in the base rate was not fully passed on to customers and therefore the banks' margin over base rates increased from ~2% in 2007 to 3% in 2011. However, in the same period, the incremental funding costs for banks increased (from <0.5% to ~3.5%), as the financial crisis made it more difficult for banks to access funding. The overall cost of capital also increased (from ~1% to ~2%), as Regulators responded to the financial crisis by increasing the amount of capital banks are required to hold against lending. Because the increase in funding and capital costs was greater than the increase in the banks' margin over base rates, lending to SMEs became less profitable to banks than it was in the pre-crisis period.

Since 2011, the incremental cost of bank funding over base rates has decreased again as economic confidence has improved. As a result, lending now generates a return on capital of approximately 3–7%. This means that lending – as a standalone product – does not yet meet the hurdle rate of return expected by shareholders. However, charges for other services (such as transaction services) typically mean that banks make a hurdle rate of return on their overall SME banking operations.

### 3.2.3 AVAILABILITY AND QUALITY OF SME DATA

**Data gaps impede policy making and credit decision making in the UK:** Two significant data gaps exist in the SME sector. These impede policy making and credit decision making in the UK.

- There is limited information available to Public Authorities, the financial services industry and SMEs themselves on the make-up and performance of SMEs. For example, there is no single business register, collateral register or credit exposure database for SMEs. This would enable a more informed set of policy decisions and financing providers to make faster and better decisions
- There is need for a comprehensive set of public statistics covering the SME sector's financing structure and capacity to support bank debt. This includes the volume of financing that is being supplied across all product types (not only bank debt). Such statistics would facilitate better policy decisions

*Recommendation 9 (within Section 6) is a suggestion for the Authorities and providers of finance to resolve this issue.*

## 4. ASSESSMENT OF RBS'S PERFORMANCE

**RBS is a particular focus of dissatisfaction:** RBS is the biggest player in the UK SME lending market, with the largest customer and borrower base. RBS was also one of the most aggressive pre-crisis lenders, particularly to the Commercial Real Estate sector, and as a result it suffered greatly in the crisis. Pressures to remedy the situation were intense, requiring significant Board and management attention. The bank has been forced to make many changes, first to stabilise the bank, and then to establish more prudent lending standards. Survival was the number one priority, and it was somewhat inevitable that lending and consideration of issues from the customer perspective were considered secondary. RBS is now 80% owned by the UK government, with the stake managed by UK Financial Investments (UKFI). As a consequence of these factors, RBS has been a particular focus of dissatisfaction, with both customers and market stakeholders concerned that it is not doing enough to support the SME sector.

**RBS's overall performance is assessed in this section:** RBS's overall performance is assessed in this section, specifically the lending and support that it has offered to UK SMEs since 2008. The objectives that the bank set itself in 2009 are described, and the major changes to the business that have taken place since then are outlined. A large body of evidence<sup>26</sup> has been gathered to inform observations regarding the outcomes that RBS has achieved, and evaluate how well the business has progressed against its own objectives. This includes a detailed analysis of RBS's trends in SME lending, relative to market. This evidence is used as the basis for drawing conclusions as to how successful or otherwise RBS has been in meeting both its own objectives and the wider expectations of external stakeholders.

### 4.1 TRENDS IN RBS LENDING TO SMES, RELATIVE TO MARKET

Trends in RBS's lending to UK SMEs relative to market provide important context for understanding the outcomes achieved by RBS. These outcomes are explored in Section 4.3.

#### Box 4: Lending stocks and flows

The "stock" of bank lending is a measure of its outstanding balances (i.e. the total of lending) at a given moment in time. Because it is a *stock*, it is measured as a snapshot at a given moment in time.

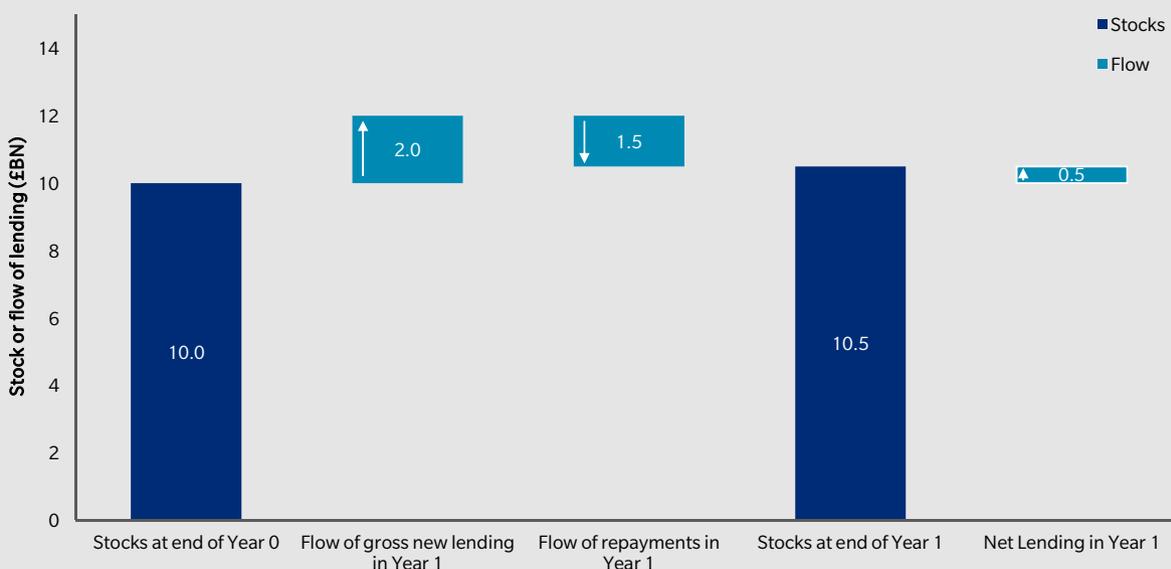
There are three important lending *flows*, which are measured over a period of time (e.g. a year):

- "Flow of gross new lending" is the amount of new lending in any given period, including both new loans and increases to existing facilities. This flow increases the stock of bank lending
- "Repayments" represent the amount of existing borrowing that is repaid in any given period. This flow reduces the stock of bank lending
- "Net lending" is the change in stock between any two points in time (which in this simplified example, can be considered as "flow of gross new lending" less "repayments")

The following example illustrates the relationship between the stock of lending, the flow of gross new lending, repayments and thus net lending.

<sup>26</sup> This includes: 16 meetings with representatives of Government, Regulators and Business Associations; >600 completed responses of the survey on the Independent Lending Review website; survey of >500 RBS customers; survey of >1,750 B&C staff; >50 interviews with RBS management and >20 with staff; independent review of >100 randomly selected individual credit files; analysis of RBS's lending portfolio and application data since 2008; analysis of industry and RBS-specific survey data; analysis of RBS pricing and economics for loans and overdrafts; analysis of RBS complaints and appeals data. See Appendix D for further details.

**Figure 8: Illustrative example of lending stocks and flows**



1. This is a simplified illustration of lending stocks and gross flows. There are many additional inputs that need to be considered in reality. For instance, stocks are also increased by: interest charged, acquisition of a loan book, reclassification, greater coverage. Stocks are also decreased by: redemptions, write-offs, sale of a loan book, sale of a loan book

In the example above, the stock of lending at the end of Year 0 is £10 BN. During the course of Year 1, the bank lends a further £2 BN through the flow of gross new lending which increases the stock of lending, but borrowers make £1.5 BN in repayments which decreases the stock of lending. In this simplified view, Net Lending is represented by the “flow of gross new lending” less “repayments”, i.e. £0.5 BN. As a result, at the end of Year 1, stocks are £10.5 BN, comprising the £10 BN at the end of Year 0 plus the £0.5 BN flow of net lending made during Year 1.

More generally, it can be seen that:

- Where net lending is positive, the stock of bank lending will increase
- Where net lending is negative, the stock of bank lending will decrease

**RBS was the largest lender in the market:** RBS’s stock of lending was £55 BN at the market peak. This figure comprised RBS’s total lending to SMEs now contained within the Core B&C and Lombard businesses, the Rainbow divestment and the Non Core Division.<sup>27</sup> The comparable stock of lending now stands at £38 BN.

**RBS’s market share of lending stock has fallen:** Since the market peak, RBS’s market share as a proportion of major high street bank stock of lending has fallen from 40% to 33%.<sup>28,29</sup> RBS’s market share in the Commercial Real Estate sector has fallen further and faster than its share of lending to other sectors of the economy.

<sup>27</sup> Lending from the RBS Invoice Finance business has not been included in these figures due to a lack of comparability with publically reported market figures.

<sup>28</sup> Figures relating to “high street banks” are based on British Bankers’ Association data. All market share figures in this document are quoted on this basis. In aggregate, from examining Bank of England data, the major high street banks have a share of the overall market of approximately 68%.

**Table 3: Stocks and flows of gross new lending over time: RBS and Market, 2008 – 2013<sup>30</sup>**

	Full Year				Half Year		
	FY2008	FY2009	FY2010	FY2011	H1–2012	H2–2012	H1–2013
<b>Total SME lending stock (£BN, at period end)</b>							
Overall market <sup>31</sup>	221	217	204	189	186	176	170
Major high street banks <sup>32</sup>	137	134	126	119	117	115	115
<b>Flow of gross new lending by major high street banks (£BN, for period)<sup>33</sup></b>							
Total	N/A	33.3	30.7	27.4	13.1	11.6	11.7
Commercial Real Estate	N/A	17.9	15.6	11.7	5.1	4.4	4.4
Other sectors	N/A	15.4	15.1	15.7	7.9	7.2	7.3
<b>RBS share,<sup>34</sup> as % of lending by major high street banks</b>							
Lending stock (total)	40%	40%	40%	37%	36%	35%	33%
Commercial Real Estate	46%	44%	45%	43%	41%	38%	35%
Other sectors	37%	38%	37%	34%	34%	33%	32%
Flow of gross new lending (total)	N/A	40%	33%	26%	24%	27%	26%
Commercial Real Estate	N/A	43%	34%	29%	30%	29%	26%
Other sectors	N/A	35%	32%	23%	21%	25%	26%

**RBS has not won enough new business to maintain its market share:** The primary driver of the fall in RBS's market share from 2008 to 2013 was a decline in its share of the flow of gross new lending, which has fallen from 42% in Q2 2008 to 27% in Q2 2013.<sup>35</sup> Over the same period, it is estimated that RBS's share of gross new lending to Commercial Real Estate has fallen from 47% to 29%, while its share of gross new lending to SMEs involved in other activities fell from 37% to 26% in Q2 2013.

Therefore, the RBS share of the total market is lower than quoted here, and these shares should not be used to make any judgments on the level of competition within the SME market.

<sup>29</sup> The overall market share of high street banks has increased as many foreign banks exited the market after the financial crisis.

<sup>30</sup> Source: Bank of England, British Bankers' Association, RBS portfolio data, Oliver Wyman analysis. Data constructed pre-2012 due to non-existence of dataset. RBS, Market and Taskforce data sets adjusted to include not for profit and financial sector businesses and non-performing loans, and to make the data sets comparable

<sup>31</sup> As defined by Bank of England: lending by UK Monetary Financial Institutions (MFIs) to Private Non-Financial Corporations (PNFCs).

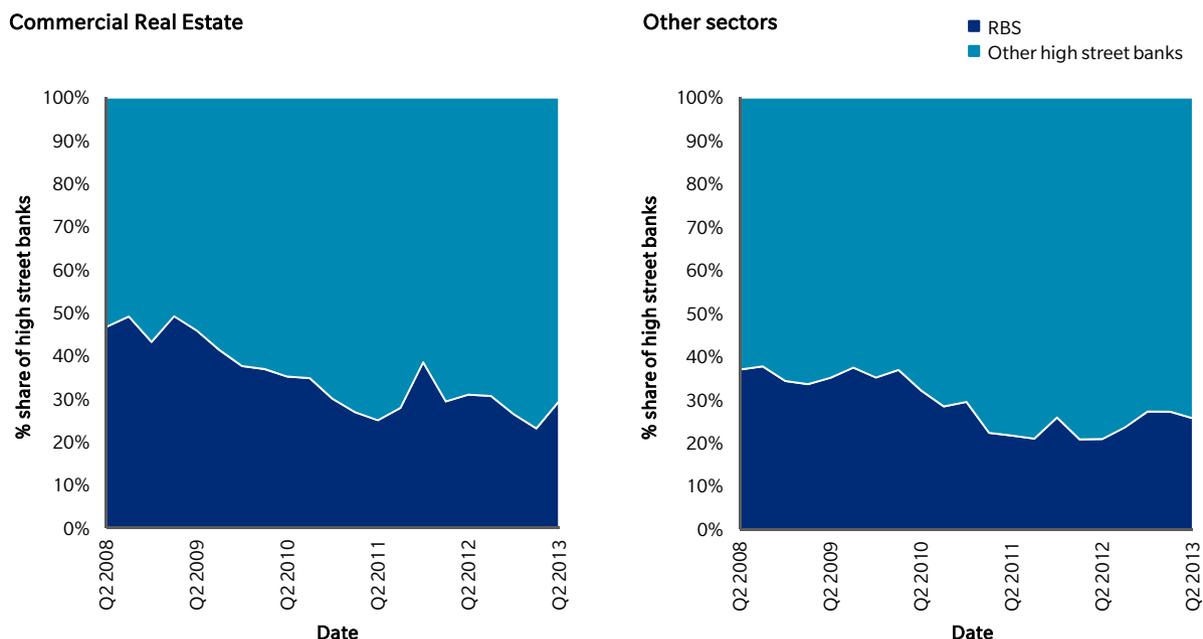
<sup>32</sup> Major high street banks contributing to British Bankers' Association dataset: Barclays, HSBC, Lloyds Banking Group (including HBOS), National Australia Bank UK (Clydesdale, including Yorkshire Bank), Royal Bank of Scotland Group (RBSG) (including NatWest), Santander and The Co-operative Bank. Includes Non-Performing Loans and Asset Finance lending.

<sup>33</sup> Data on the flow of gross new lending is not available for the full year 2008.

<sup>34</sup> RBS share includes the proposed Rainbow divestment.

<sup>35</sup> Share of gross new lending flows is more volatile than that of stock.

**Figure 9: RBS share of the flow of gross new lending, Commercial Real Estate and other sectors, Q2 2008–Q2 2013**



Source: Bank of England; British Bankers' Association *Banks' Support for SMEs*; RBS EID form submission

1. Share represents RBS's share of banks in British Bankers' Association Taskforce dataset

2. Data constructed pre-2012 due to non-existence of dataset

3. RBS and Taskforce adjusted to include not for profit and financial sector businesses and non-performing loans. View of "total market" not shown on chart

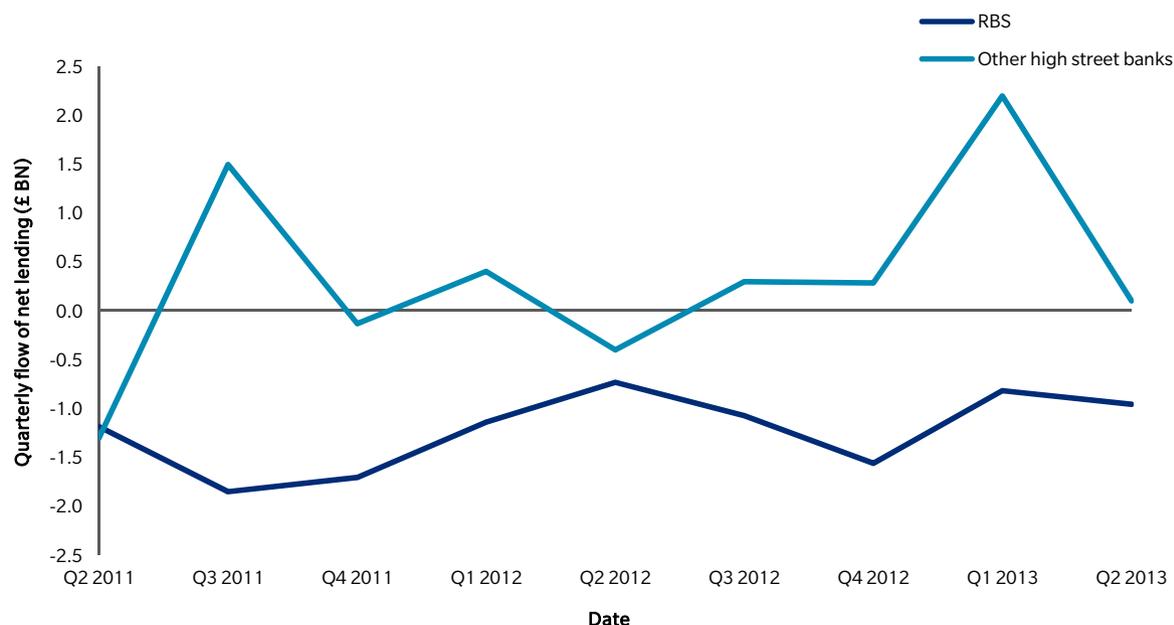
**Repayments to RBS have increased since 2012:** More recently, growth in RBS's stock of lending has also been restricted by a rise in the rate of repayments. From 2012, quarterly repayments as a proportion of stock have been higher at RBS than at other major high street banks. This makes it more difficult for RBS to sustain a positive net lending position, because a higher volume of repayments needs to be offset with a greater flow of gross new lending.

**RBS's net lending has diverged from that of other banks:** As a result of the above, RBS's stock of lending to SMEs has been in decline since 2010, and continues to shrink. In contrast, the stock of lending at other major high street banks stabilised at the end of 2012. In the first half of 2013, RBS's stock of lending to SMEs shrank by £1.8 BN<sup>36</sup> (-4%), while it grew in aggregate by £2.3 BN (+3%) at other high street banks.<sup>37</sup> The total stock of lending to SMEs by all the major high street banks (including RBS) has therefore been broadly stable (increase of just under £0.5 BN) over the first half of 2013.

<sup>36</sup> This figure comprises RBS's total lending to SMEs now contained within the Core B&C and Lombard businesses, the Rainbow divestment and the Non Core Division.

<sup>37</sup> Source: British Bankers' Association; Oliver Wyman analysis.

Figure 10: Flows of quarterly net lending, RBS and other high street banks, Q2 2011 – Q2 2013



Source: British Bankers' Association *Banks' Support for SMEs*; RBS EID form submission; Oliver Wyman analysis

1. Net lending calculated on a quarterly basis
2. "Other high street banks" represent banks that submit data to the BBA Taskforce data set, excluding RBS
3. RBS and Taskforce adjusted to include not for profit and financial sector businesses and non-performing loans.
4. Net lending calculated as the difference between the stock of lending at the beginning and end of each quarter

**RBS's share of lending stock may continue to fall until 2018:** If current trends in RBS lending against the market were to continue, it is estimated that RBS's share of total market stock will continue to fall, stabilising at about 26% in 2018. After the divestment of the Rainbow business, the market share retained by RBS will be approximately 19%. This assumes that all Non Core lending to SMEs will have been run off, and thus the retained market share will be solely the result of lending by the ongoing B&C and Lombard businesses.<sup>38</sup>

**RBS's share of lending stock is now more in line with its share of the customer base:** It is estimated that RBS's current share of the number of SME customers (as opposed to its share of the amount of lending) is 25–30% (including Rainbow and Non Core). It has a higher share of SME customers for larger SMEs handled by Commercial Banking (where it is closer to 30%) than for the smaller ones handled in Business Banking (where it is closer to 25%).<sup>39</sup> RBS's current and projected market share of lending stock is therefore more consistent with the size of its customer base than it was in the run up to and immediately after the start of the crisis when it was at higher levels.

**The majority of the decline in RBS stock is due to Non Core and Commercial Real Estate:** The majority of the decline in RBS's total lending stock is associated with the reduction in the size of the Non Core portfolio and the Commercial Real Estate sector. RBS has maintained an explicit strategy of running off the former and reducing its exposure to the latter, as a means of stabilising and rebalancing its SME business.

<sup>38</sup> As per above, RBSIF data is not included in market share comparisons to ensure data comparability.

<sup>39</sup> See Section 4.2 for details of the Commercial and Business Banking segment definitions.

**RBS also lost competitiveness in sectors other than Commercial Real Estate:** Between 2010 and 2012, RBS's share of gross new lending to other industry sectors also fell to a low of 21% in Q2 2012, before rebounding to the current levels of 26%. This dip – and subsequent rebound – in RBS's performance suggests that RBS could have been more successful at lending to these sectors from late 2010 to early 2012.

## 4.2 RBS'S OBJECTIVES FOR THE SME BUSINESS

**Pre-crisis situation:** As explored in Section 3.2, pre-crisis growth in the SME market was fuelled by lending to the Commercial Real Estate sector,<sup>40</sup> as well as to businesses utilising real estate collateral to support speculative and other trading activities. RBS built a large share in the SME market, primarily through real estate lending of both types, often relying on rising asset prices to support lending applications rather than analysing the quality of the customer's business and its suitability for bank finance. This resulted in Relationship Managers (RMs) relying too heavily on asset values instead of cashflow analysis in order to make lending assessments. It also raised customer expectations to unsustainable levels, as prices were too low and lending standards too lax. The excessive lending was rapidly manifested by a sharp increase in non-performing loans after the financial crisis in 2008, particularly in the Commercial Real Estate sector.

**Post-crisis change of strategy at RBS:** RBS recognised that both its strategy and its risk management processes had been imprudent in the SME lending market. In 2009, a strategic review established four objectives for the SME business,<sup>41</sup> which were approved as part of RBS's strategic planning process. These are set out below:

1. **Stabilise and rebalance the business:** To rebalance the balance sheet, reducing concentrations in the lending portfolio and growing the volume of deposits (to close the "funding gap" that had developed)
2. **Focus on creating value for shareholders:** To improve profitability, through more disciplined (and higher) pricing on lending, actions to manage impairment levels and to achieve better cross-selling of other products
3. **Build a platform for sustainable growth:** To invest in the infrastructure and skills available within the business, to provide a better experience for customers and staff
4. **Support the SME sector:** To play a role in the recovery of the UK SME sector, by meeting Government lending commitments (without compromising lending standards) and supporting customers through the downturn

**Creation of Non Core Division and Rainbow business:** Two major structural changes were also imposed upon the RBS SME business whilst it sought to remedy the problems that it faced. The first was to create the Non Core Division, by identifying and transferring responsibility for approximately £15 BN of SME lending assets to it. Non Core assets were identified in a one off exercise in 2009. SME assets identified as Non Core mainly comprised Non Performing assets (i.e. those in SRM and GRG) and poorly priced real estate assets. The Non Core Division was given the mandate by RBS Group to run off these assets by the end of 2013. Non Core assets were either exited (via repayment, refinancing with other banks, or write-offs) or returned to the Core bank after a change in circumstance or to the underlying contractual terms. The second structural change was the separation of the Rainbow business from the rest of the Core SME business. This was a requirement set by the European Commission. Rainbow is now in the process of being launched as a standalone competitor; Rainbow customers will no longer belong to the RBS Group once full separation occurs.

<sup>40</sup> The Commercial Real Estate sector comprises businesses involved in developing or investing in residential or Commercial Real Estate. RBS calls this "Real Estate Finance" to differentiate it both from lending to businesses involved in related activities (e.g. construction) and from lending to trading businesses secured on real estate assets (e.g. commercial mortgages).

<sup>41</sup> RBS, Business & Commercial Strategic Plan 2009-2013, 13<sup>th</sup> July 2009.

**B&C is the major SME business retained by RBS:** The residual SME business retained by RBS is currently managed primarily within its Business & Commercial Banking unit. B&C is divided into Business Banking for smaller SMEs (generally for customers with aggregated debt of less than £250 K and annual turnover less than £2 MM) and Commercial Banking for larger ones (generally for customers with aggregated debt greater than £250 K or turnover £2 MM to £25 MM). These are supported by smaller specialist product units such as Lombard and RBS Invoice Finance that sit within Customer Solutions Group (CSG). Although not reporting to B&C, both Lombard and RBS Invoice Finance are managed within the Corporate Banking Division. These are the ongoing engine of the UK RBS SME business.

**External reporting includes Non Core, Rainbow and B&C:** Internally, RBS has separated the financial results of the Non Core Division and Rainbow business, and both manages them and reports on them separately. However, it is important to note that the SME elements of these businesses are consolidated in the lending statistics that are published by both the Bank of England and the British Bankers' Association, together with the results of the Core retained businesses. This makes the transparent communication of RBS's results and performance (successful or otherwise) very difficult.

## 4.3 OVERVIEW OF THE OUTCOMES ACHIEVED BY RBS

In this section the outcomes achieved by RBS are assessed relative to the four objectives outlined in Section 4.2.

### 1. Stabilise and rebalance the business

- **Funding:** RBS's SME business had an excess of lending over deposits ("funding gap") in the run-up the crisis. The Loan To Deposit (LTD) ratio<sup>42</sup> was ~120% in 2008. The funding gap has since been closed, with a 100% Loan To Deposit ratio achieved in the Core SME businesses (i.e. both B&C and Rainbow) by 2011
- **Commercial Real Estate:** The concentration of the stock of lending to the Commercial Real Estate sector has been reduced. In the B&C portfolio, the concentration of the stock of lending to the Commercial Real Estate sector is expected to hit its reduced target of 20% of total lending stock<sup>43</sup> at the end of 2015 or early 2016
- **Non Core:** ~£15 BN of SME assets were identified and transferred to the Non Core Division in 2009. Assets placed into the Non Core Division were either distressed or those considered to be the most unattractively priced (predominantly Real Estate Finance). There are now just over £2 BN of Non Core SME assets remaining, which though small, remain a distraction
- **Rainbow:** The Rainbow business has been separated, and is now managed independently from the B&C business that will be retained by RBS. Rainbow consists of ~315 branches, ~1.7 MM customers, has a ~5% share of the SME market and ~2% share of the retail current account market. This divestment will result in RBS' retained SME business shrinking by ~20–25%<sup>44</sup>
- **Capital requirements:** Revisions to the calculation of capital requirements to support lending activities have been implemented, as required by the Regulators. These include the introduction of new risk models and the "slotting" approach<sup>45</sup> for lending to the Commercial Real Estate sector. At the Group level, core tier 1 capital has been increased from 5.9% in 2008 to 11.6% at Q2 2013<sup>46</sup>

<sup>42</sup> The proportion of customer loans as compared to customer deposits held on the Balance Sheet.

<sup>43</sup> 20% target for Commercial Real Estate measured against committed exposures within the Corporate Banking Division.

<sup>44</sup> On a stock of lending basis.

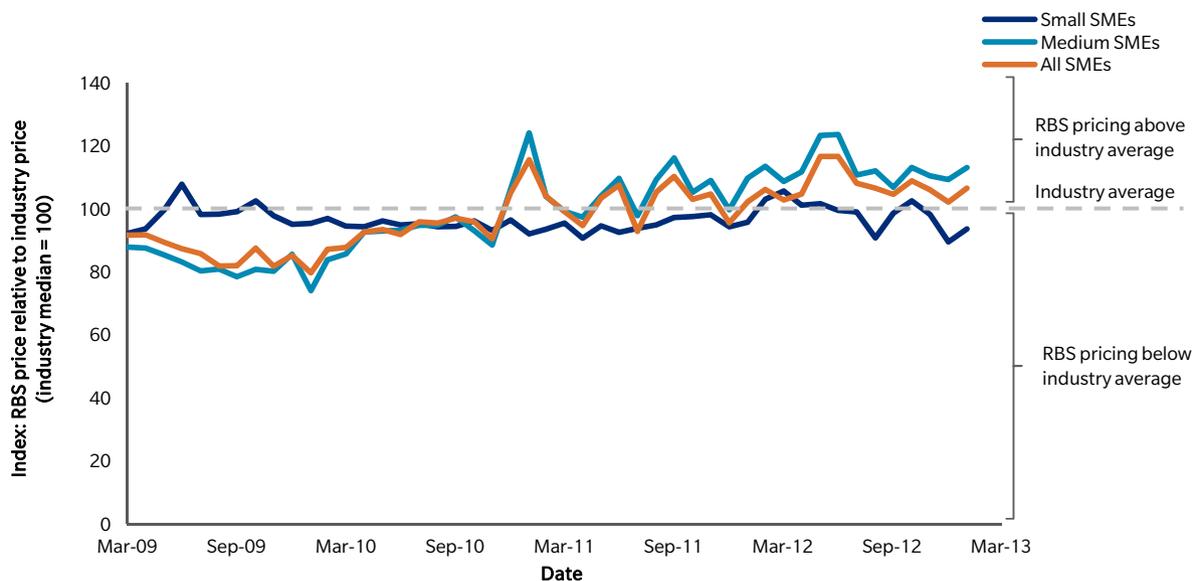
<sup>45</sup> The Financial Services Authority determined that the models being used by UK banks to calculate the Probability of Default (PD) for the Commercial Real Estate sector were not compliant with the Internal Ratings Based approach set out under the Basel Accords. It introduced a standard approach across the industry, based on "slotting" individual exposures into one of 5 categories ranging from strong to default. In general, this results in significantly higher capital requirements for Commercial Real Estate lending.

<sup>46</sup> Source: RBS Group annual reports.

## 2. Focus on creating value for shareholders

- **Lending standards:** Lending standards have been tightened, with a revision of the Policy & Guideline framework<sup>47</sup> used to govern individual lending decisions. This results in new lending being focussed on higher quality borrowers, with lower future losses expected as a result
- **Impairments:** Impairment levels in the Core SME businesses (i.e. B&C and Rainbow) have been reduced. This has been driven by policies and procedures, and the stabilisation of the macroeconomic environment
- **Pricing:** Lending has been re-priced, particularly in the Commercial Banking business sub-unit. As a result RBS has moved from offering one of the cheapest prices in the market at uneconomic rates, to pricing near the market average and generating a positive Return on Equity (RoE)

Figure 11: RBS pricing relative to market, March 2009 – February 2013



Source: Bank of England Trends in Lending; RBS submission to BIS; Oliver Wyman analysis

1. Prices represents median price at “margin over base rate” for new loan variable rate loan facilities
2. Industry represents median of Barclays, HSBC, Lloyds and RBS. Group
3. SMEs: annual turnover of less than £25 MM. (Small SMEs: <£1 MM turnover; Medium SMEs: £1–25 MM turnover)
4. 100 represents the industry median price in each month. RBS’s price is then measured relative to this (e.g. if RBS is at 110, its median price is 10% higher than the industry median in that month)

- **Returns:** It is estimated that “traditional” SME lending (not including asset finance or invoice financing) currently generates a Return on Equity of 3–7% for RBS. The overall SME banking business, which includes other products such as transaction banking and deposits, generates an RoE of ~ 10–15%<sup>48</sup>

## 3. Build a platform for sustainable growth

- **Staff:** Staff engagement levels are high across the B&C business, as evidenced by recent survey results which show them to be high compared to peer benchmarks, having risen above the Corporate Banking average since 2009<sup>49</sup>

<sup>47</sup> See Section 5.1 for more detail on Policy & Guideline framework and the implementation of lending standards.

<sup>48</sup> Overall SME banking business includes lending (including asset-based and invoice financing), deposits and transaction services.

<sup>49</sup> Source: RBS engagement statistics sourced from Towers Watson; RBS Group HR; PricewaterhouseCoopers.

- **Customer:** Customer satisfaction levels are broadly in line with those of competitors for the NatWest brand. For example, NatWest has the second highest Net Promoter Score (NPS) in the market for SMEs in the £2 MM to £25 MM customer turnover bracket (the Commercial Banking unit) according to Charterhouse data. In micro businesses (defined by Charterhouse as SMEs having less than £250 K turnover), NatWest has an above market average NPS score. In the £250 K to £2 MM turnover segment, NatWest has a below market average NPS score. Across all measures of satisfaction, the RBS brand scores significantly worse than the NatWest brand and the market average. Whilst it has not been quantified, this may be largely attributable to the impact of negative media sentiment attached to RBS, given that the customer proposition and service levels are not materially different between the two brands
- **Training:** A training and accreditation programme for Relationship Managers, who are the main customer facing staff, has been implemented, including the introduction of externally recognised professional qualifications
- **Performance assessment and compensation:** The performance assessment and compensation schemes of Relationship Managers have been changed. Performance is now assessed on the basis of a “balanced scorecard” (which includes risk management), and variable compensation is determined on a discretionary basis (i.e. it is not directly linked to short-term quantifiable objectives, such as lending volumes achieved), in line with regulatory guidance
- **Credit process:** Changes have been made to the process that is used to assess and decide upon applications for credit from SME customers. For micro and very small businesses customers, decisions are made using “credit scoring” techniques built specifically for SMEs that are similar to those prevalent in personal lending. Before credit scoring is undertaken, an affordability calculation is used to give sufficient confidence that there will be adequate cashflow available to support repayments.  

For larger customers, the bank assigns a Relationship Manager and follows a set process in making the credit decision. Applications which meet the criteria that have been set in the credit scoring model and which are also within the approval authority that has been delegated to the Relationship Manager, can be approved by the Relationship Manager. Where applications fail to meet the scorecard criteria or are outside the Relationship Manager’s decision authority, they are referred to a Credit Officer, using one of two application processes: either a “standardised” data collection template (for smaller and simpler applications) or a “bespoke” data collection template (for larger and more complex applications)
- **Segmentation:** To meet the needs of its SME customers while managing its overall cost base, many customers have been re-assigned between the Business Banking and Commercial Banking sub-units
- **Channel technology:** In Business Banking (for smaller SMEs), significant investment was secured in 2010 to re-develop telephone, internet and branch based services. The infrastructure was built over the course of 2011 and 2012, and was put in use at the start of 2013
- **Sector specialists:** In Commercial Banking<sup>50</sup> (for larger SMEs), RBS has created teams of specialist Relationship Managers supported by teams of specialist Credit Officers in industry sectors such as Commercial Real Estate, Agriculture and Healthcare. Relationship Managers in these teams manage customers who are predominantly in a single sector, and work closely with teams of Credit Officers who have specialist knowledge of that sector. This approach is intended to enable better provision of sector-based expertise to customers and better management of the risks taken by RBS when lending to them

<sup>50</sup> Sector specialists already existed in Business Banking, for example in Agriculture and Healthcare sectors

#### 4. Support the SME sector

- **Supporting customers in difficulty:** During 2009 and 2010, B&C transferred many experienced Relationship Managers away from new lending activities to two areas:
  - Specialised Relationship Management unit: SRM, part of B&C, is responsible for supporting customers who are beginning to encounter financial difficulties. The purpose of this was to ensure that the most experienced individuals could best advise customers as they begin to experience financial problems
  - SME unit of the Global Restructuring Group: GRG has a Group-wide responsibility both for the use of financial restructuring to restore customer businesses to health and for the protection of RBS's capital position through the recovery of value from the assets of failed businesses to whom RBS has lent. GRG is not part of B&C, but it manages RBS's relationships with distressed customers on behalf of B&C
- **Support schemes:** RBS has actively participated in a number of Government SME lending initiatives such as the Funding for Lending Scheme (FLS), the Regional Growth Fund (RGF) and the Enterprise Finance Guarantee scheme (EFG).<sup>51</sup> For example, RBS has been a major contributor to the EFG, and was responsible for 40% of all drawn funds from the scheme in the financial year 2012/2013. It is also involved in the RGF and has established a "fee free" product through the FLS.
- **Government lending targets:** RBS committed to meeting lending targets for larger corporates and SMEs. These were initially agreed directly with the Government and then as part of an industry wide initiative called Project Merlin. Whilst RBS did not meet the Government lending target set in 2009 (based on net lending), it did hit the flow of gross new lending target set in 2010. It also hit the "stretch" target for the flow of gross new lending to SMEs in 2011 that was agreed as part of Project Merlin

**Majority of objectives have been achieved...:** RBS has accordingly succeeded in meeting the majority of its objectives. It has successfully rebalanced its asset mix, prudential and commercial standards have been remedied, and investments in infrastructure and people have improved the ease with which customers can access the bank's services (e.g. through mobile and telephone banking).

**...But expectations with regard to lending have not been met:** Two specific issues have clouded the situation. Both the provision of lending and the consideration of SME customer perspectives were lower on the list of priorities, as RBS sought to meet its prioritised objectives (including the closing of the funding gap). RBS has therefore not succeeded in supporting the SME sector in a way that has met either its own financial targets, or the expectations of customers and external stakeholders. Furthermore, legacy issues arising from the measures needed to cope with the severe collapse of the bank in 2008 remain the root cause of many of the issues which continue to frustrate SME customers to this day.

**RBS has been unable to deliver on its aim to grow SME lending:** RBS planned to grow its SME lending business over the period 2009 to 2013, and – via the planning and budgeting process – made the resources available to B&C that would be required to do so. However, for the reasons set out in Section 5, RBS was unable to deliver these plans.

<sup>51</sup> The Funding for Lending Scheme is a lending scheme launched by the Bank of England and HM Treasury in July 2012 to incentivise lending to the UK economy by providing extended funding to banks and building societies at lower prices. It covers both mortgages and SME lending. The Regional Growth Fund is a fund established by the Department for Business, Innovation and Skills to support projects and programmes that use private sector investment to create economic growth and sustainable employment. The Enterprise Finance Guarantee is a UK government lending scheme intended to help small businesses that may otherwise struggle to access finance, under which the Government provides a guarantee to boost the credibility of loan applications by small businesses.

**Recent lending initiatives appear to have had a positive effect...:** RBS's share of gross new lending to SMEs outside the Commercial Real Estate sector has rebounded from a low of 21% in Q2 2012 to 26% today. This suggests that some of the recent initiatives that RBS has put in place have had a positive effect. In particular, RBS has focused on stressing the overall primacy of lending objectives, improving the skills of Relationship Managers, building business development capabilities and simplifying and streamlining the framework by which lending decisions are shaped.

**...However, there remains further room for improvement:** RBS has room to improve the way it executes its strategy and delivers its services to SMEs. Not enough customers have yet "felt" a sufficient improvement in their day-to-day experience of RBS to challenge the perception of a sizeable minority that RBS is not "open for lending". RBS has done much to ensure that it is able to lend prudently to its SME customers, without repeating the mistakes of the past. However, many of these changes have made it harder for the bank to lend. RBS must find ways to meet its own objectives for lending (and the expectations of others) and supporting the SME sector while working within the new lending standards it has set itself.

The real and perceived shortfalls in RBS's results have arisen for several reasons, which are set out in Section 5.

## 5. ANALYSIS OF RBS SPECIFIC ISSUES AND THEIR ROOT CAUSES

This section summarises the findings of the diagnosis regarding RBS specific issues that have impacted its efforts to lend to and support UK SMEs, and the extent to which such issues have already been addressed. This analysis covers multiple dimensions:

- Objectives and standards (Section 5.1): the basis on which RBS sets objectives for the SME business, and ensures that they are consistent with its own prudential, lending and economic standards
- Organisation (Section 5.2): the way in which responsibility for objectives and standards is distributed within RBS, and the organisational structures put in place to achieve these objectives
- Strategy and business model (Section 5.3): the decisions, actions and plans that direct resources within each part of the organisation
- People (Section 5.4): the number, skills and behaviours of the people working within each of the RBS departments tasked with delivering its strategy
- Process (Section 5.5): the processes and tools used to develop new lending opportunities, convert those opportunities into borrowing, and manage existing customer relationships
- Communication (Section 5.6): the way in which customers experience RBS, as well as the way in which customers and stakeholders hear about RBS's objectives and performance

The analysis and judgements made have drawn on the available evidence collected over the course of the Review, and are presented in the remainder of this section.

### 5.1 OBJECTIVES AND STANDARDS

The Review has explored the basis on which RBS's objectives for the SME business were set and the constraints within which RBS was required to meet them. These constraints comprise prudential standards (such as the sufficiency of capital and funding), lending standards (as set out in RBS's credit policy) and economic standards (such as pricing).

**Lending objectives lacked coherence with other objectives and required prudential standards...:** In hindsight, the lending growth that RBS aspired to in its financial targets as set in 2009 (along with those of subsequent years) was overly ambitious. Adjusting for the fact that the total market stock of lending grew less than RBS expected when it set these financial targets in 2009, RBS's SME business would have had to retain a market share of ~40% in order to meet these plans. This target was also inconsistent with stated objectives and standards. RBS had set itself the objective of a market share of lending more consistent with its overall customer franchise (implying a reduced, not constant share). It also established tighter standards, imposed from both external (e.g. Regulators) and internal (e.g. RBS Group) sources. Examples of these include risk standards and sales practice, or conduct, standards, both of which were externally imposed, but also internally applied. These standards are tighter at RBS than they were before the financial crisis. Industry benchmarking suggests that RBS has not 'gold plated' these standards. However, the lending objectives set were inconsistent with these standards, and were not achievable without breaking the prudential standards which had been set. Given the reduction in exposure to the Commercial Real Estate sector and the run off of Non Core assets, these plans could only have been achieved by growing RBS's market share of lending stock beyond 40% in other (non Commercial Real Estate) industry sectors. Even if successful, RBS's SME business could not have achieved this outcome without violating lending standards and potentially even raising competition issues. *Recommendation 1 (see Section 6) is made to ensure the future resolution of this issue.*

**Capital and funding were made available through the planning process:** RBS Group budgeted for and made available the capital and funding required to achieve the planned growth in lending to SMEs. However, as actual lending consistently fell short of targets, not all of the capital and funding that had been budgeted were deployed. From this, it is concluded that RBS has not restricted or withheld capital or funding from SME lending as part of the planning and budgeting process.

**Risk Appetite framework was introduced to manage risks:** RBS Group introduced a Risk Appetite framework, which was implemented in the SME business in 2011 to manage its overall risk profile. The use of a Risk Appetite framework is common practice in the banking industry. It includes two major elements that are relevant to this Review:

- **Concentration limits:** The Risk Appetite framework includes “concentration limits” based on aggregated exposure across RBS’s lending portfolios as a whole. These set boundaries on the level of lending to different types of businesses (e.g. Retailers or Manufacturers or Leisure) on the basis that the greater the concentration in a given type of business, the higher the risk that, if difficulties arise, losses would be unacceptably high in relation to risk appetite.<sup>52</sup> This is particularly important for lending to the Commercial Real Estate sector, where a fall in property prices can generate substantial losses for banks, as occurred in 2008. RBS therefore created a target portfolio mix, including a maximum 20% of total committed lending stock to the Commercial Real Estate sector, to be met by the end of 2015.<sup>53</sup> The need to meet this limit has resulted in the rejection of otherwise sound lending opportunities in the Commercial Real Estate sector during this period. In the Credit File Review exercise (see Appendix D.5.2) undertaken by the Review for example, the rejection of Commercial Real Estate applications which appeared to have sound fundamentals was observed, citing a lack of sector appetite. There also appeared to be broader inconsistencies in decisions pertaining to Commercial Real Estate. While concentration limits are sensible and prudent, they have created a barrier to new lending. *Recommendation 1 (see Section 6) tackles this issue*
- **Credit policies:** The Risk Appetite framework includes the application of credit policies to govern individual lending decisions. The credit policies applied by RBS were revised immediately after the crisis, and were regularly updated throughout 2009 and 2010. A further major initiative to overhaul the credit policies was implemented in 2011. This included the introduction of a “no exceptions” approach to Policy, and a supplementary set of Guidelines to indicate what a “good” lending decision might look like. Together, these are known as the Policy & Guideline framework. In terms of its formulation and calibration, this framework reflects good prudential lending standards. However, the way in which the Policy & Guideline framework was initially applied proved difficult for some Relationship Managers and Credit Officers to understand and implement in practice. The *application* of higher lending standards has therefore contributed to unnecessary risk aversion amongst the Relationship Manager population. *The theme of risk aversion is covered in Section 5.4 below and solutions are suggested in Recommendation 6 (see Section 6).*

<sup>52</sup> Lending concentrations are also a significant factor in the stress tests used by Regulators to determine the capital that RBS Group needs to hold overall. In assessing the adequacy of group capital under stress, such tests require the allocation of larger amounts of capital to the areas of the portfolio that contain more significant risks.

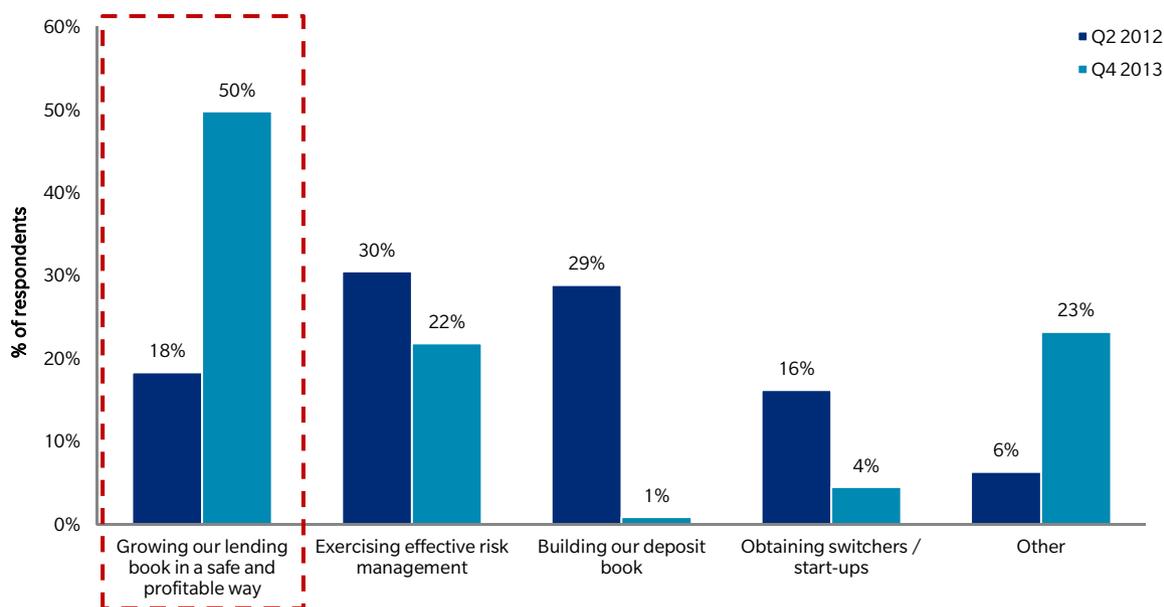
<sup>53</sup> 20% target for Commercial Real Estate measured against committed exposures within the Corporate Banking Division.

**Indirect barriers were introduced by the focus on funding:** The objective of closing the funding gap and meeting a Loan To Deposit ratio target of 100% was achieved in the Core business by 2011. It was delivered via a push to raise customer deposits (rather than by reducing lending). This focus on funding costs did however create two indirect barriers to lending:

- **RBS shortened its commitment period for loans:** As a result of the Group’s long term funding costs, RBS shortened the commitment period for term loans offered to customers. For example, the average contractual term for Commercial Banking loans was ~9 years for accounts opened in 2008, which shortened to ~5 years in 2009, and has continued at that level since. These shorter terms are now contributing to the comparatively fast repayment profile of the RBS loan book, which hinders RBS’s ability to grow its stock of lending (see Box 4 for further explanation)
- **Lending was a lower priority for staff:** Between 2010 and 2012, staff were not as focused on lending as they were on RBS’s other objectives. A survey of staff in Q2 2012 showed that they considered lending to be their 3<sup>rd</sup> priority, well behind deposit gathering and risk management

**RBS has made progress in addressing some of these issues:** RBS has already acted to address these two issues (although the former will continue to dampen RBS’s net lending for 2 to 3 more years). For instance, Figure 12 shows that 50% of staff considered growing the lending book to be the 1<sup>st</sup> priority in the most recent Q4 2013 staff survey, compared with only 18% in the Q2 2012 survey. It has also begun work to simplify and streamline the Policy & Guideline framework. *The process for setting objectives and the impacts of concentration limits on lending to Commercial Real Estate place are revisited in Recommendation 1 (see Section 6).*

**Figure 12: Relationship Manager and Credit Officer #1 priority, Q2 2013 and Q4 2013**



Source: RBS staff surveys Q2 2012 and Q4 2013

1. Bars represent the proportion of staff selecting that category as their “1<sup>st</sup> priority”

## 5.2 ORGANISATION

Several organisational issues were encountered in the course of the Review.

**Organisational responsibility for the SME business is fragmented:** The four objectives that were set in 2009 (described in Section 5.2 above) applied to the entirety of RBS's SME business. As a direct consequence of the major organisational changes implemented in the wake of the financial crisis, the SME business as a whole is no longer managed by a single management team. This has two important impacts:

- **There is no single point of responsibility for the entirety of the SME business:** The creation of the Non Core Division and the Rainbow business, the expansion of the Global Restructuring Group and the creation of the Customer Solutions Group (which is separate from B&C but reports to CBD) have fragmented overall responsibility for meeting RBS's objective of supporting the SME sector. There is no management layer below Group CEO responsible for ensuring that both this overarching objective and the expectations of external stakeholders are met.<sup>54</sup> Since data on RBS's lending to SMEs is submitted to the Bank of England on an aggregated basis, the fragmentation of responsibilities has also hampered the clarity of external communication, as market stakeholders are unable to reconcile the figures RBS reports to the Bank of England with its external communications about the Core ongoing RBS SME lending business
- **There is an "ownership" issue for viable customers in need of remediation:** The SRM sub-unit within B&C, and GRG (which reports separately from B&C), each have a mandate to support viable borrowers in financial difficulties.<sup>55</sup> However, the organisational boundary has two implications. First, in terms of customer experience, SME borrowers can be subjected to a double handover of a relationship from their existing Relationship Manager to a new one, sometimes within a short period of time. Second, from the point of view of managing the business, B&C itself has limited ability to see or influence what happens to those borrowers within GRG due to the different reporting lines. Despite being in financial distress, these borrowers may still have a viable business and therefore may be appropriate for future return to B&C

**Resolution of these issues is a pre-condition to improving operational performance:** Resolving the resulting organisational complexity is a pre-condition to improving operational performance, because responsibility for meeting the objective of supporting the SME sector needs to have appropriate focus if it is to be met. The separation of the Non Core Division and Rainbow from B&C has added greater complexity to an already complex organisation. As well as fragmenting responsibility for meeting objectives, this complexity hinders management effectiveness and consumes the risk, finance and business analyst skills required to maintain it. *This issue is addressed in Recommendation 2 (see Section 6).*

**Within B&C, three additional organisational issues are hindering operational performance:** This Review also highlights three additional organisational issues. It is not necessary for these to be resolved to ensure sufficient focus on RBS's objective of supporting the SME sector, but they hamper the ability of B&C to deliver good customer outcomes:

- **Access to the supporting capabilities required to serve SMEs:** Serving SME customers well requires the sharing of back up capabilities and services which are housed in a number of different organisational units within the bank. For example, in Business Banking much of the infrastructure used to support micro and small businesses (such as the banking platform, online channels and credit scoring technology) is owned and operated in the RBS Retail Bank. To gain access to these resources, B&C needs to be accorded adequate priority with respect to other units in the bank. To the extent that this cannot be relied upon, it becomes more difficult for B&C to serve its SME customers well

<sup>54</sup> For financial reporting purposes, the SME-specific balance sheet and income statements managed by Rainbow and GRG are consolidated within B&C's figures. However, these businesses operate under separate management teams, with distinct reporting lines, objectives, strategies and operations.

<sup>55</sup> SRM manages customers exhibiting early signs of problems; GRG handles more severely distressed customers.

- **Unnecessary movement of customers between units:** Some of the boundaries between organisational units within B&C are based on criteria which do not explicitly relate to customer needs. For example, there are two specialist Agriculture teams, one in Business Banking and one in Commercial Banking. Movement of a customer relationship between the two on the basis of an increase or decrease in – for example – turnover, does not result in a meaningfully different service offering. Where specialism is warranted, a single specialist team should suffice
- **Insufficiently distinct skillsets across units:** Similarly, the criteria used to determine whether a credit application follows the “standard” or “bespoke” process<sup>56</sup> are not in line with the criteria used to define organisational units. This makes it harder for RBS to utilise specialist capabilities within its SME business. For example, a Relationship Manager in Business Banking who predominantly uses the standard process, does not need to develop the incremental expertise to use the bespoke process. Equally, a Relationship Manager in Commercial Banking who is asked to use the standard process might be frustrated that their carefully trained credit expertise cannot be used as they deem appropriate. *This issue is tackled in Recommendation 4 (see Section 6)*

**RBS has yet to resolve these issues:** These organisational issues remain unresolved within RBS. The recent announcement by Her Majesty’s Treasury (HMT) that an “internal bad bank” will be created does not resolve the issue that there is no single point of responsibility for the entirety of the SME business (and nor was it the mandate of the HMT Review to resolve this). *Recommendations have been identified in Section 6 to address the key prevailing issues here.*

## 5.3 STRATEGY AND BUSINESS MODEL

Each of the organisational units responsible for managing a part of RBS’s SME business (that is: B&C, CSG, Lombard, RBSIF, Non Core, GRG and Rainbow) have separate management teams, strategies and processes in place to guide decision making within the organisation. This section focusses on the ongoing part of the SME relationship banking business that RBS will retain. This includes B&C and the business units (Lombard and RBSIF) that support it, but does not include Non Core, Rainbow or GRG. It considers both RBS’s strategy (that is, the basis on which RBS tries to win new business) and its business model (defined by the markets in which RBS chooses to participate).

### 5.3.1 STRATEGY

**B&C’s relationship-based strategy makes it harder to grow loan and overdraft volumes quickly...:** B&C’s strategy is centred on relationship banking. This prioritises customers who are willing to move their business current account (or the majority of their banking services) to RBS, such that RBS becomes their main banking provider. A consequence of this is that it is harder for RBS to develop new lending business outside their existing customer base because it is more difficult to “win” customer relationships than it is to lend on a purely transactional basis. This is particularly an issue given that established medium sized businesses (who borrow more than smaller businesses) change their main banking provider infrequently, while start-up and micro businesses (who change their main banking provider more regularly) both tend to be higher risk than medium sized businesses and do not borrow as much in absolute terms. At the same time, the resurgence of the broker channel (intermediaries that work on behalf of businesses to find the specific financial products they are seeking) and the rapid growth of the online channel mean that an increasing proportion of the flow of gross new lending in the overall market is undertaken on a transactional basis.

<sup>56</sup> See the overview of changes made to the credit process in Section 4.3 under “Build a platform for sustainable growth”.

...And this is not being offset by growth in RBS's alternative financing product set: B&C is supported by the Lombard, RBS Invoice Finance and Trade Finance<sup>57</sup> businesses, which are managed within the Customer Solutions Group. The "alternative financing" products sold to SME customers by these units are – by their nature – more transactional than B&C's relationship based full service offering, and they attract many customers who do not necessarily use RBS as their main banking provider. They are aimed at financing specific customer needs (such as exporting) and are not suitable for every situation. The stock of lending in the Lombard, RBS Invoice Finance and Cards businesses increased by 10% from £4.0 BN in January 2009 to £4.4 BN in 2013, yet because they represent only a small proportion of RBS's total stock, this growth has not been enough to offset the decline in the stock of loans and overdrafts in B&C.

### 5.3.2 BUSINESS MODEL

**RBS participates in all geographic markets in the UK:** RBS has a presence in all the major geographic regions of the UK,<sup>58</sup> and has retained this "national footprint" since the crisis.

**RBS lends to customers of all sizes and from the majority of industry sectors:** RBS does not exclude any potential borrowers on the basis of size (whether by turnover or size of loan), and offers lending products to all major sectors of the SME population.<sup>59</sup> RBS has also introduced "Sector Specialist" teams of Relationship Managers who have a deeper understanding of a sector and therefore their customers' businesses, and is investigating opportunities to cost effectively extend the specialist model more widely across the regional network.

**RBS maintains a wide set of lending products:** RBS supplements its traditional bank lending products (i.e. loans and overdrafts) with alternative financing products (such as leasing, invoice discounting and trade finance). Beyond this, RBS actively participates in government support schemes, including Funding for Lending Scheme, Enterprise Finance Guarantee and Regional Growth Fund. RBS has also piloted and launched new ways of meeting SME financing requirements. These include a programme to refer customer enquiries to Community Development Finance Institutions and a pilot that developed a way of better responding to SMEs' working capital needs.

**RBS originates the vast majority of new lending directly through its Relationship Managers:** RBS has sought to minimise all SME lending products originated through the broker channel from 2009 onwards. However, it has recently launched a pilot to investigate re-entry into the broker market. RBS has had an online and telephone-based loan and overdraft origination capability in place for several years, but leads originated through these channels are handed off to a manual process for completion.

### 5.3.3 RESOURCE ALLOCATION

**To grow lending faster, RBS must allocate its resources to capture growing sources of demand:** Given both its relationship-based strategy and broad business model, RBS cannot grow its lending by simply entering new geographic or sector-based markets, as it already participates in the vast majority of these. If RBS is to accelerate the speed with which it attracts and wins new lending business, it must make good decisions about where to deploy its resources across the markets in which it already participates (for example, re-assigning Relationship Managers to a particular sector or region), grow volumes through different channels into those markets (e.g. online or broker) or launch new lending products that better meet customer needs.

<sup>57</sup> Lombard is the UK's leading provider of asset-based finance products. These products are structured around the asset being financed (e.g. machinery, trucks) and are typically longer term in nature. RBS Invoice Finance is the UK's leading provider of factoring and invoice discounting, providing debtor management services and financing options based on an SME's debtor book. Trade Finance products facilitate and finance the trade process for SMEs importing or exporting internationally.

<sup>58</sup> RBS SME coverage of Northern Ireland is provided by Ulster Bank, which is not in scope of this Review.

<sup>59</sup> RBS has lending restrictions in place in a small number of sectors (e.g. Defence, Gambling, Oil & Gas, Online Adult Entertainment) and in ~20 sub-sectors.

**RBS does not yet allocate its resources on a deeply informed or systematic basis:** In the course of this Review, little evidence has been seen to demonstrate that RBS systematically monitors lending potential in different areas of the market (e.g. across industry sectors, regions and channels) or systematically assesses the impact of re-deploying people or limited finance from one place to another. As a result, RBS has not had a strong basis on which to allocate its resources across different areas, activities and roles. In conclusion, a stronger capability to make decisions about the allocation of scarce resources is needed, supported by better information and more analytical rigour. *This is addressed in Section 6 under Recommendation 5.*

## 5.4 PEOPLE

This section reviews the skill levels of RBS's Relationship Managers and Credit Officers, who – together – are responsible for making decisions on whether to lend.<sup>60</sup> It also considers the ways in which behaviours of individuals are affected by the environment, culture and incentives that RBS has put in place around them.

**Compared to the pre-crisis period, the number of RBS Relationship Managers is not a limiting factor:** RBS has reduced the number of Relationship Manager employees since 2008 by ~10%. The number of Relationship Managers dedicated to new lending activities has decreased by ~20% due to their re-allocation to business units dealing with customers in financial difficulty (as per Section 5.5.3). In addition (as per Section 5.5.1), Relationship Managers spend proportionally less time on lending activities than they did before the crisis. Clearly, increasing the number of Relationship Managers would result in a marginal increase in lending volumes. However, for reasons cited below and in Section 5.5.1, Relationship Managers are currently less productive in terms of lending volumes than they were pre-crisis. There is therefore scope to increase productivity of the existing customer facing staff, which means that the number of Relationship Managers is not a limiting factor relative to the pre-crisis position.

**RBS has invested in the skills of its Relationship Managers:** RBS has invested significantly to restore skills that had been eroded in the run up to the crisis. It has introduced a training and accreditation programme for its Relationship Managers and has also begun a programme to ensure that its Relationship Managers hold a professional bankers' qualification. The introduction of "Sector Specialist" teams and the "Working With You" programme (which seeks to ensure that Relationship Managers spend four days a year on site with their customers) have improved staff's understanding of customers' businesses. Based on the Review's assessment of the quality of credit files, interviews with Relationship Managers and Credit Officers and feedback from external third parties, the overall skill level of Relationship Managers is judged to be broadly in line with industry standards.

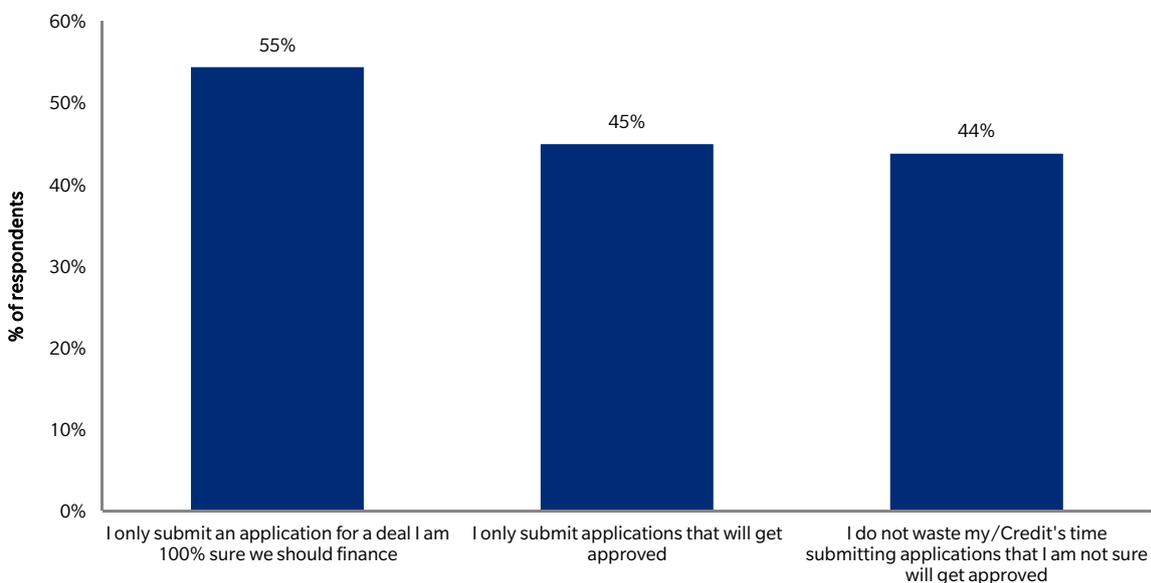
**Relationship Managers' credit skills remain variable and lower than required:** However, Relationship Managers' credit analysis skills – which enable them to structure applications on behalf of their customers – remain variable and generally lower than required to support RBS's aspiration of market leadership based on a relationship-based strategy. For example, in the Credit File Review (see Section D.5.2) a significant variation in the quality of analysis and standard of application was observed. Whilst some applications were of a high standard, some applications were of insufficient detail and clarity for a well informed decision to be made.

**Credit Officers could be more creative when discussing deals with Relationship Managers:** Based on a benchmarking exercise, it is observed that the skills of Credit Officers are broadly in line with industry standards, and in some areas exceed them. Nevertheless, limited flexibility and creativity in both parties was observed when Credit Officers discussed the structuring of deals with Relationship Managers, and it would be desirable to develop a greater sense of "mutual endeavour" and increased trust to improve lending volumes. For example, expert reviewers felt that in 15% of the cases discussed, an alternative facility or outcome would have been more beneficial for the customer than that which was in fact agreed. Both Credit Officers and Relationship Managers have a role to play in ensuring the best possible customer outcomes.

<sup>60</sup> Credit Officer involvement is not required in the decision making process on all applications, e.g. for loans below certain size thresholds.

**Compared to the pre-crisis period, there is less encouragement to generate lending applications:** Relationship Managers are now appraised (and therefore financially rewarded) less directly based on lending volumes and financial performance than in the pre-crisis period. These changes have reduced the propensity for Relationship Managers to submit lending applications that might be rejected through the credit process. In addition, changes in the appraisal process for Credit Officers mean that approving applications that subsequently turn bad results in greater personal sanction. The implications of this can be seen in Figure 13, which shows that more than half of RBS staff only submit applications for deals that they are 100% sure should be financed, and nearly 50% only submit applications that will get approved.

**Figure 13: Attitudes of RBS staff to submitting applications for finance, Q4 2013**



Source: RBS staff survey Q4 2013

**These factors have resulted in risk aversion at an individual level:** In combination with the way in which the Policy & Guideline framework was initially introduced and communicated (as outlined in Section 5.1), it is concluded that Relationship Managers and Credit Officers have become more risk averse than they need to be. This has resulted in some lending not being made that is within the risk appetite of RBS at a portfolio level. These factors have also frustrated Relationship Managers, whose confidence in realising their own potential for business development is compromised. *These issues are addressed in Recommendation 6 (see Section 6).*

## 5.5 PROCESS

This section assesses the extent to which the processes and tools used by RBS are affecting its ability to meet its objective of supporting the SME sector. The processes reviewed are the business development process, which is used to generate new lending opportunities (primarily from existing customers of the bank); the lending process, through which RBS converts those opportunities into drawn facilities; and the processes used by RBS to manage risks or issues that arise among its existing borrowers.

## 5.5.1 BUSINESS DEVELOPMENT

**RBS's borrower base is shrinking:** RBS's existing borrower base is shrinking and, in line with the rest of the market, fewer new prospective borrowers are approaching RBS.<sup>61</sup>

**Relationship Managers have less time for business development:** Relationship Managers have primary responsibility for developing new lending business. However, they spend only a small proportion of their time working on this. Relationship Managers report that they spend less than 10% of their working hours looking for new customers with a borrowing need, according to the Q4 2013 staff survey.

**Work is already underway to prioritise business development:** RBS has taken steps to free up Relationship Managers' time for business development and other client focused activities, and to focus staff on business development activity in a more systematic way:

- Business Banking introduced a new Customer Relationship Management system in 2012. This has increased the discipline with which Relationship Managers approach business development
- Commercial Banking has launched initiatives focussed on particular sectors (such as leisure) and the needs of particular customers

**Better use of central information could be used to improve business development further:** There is still further room for improvement. Business development is not yet informed by high quality information and a strong central capability to use this information to change and improve how RBS seeks to develop new lending business. For example:

- The bank does not systematically search, develop and reapply "best practices" from across the business, with commercial practices varying widely across local teams and sectors
- Pricing is not well informed by insight on the impact it will have on lending volumes
- Relationship Managers and central support functions could work much more closely together to improve business development activity

*Better use of data, insights and metrics is captured in Recommendation 5 (see Section 6).*

## 5.5.2 LENDING

**The end-to-end lending process can be decomposed into four stages:** The individual decisions that a bank makes about whether or not to lend are a result of the end-to-end lending process that it has in place. There are four discrete stages in this process:

- **Pre-contact:** For the customer, the act of borrowing often begins with an assessment of their own need for external finance and the crystallisation of that need in a decision to approach a finance provider (be that a bank, building society, finance company or investor) to discuss it in more detail
- **Initial engagement:** The bank's first interaction with the customer often occurs when the customer approaches it to discuss its financing need. The bank will make an initial examination of the request, which is framed against the bank's lending policies. This request can be progressed, amended, dropped by the customer, or turned away by the bank
- **Application, approval and appeal:** If the customer's request progresses, the next step is the completion of a formal application, setting out the request in detail and seeking approval via the appropriate decision making process in the bank. The procedure for reviewing the decision process is known as underwriting. Rejected applications can be appealed by the customer and may be subsequently approved

<sup>61</sup> SME Finance Monitor, YEQ2 2013 Quarterly Survey, August 2013. Proportion of all SMEs interviewed that reported a Type 1 borrowing event (new application/renewal) in the 12 months prior to being interviewed.

- **Completion, contracting and draw down:**<sup>62</sup> If the application is approved, the bank will complete the contractual paperwork (in which the terms and conditions of the deal are prescribed), after which the customer facility is set up on the bank's systems. The customer may agree to, and use the facility. Alternatively, the customer may choose not to agree to take up the facility, or agree to take up the facility but not make use of it (i.e. it may not "draw down" on the facility)

**There are many reasons for attrition between initial engagement and draw down:** At each stage of the process there is attrition or fallout as customer enquiries are not progressed further. From the point of initial contact with a bank, there are many potential reasons for this, including:

- **Initial engagement:** The customer decides that they no longer have a need for finance; the customer decides that an alternative source of finance (non-bank) is more suitable; the bank informs the customer they are not sufficiently credit worthy to be approved and the customer decides not to progress; the bank informs the customer of the likely cost or terms and conditions of the loan and the customer decides not to progress
- **Application, approval and appeal:** The bank rejects the application; the customer appeals the application but the original decision is upheld
- **Completion, contracting and draw down:** The customer is unwilling to meet the terms and conditions as set out by the bank; the customer is unwilling to pay the price offered by the bank; the customer has a more favourable offer from a competitor; the customer accepts the facility, but does not draw it down because they ultimately do not need it

**Some of this fallout is inevitable or outside of the banks' control:** It is inevitable that some customers will drop out of the lending process at each stage. For example, customers who are not credit-worthy may submit an application but should not be offered a facility. It may also be the case that a customer is seeking debt finance from a bank, but in actual fact their requirements are much better suited to an alternative form of finance (e.g. equity finance; see Box 2 for further discussion). Some of the fallout is also outside the bank's control. For instance, a customer may well make an enquiry for bank finance but subsequently decide that they no longer need this finance.

**Attrition through the end-to-end lending process is greater than rejected formal applications:** Approval rates on formal applications are often cited in public debates regarding SME lending. These are important statistics, but should be considered in the context that the decision on a formal application is just one of multiple stages in the lending process. The overall fallout rate from initial approach to drawdown is therefore much higher than the proportion of formal applications which are rejected.

**RBS converts ~1 in 4 of all approaches into lending, slightly lower than the market average:** On average, RBS succeeds in converting approximately 1 in 4 of all approaches it receives from SMEs seeking finance into a drawn facility. This is slightly lower than the market average. However, RBS's conversion rates do differ significantly by sector (e.g. Hotels and Restaurants, Health and Social Work, and Agriculture have higher conversion rates than Construction and Real Estate).

<sup>62</sup> Draw down occurs when a customer actually uses the facility to which they have been granted access.

**Table 4: Conversion rates along the SME lending process from an initial customer approach: RBS and Market**

Stage	Pass through rate per approach for borrowing (%)	RBS	Market
Initial engagement	SMEs contacting bank to discuss financing	100	100
Application, approval and appeal	SMEs submitting a formal application to the bank	40	51
	Bank approves the application	33	39
Completion, contracting and draw down	SMEs accepting the approved facility	32	37
	SMEs drawing down on the approved facility	23	27

**RBS “pre-screens” more customers early on in the lending process than its competitors:** As shown in Table 4, it is estimated that the rest of the market converts marginally more approaches into a drawn facility than RBS. The major driver of this difference in conversion rates occurs at an early stage; RBS does not progress as many approaches from SMEs from pre-application stage into formal applications, pre-screening ~60% of applications after initial discussions, compared to ~50% on average for peers.

**This may in part be due to differences in processes...:** Differences in processes between banks may in part explain this difference. For example, it is noted that the RBS affordability calculation used for all smaller lending is separate from the credit scoring, and takes place *before* credit scoring (i.e. before application). SMEs seeking finance from RBS but fail the affordability test are therefore not considered to have made an application, unlike with other banks. This is not necessarily the case for all other banks. This results in a number of enquiries which do not proceed to application at RBS, which might proceed at other banks.

**...But the root causes are not entirely benign:** Two factors have been identified to explain RBS’s tendency to screen out more potential borrowers at an early stage, relative to the market average:

- The personal risk aversion of both Relationship Managers and Credit Officers highlighted in Section 5.4 above (*see Recommendation 6*)
- A time consuming credit process which uses relatively weak customer scoring models and infrastructure,<sup>63</sup> and which takes longer to complete than those of competitors (*see Recommendation 4*)

**At the application, approval and appeal stage, RBS appears to perform better than peers:** Once SMEs have submitted a formal application, all the evidence seen suggests that RBS performs broadly in line with, or better than, its competitors, and that the majority of SMEs (80–85%)<sup>64</sup> are satisfied with the outcome. Specifically, British Bankers’ Association data suggests that compared to the market average RBS approves a higher proportion of applications, has a lower rate of appeal and a lower overturn rate upon appeal. Other data sources broadly support this finding. However, it is difficult to draw conclusions from these figures in isolation. For example, the finding that RBS screens out more potential borrowers at an early stage than other banks do is consistent with, and may be a partial reason for, these higher approval rates, because customers that make it through to the formal application process will be of a higher quality, on average.

**Although an application might be approved, the SME may not necessarily use it:** Survey evidence suggests that many borrowers that have an application accepted are not offered the exact deal that they applied for. In some cases, customers will not agree to a facility due to, for example, altered pricing or terms and conditions. Furthermore, although terms and conditions are contractually agreed between the borrower and lender in a very high proportion of the cases where applications are approved, a significant proportion of these agreements are never used by the customer. There is little evidence to suggest that outcomes for RBS differ from the market in regard to completion and draw down.

<sup>63</sup> As assessed based on a detailed industry benchmarking.

<sup>64</sup> RBS event based survey April 2013; 425 responses.

**It is likely that pre-screening is limiting borrowing:** In conclusion, it is estimated that RBS is screening out more customers at the initial engagement stage than the rest of the market. Some of those being screened out are likely to be suitable for bank financing. Like all banks, RBS makes mistakes when declining formal applications, as evidenced by the independent appeals process. RBS's own analysis suggests that as many as 10% of the formal applications that RBS declines are in fact potentially suitable for bank financing: some of the 10% identified in the analysis were subsequently overturned on appeal, some were left as 'marginal' declines. This analysis suggests that it is reasonable to assume that as many as 10% of SMEs who are being screened out by RBS at the pre-application stage, might in fact also be suitable for bank financing. This is particularly the case given that formal applications by definition entail a higher level of due diligence than an early stage customer discussion that results in the customer being screened out at that point. If RBS were able to put these marginal deals into the formal application process, RBS's approval rate for applications might decline slightly, but its overall conversion rate would likely improve as some of these deals would be accepted.

**RBS has launched a project to review its lending process:** RBS has already launched a major project to review the end-to-end lending process to address this issue. *Following Recommendations 4, 6 and 7 (see Section 6) will further aid resolution of these issues.*

### 5.5.3 MANAGING CUSTOMER RELATIONSHIPS

#### 5.5.3.1 MARKET WIDE ISSUES

##### 5.5.3.1.1 REASONS FOR APPROACHES TO CUSTOMERS

**The majority of SME borrowers repay according to the agreed contractual terms:** The vast majority of SMEs who borrow from a bank (not just RBS) are likely to repay in full, and in accordance with the agreed contractual terms. This engenders a mutual sense of respect and trust between a Relationship Manager and the customer. On average, across a full economic cycle, approximately 3–7% of micro and small businesses who borrow will default on their repayments, compared with approximately 0.5–2% of medium sized businesses (depending on sector definitions and prevailing lending standards).

**Banks have become more active in approaching customers:** Two main factors have driven banks to become more active in recent years in approaching customers to restructure facilities or make changes to the terms and conditions attached to loans:

- **The pressure on banks' balance sheets has increased:** Following the financial crisis, the strain on bank balance sheets has increased. Some of this pressure is a direct result of the sharp increase in the number of borrowers generally (beyond the SME population) defaulting on their loans, which resulted in significant losses for the banks and in turn has depleted their capital reserves. At the same time, regulatory changes have required banks to hold more capital against their lending portfolios. Banks have therefore been anxious to improve the economics and risk management of their SME lending and to reduce the capital reserves that must be held against such lending
- **The financial situation of some SME borrowers has deteriorated since the crisis:** The recession which followed the financial crisis of 2008 has put severe strain on the finances of some SMEs, as evidenced by the fact that insolvency and bankruptcy rates amongst SMEs spiked sharply in 2009 and 2010 (particularly within Commercial Real Estate). Although these rates have subsequently fallen, research suggests that over 85% of SMEs have seen shrinking or flat profit margins, cashflows, reserves and investment in the past two years.<sup>65</sup> Financial performance is mixed across the SME population: the 60% of SMEs who express confidence about their business outlook have been buoyed by considerably better financial performance over the past two years than the 40% of SMEs who are less confident. Indeed, one industry organisation

<sup>65</sup> Zurich and The Economist Intelligence Unit, "Adapting in tough times: the growing resilience of UK SMEs", November 2012.

estimates that as many as 9% of all UK businesses now operate as “zombie companies”<sup>66</sup> struggling to service their debts. Affordability considerations or signs of financial pressure have made banks keen to mitigate the danger of potential future defaults

Both of these reasons have contributed to banks approaching many SME and corporate customers with existing borrowing agreements and seeking changes in the terms on which lending is carried out. Much of this re-negotiation occurs at the point when contracts are up for renewal.

#### 5.5.3.1.2 ACTIONS WHICH BANKS MAY TAKE

The actions taken by banks in approaching customers fall into three categories, depending on the purpose of the approach. Issues arise that are relevant to the management of the relationship in each case. These become more difficult as the seriousness of the financial condition of the SME rises.

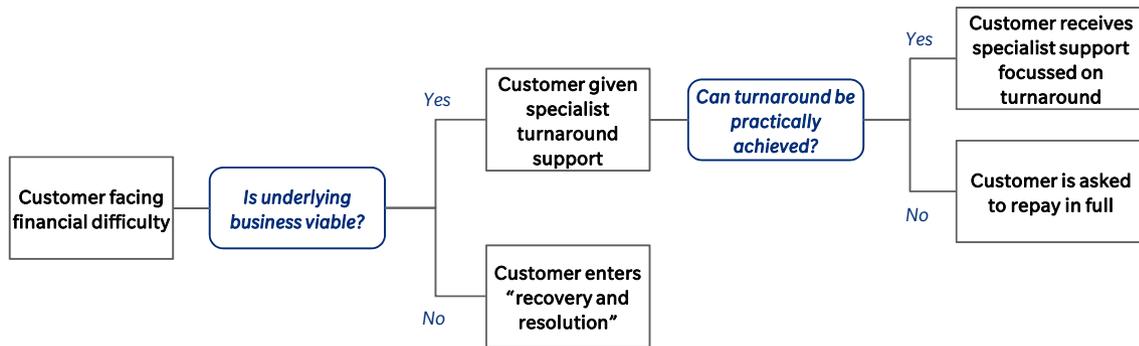
1. **Changes to an existing facility:** Not all changes to existing facilities are due to concerns that customers are having or will have financial difficulties. A bank might approach a customer to make changes to a facility for its own risk management or economic reasons. As such, banks may alter existing facilities:
  - To reduce unnecessary consumption of capital (e.g. the reduction of overdraft limits to better match the extent to which the customer is actually using those limits)
  - To provide a more suitable product while also reducing capital consumption for the bank (e.g. the conversion of an overdraft into an invoice finance facility, or a loan into a leasing arrangement)
  - To manage its risk exposure (e.g. the conversion of an overdraft which is being consistently and highly utilised into a loan)

It should be noted that where the act of changing an existing facility makes it more expensive or less flexible, then the change itself can create financial difficulties for the customer.

2. **Specialist support, focused on “turnaround”:** If a borrowing customer’s financial situation does begin to deteriorate, its bank will need to assess both whether the business remains viable, and also establish what changes may be required to ensure that customer’s viability. As long as these changes can be realistically achieved, then the interests of the bank and the SME are likely to remain closely aligned. Expert advice may need to be deployed to support the customer: for example, either to make changes to the operations of a business or to alter its capital structure. Such advice may also be needed to support the bank’s decision making: for example, to assess the costs and benefits of allowing a capital repayment holiday, restructuring the facilities, or – in more challenging cases – writing off a portion of the debt or converting it into equity
3. **“Recovery and resolution”:** If the business is deemed non-viable, or agreement cannot be reached on how to ensure viability, the interests of the bank and its shareholders must still be protected. At this point, the interests of the bank may become increasingly divergent from the wishes of the customer concerned. Typically this will mean that the bank asks for its lending facilities to be repaid in full. The customer may be able to do so by drawing on other funds, selling assets or refinancing with another bank or lender. Alternatively, the bank (or another creditor) may make a statutory demand for repayment if it feels the business is not viable. This demand, if not met, will result in an insolvency process. The bank will assert the primacy of its position as a lender and seek to recover the money owed to it, working with the administrator of the insolvency process to resolve its claims

<sup>66</sup> R3 (Rescue, Recovery, Renewal) “Are zombies really attacking the UK economy?” A “zombie” company is defined as one which experiences any of the following: just paying the interest on debts (and not the debt itself), will be unable to repay debts if interest rates rise, having to negotiate payment terms with creditors, struggling to pay debts as they fall due.

Figure 14: Illustrative decision process for customers in financial difficulty



**Key**

Customer situation

Bank decision point

### 5.5.3.1.3 HANDLING APPROACHES TO CUSTOMERS

Whatever the reason for the approach, banks face decisions which are difficult and require sensitive handling. Alterations to facilities are liable to provoke a reaction: Any alterations of terms in the bank’s favour are liable to provoke a reaction, particularly if not transparently and well explained. This can damage the good relationships that a bank has built up with its customers. This is the case both for instances where the bank’s own economic and risk standards considerations apply, but particularly where deteriorating financial performance is the driver.

- At the point at which the customer’s situation causes the bank to move the SME to recovery or resolution, customer and bank interests can become misaligned. The method by which the bank seeks to protect its interests on behalf of its shareholders may then differ from the customer’s preferred course of action. A bank will seek to minimise the loss it is exposed to, were the business ultimately to fail and be unable to repay the amount it owes
- Particular care is needed in the SME sector, because business and personal finances are often interconnected. Consequently, any decisions that banks might take which affect the financial position of the business are complex, and can affect the livelihood and lifestyle of the people involved in that business. Unsurprisingly, therefore, these decisions can evoke strong emotions

Challenges arise both in terms of the key decisions which need to be made and the means by which they are communicated to the customer.

The following factors are relevant to banks in handling their relationships with customers:

- **Banks’ actions have consequences for customers:** Actions taken by a bank to approach borrowers can be extremely stressful. “Early stage” changes (such as reducing overdraft limits to better reflect the amount the customer typically borrows each month) might appear to have no immediate impact on that customer: but they can nonetheless be viewed as detrimental. At best, the customer may perceive such action as signalling a reduced willingness to lend to them. At worst, such actions can themselves directly affect the financial performance of the borrower, who may subsequently find themselves with less financial flexibility just when they need it

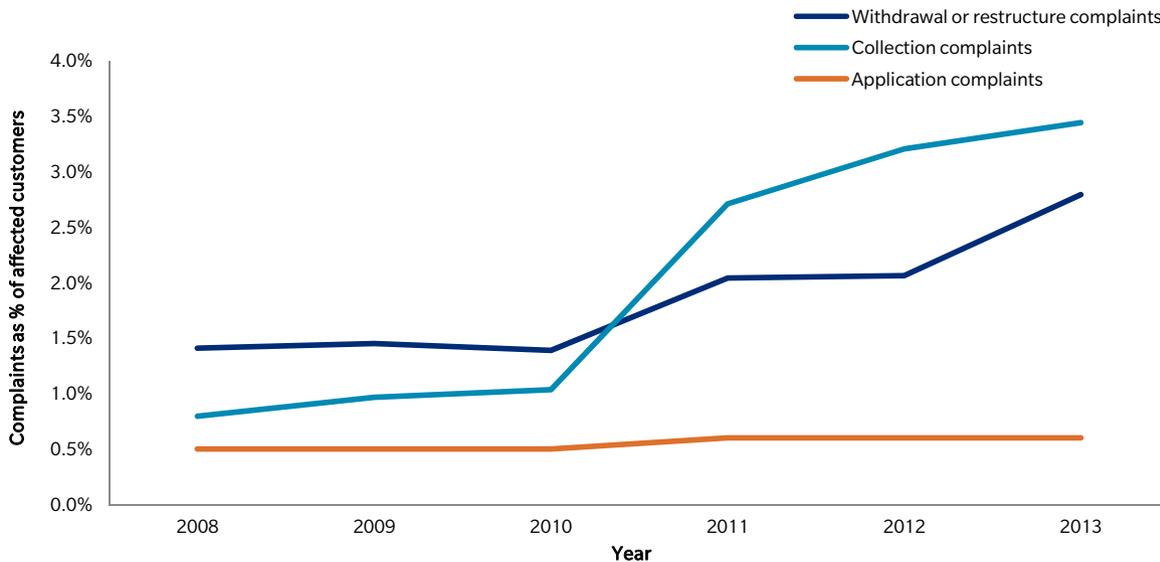
- **Banks must still act fairly and proportionately:** The respective interests of both the bank and the SME should be handled in a fair and proportionate manner, and banks should hold themselves to high behavioural standards, regardless of the existence or level of financial distress faced by the customer. The small size of SMEs means they are typically unable to draw on significant resources or experience to pursue their interests in the way that larger corporates may be able to. This means the balance of power is tilted in favour of the banks. Irrespective of how well judgements and decisions have been made by a lender and imparted to the borrower, this structural imbalance leaves the bank open to criticism and potential reputation risk
- **Appropriate governance and processes are needed to ensure fair and proportionate behaviours:** Given both the risk that customers may (from their point of view) receive a sub-optimal outcome and the associated reputational risk for banks, banks must ensure that there are adequate checks and balances built into the processes and governance structures for dealing with deteriorating situations. Decisions must be taken with due consideration of not just the bank's position but also the long term interest of the customer, at each stage of the process:
  1. **Changes to an existing facility prompted by the banks' own economic or risk management considerations:** While the bank's economic or risk management rationale for such action may be sound, the decision to act in the case of any individual customer should be made on the basis of a good understanding of how it might affect the position of the business, and should be well communicated, so that the customer understands what is happening and why. This should be the responsibility of the Relationship Manager and Credit Officer who look after the relationship with the borrowing SME customer on behalf of the bank
  2. **Specialist support, focused on "turnaround":** Decisions to deploy the expert advice required at this stage should ideally lie with the overall management of the bank's SME lending business, and should ideally sit alongside the Relationship Manager. This is because the intention of the turnaround stage is just that: to turn the business of the SME around so that it may once again be regarded by the bank as a healthy ongoing concern, capable of servicing its obligations. However, processes must be in place to manage any natural inclination for potential forbearance on the part of the SME's normal Relationship Manager, who may not act quickly enough to put in place the relevant measures to turn the company around
  3. **"Recovery and resolution":** This process is typically managed by a specialist recovery unit. If the recovery unit is run as a profit centre, then the incentives of the unit will be linked to the added value that it can bring to the bank's shareholders by maximising the recovery of the bank's position. In this instance, it is particularly important that there is an independent authority responsible for deciding when a customer relationship should pass from a turnaround situation (where the interests of the SME and the bank are aligned) to recovery and resolution (where they may diverge). At this stage the relationship with the customer will inevitably alter, so extra care will be needed to limit the breakdown of relationship as the bank asserts its own interests on behalf of its shareholders

#### 5.5.3.2 SITUATION AT RBS

**RBS has been particularly active in approaching customers both for the bank's own economic and risk management reasons and as customers have experienced financial distress:** In keeping with the tighter credit policies and adherence to higher prudential standards that were introduced after the financial crisis, RBS encouraged its Relationship Managers to address legacy issues in the lending portfolio. This included using annual reviews and renewals of expiring facilities as an opportunity to approach customers to make changes to their facilities which would reduce RBS's risk and increase their returns. In addition, ~£15 BN of SME assets were deemed Non Core, with an explicit goal to reduce lending exposure to these assets.

**RBS customers have been vocal about this treatment:** Complaints by RBS customers about changes to a facility have increased both in absolute terms and as a proportion of all RBS SME borrowers. In addition, complaints about RBS’s collections processes have risen six-fold since 2008. As a proportion of the SMEs affected, both types of complaints are nearly five times more likely than a complaint about the application process (see Figure 15). This may be an indication of inadequacies in one or both of RBS’s decision making processes and its communications with customers.

**Figure 15: RBS SME lending complaints as a % of affected customers, 2008–2013**



Source: RBS complaints data, SME Finance Monitor; Oliver Wyman analysis

1. “Withdrawal or restructure” complaints measured relative to # SMEs approached by RBS to renegotiate or cancel an existing facility; “Collection” complaints measured relative to SMEs in bad debt; “Application” complaints measured relative to number of SMEs who made an application for a loan or overdraft

2. 2013 figure is estimated based on data to June 2013

**The scale and nature of complaints can adversely impact the bank’s reputation and have broader implications...:** Both RBS’s leading market share and the scale of the legacy problems in its lending portfolio have contributed to the number of approaches it makes to customers to alter their facilities. For both of these reasons, it is likely that dissatisfied RBS customers are highly visible in media coverage of such issues. This has broader implications: any perception that the bank is not lending money, but rather withdrawing it, has the potential to discourage some customers from approaching RBS to discuss new borrowing needs, thus reducing current and future demand for borrowing.

**There are two important issues in considering the dissatisfaction expressed by customers:**

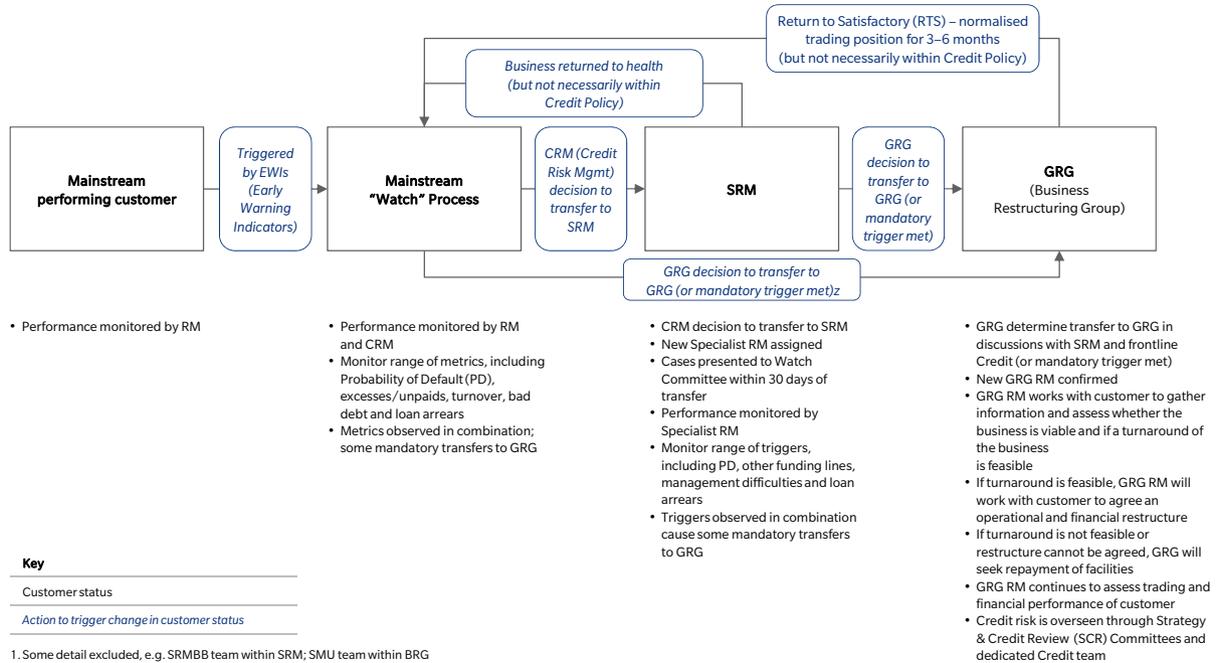
#### 1. Process complexity

- **Relationships with financially distressed customers are managed within RBS by different units depending on their situation...:** As the financial position of a borrower deteriorates, RBS offers specialist turnaround support to try to restore the SME to financial health. Less serious or “early stage” cases are managed within B&C, where the Specialised Relationship Management unit deploys expert credit skills and has the mandate to use techniques that do not fundamentally alter the customer relationship (e.g. capital repayment holidays). If the business continues to deteriorate, responsibility for both managing the customer relationship and enforcing credit policy is transferred from B&C to GRG.<sup>67</sup>

<sup>67</sup> GRG does not manage all SME customers that meet the relevant criteria to be considered sufficiently distressed to be GRG eligible (e.g. customers which hit mandatory triggers for transfer as per Figure 17). For example, in Business Banking, distressed customers are managed in Specialised

As per Figure 16, some customers are moved straight to GRG if pre-defined triggers are met which result in mandatory transfer. This business unit has two functions: first, responsibility for debt restructuring as part of turnaround cases; and second, past the point of non-viability (where the governance process for the decision is of such importance), for recovery and resolution in the event that an SME does not agree to the restructuring or is deemed to be unviable. GRG has a broader mandate than SRM to restructure existing facilities (including, for example, debt-for-equity swaps), which are often used to aid turnaround of cases. In each case the expertise and skill deployed appears to be of high quality

**Figure 16: Transfer process for distressed customers within RBS**



- **... But this results in a complex process:** Customers undergoing turnaround may be subject to “double handovers” as their situation deteriorates, being passed from their original Relationship Manager to the SRM Relationship Manager and then again to the GRG Relationship Manager. As this occurs, the Relationship Manager originally serving the SME will no longer be directly involved in the case. This process is difficult to explain to customers and can result in customer dissatisfaction and complaint, particularly if changes to a customer’s Relationship Manager then occur subsequently within either SRM or GRG. *Recommendation 2 (see Section 6) deals with this issue*

## 2. Perceptions of conflict of interests

- **A small minority of RBS customers have made more extreme accusations:** In addition, the customer consultation exercise highlighted a small number of customers who are angry about the treatment they have received from RBS during periods of financial distress. The Review has received information in relation to such allegations from three separate sources. First, the Department for Business, Innovation and Skills (BIS) shared with the Independent Lending Review a “mailbag” of emails and letters that Ministers and MPs have received from SMEs. These contained several examples of existing borrowers complaining about their treatment by RBS. Second, this was also highlighted by 11 of the ~550 RBS SMEs who provided feedback on the website set up as part of the Independent Lending Review. Third, BIS also shared with the Independent Lending Review material written by its Entrepreneur in Residence

Relationship Management Business Banking (SRMBB) and are therefore not transferred to GRG. Financially distressed customers with debt of less than £1 MM in Commercial Banking are managed by SRM, but the Credit Office is switched from B&C to SMU (which is part of GRG). Sufficiently financially distressed customers with debt of >£1 MM are managed within GRG (those customers with a turnover of up to £25 MM are managed by the Business Restructuring Group (BRG) sub-unit within GRG).

Dr Lawrence Tomlinson, which compiled further case studies and examples relating to this issue. It is important to note that the validity of the accusations made in these sources has not been investigated, as a forensic inquiry into individual cases was not in the scope of the Independent Lending Review. It is however recommended (*see Recommendation 3 in Section 6*) that an investigation into such claims is undertaken separately

- **The accusations however highlight a perceived conflict of interest within RBS:** The accusations mainly stem from a perceived conflict of interest within RBS, such that RBS does not meet expected standards of conduct and may even be profiting by working against the best interests of financially distressed customers. These claims focus primarily on RBS's Global Restructuring Group. They assert that on occasion, although purporting to be acting in the interests of a turnaround, GRG may in fact be acting to retrieve the maximum value for the bank and its shareholders by initiating a recovery or resolution process and thereby actually hastening the failure of businesses. The accusations also highlight the role played by West Register, a wholly owned subsidiary of RBS responsible for acquiring, managing and selling properties as part of the recovery and resolution process. *Recommendation 2 (see Section 6) will help resolve this issue*
- **GRG has been successful in executing its mandate...:** The processes that are currently in place at RBS have been designed to ensure that the bank is able to deploy the deep expertise contained within GRG quickly and effectively, for the benefit of both the customer and the bank. It is important to note that despite the accusations from unhappy customers, over half of all customers under the relationship management of GRG are returned to normal relationship management within B&C, around a third refinance with another bank or repay through asset disposals and only a minority (~10%) enter insolvency proceedings. Indeed, there are examples where SMEs want their relationship to remain within GRG due to the expertise and assistance that they have provided in turnaround situations
- **...However, RBS's governance structures do not do enough to address the potential conflict of interest:** Internal structures at RBS are not well suited to mitigating the risk of poor perceptions arising for the whole bank as a result of the experiences of distressed customers:
  - o GRG is run as an "internal profit centre", with its profit and loss account based on the incremental income that it generates for the bank, less its operating costs. Yet GRG retains the ultimate authority over which customer relationships are transferred to it. In practice, decisions to transfer customers to GRG are usually initiated by the (Specialised) Relationship Manager or Credit Officer within B&C (in consultation with GRG). However, GRG officially retains the ultimate decision making authority rather than an independent body, and there are no other procedural checks and balances in place (such as a negotiated transfer price between B&C and GRG)
  - o GRG also has responsibility for the move from turnaround to resolution and recovery. Once responsibility for managing the relationship with a customer has been transferred to GRG, B&C has limited visibility over the actions taken and decisions made by GRG, regardless of whether the objective is turnaround or recovery and resolution. The governance process for the critical decision of whether a business has reached the point of non-viability is therefore opaque both to B&C and to the SME itself, which may be unaware or unprepared for the consequences of the change
  - o Any such move requires timely decision making and an absence of any forbearance, but as outlined above this change requires particular care given that this is the point where the interests of the customer and the bank are likely to diverge. These governance structure issues exacerbate the risk of a perceived conflict of interest
- **Potential conflicts of interest in processes and governance structures are a particular issue for SME customers...:** This issue of potential conflict of interest in the processes and governance structures used by RBS to manage relationships with customers who encounter financial difficulties is particularly acute in relation to RBS's SME lending business. This is because the decisions and actions taken by the bank can be highly unsettling and emotional for the customer, as they will likely impact the livelihoods of the individuals and families who own and run the SMEs in question. Unlike larger corporates, SMEs

typically lack the funds or expertise required to challenge the banks in protecting their interests. RBS has not been sufficiently cognisant of the impact that its current approach is having on its SME customers and the reputational risk associated with this

- **...and RBS should take individual accusations of inappropriate behaviour seriously:** The individual accusations and allegations that the Independent Lending Review has been made aware of through its customer consultation exercise raise questions of behaviour and ethics, as well as those of process and governance. The Review has not sought to assess the underlying substance or veracity of these assertions and allegations. To do this would require specific forensic capabilities and due process to be put in place. However, it would be harmful for all parties for such accusations to go unaddressed. RBS should therefore instigate a separate investigation to substantiate or refute the serious accusations that have been made (*as per Recommendation 3 in Section 6*). Depending on the outcome, this could lead to the need for cooperation with the relevant Authorities, as well as potential changes in behaviour or culture

## 5.6 COMMUNICATION

RBS communicates in a broad sense with multiple parties regarding its lending to SMEs. Three broad groups are particularly important: SMEs (customers and prospective customers); market stakeholders (e.g. Government, Regulators, politicians); and internal stakeholders (in particular, customer facing employees). The consultation exercise undertaken by the Review highlighted the importance of RBS communicating effectively with each of these groups.

### 5.6.1 CUSTOMERS

Communication with customers is an important tool for all banks. First, it enables banks to make SMEs aware of the products and services that they offer. A clear “open for lending” message will attract more would-be-borrowers. Second, communication can make a bank’s products and services easier to access, use and experience. This can be achieved via several mechanisms: managing customer expectations (e.g. the decision process will take “x” days); making it clear what improvements are being made and why (e.g. we know that “x” days is too long, and we have implemented specific initiatives to improve it and reduce the time taken to “y” days...); and engaging customers in a two way interaction to make the experience better for all parties (e.g. if you provide us with up to date financial information in a particular format, we can reduce the processing time to “z” days).

#### 5.6.1.1 CUSTOMER AWARENESS

**After the crisis, RBS centralised control over customer marketing...:** For the first few years after the crisis, the bank centralised control over customer marketing. This included the withdrawal of local PR budgets, and a policy that restricted Relationship Managers in independently contacting their customers via letter or email. This reduced the bank’s ability to promote the message that it is “open for lending” to individual customers and in local markets.

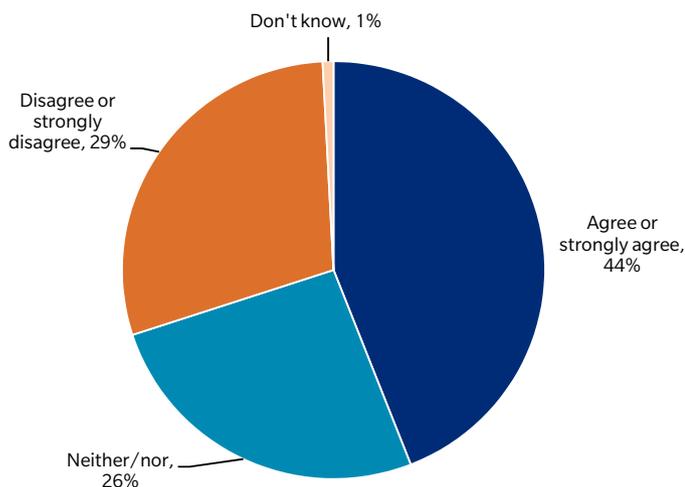
**...But it has now acted to reverse this:** RBS reinstated local PR budgets in 2012 and launched customer roadshows to promote the bank’s lending activity at a local level. The bank also invested in a national advertising campaign targeting SMEs specifically, although this had broader aims and did not focus on the specific message that the bank is “open for lending”. More recently, the bank has begun to promote its industry funds (for example, RBS has a £300 MM Fund<sup>68</sup> available to support SME businesses within the UK leisure sector) and

<sup>68</sup> The Leisure Fund was extended by £150 MM to £300 MM in October 2013 after the initial £150 MM fund pledged in May was fully allocated.

contact individual customers to outline its “statement of appetite” for lending (for example, RBS has proactively written to more than 1,400 SME customers stating its appetite to lend them more than £1.4 BN).

**However, not all customers have yet “heard” the messages that RBS has been communicating:** Yet, 30% of RBS customers who were surveyed as part of this Review disagreed with the statement that RBS was “open for lending”. *Recommendation 8 (see Section 6) tackles this issue.*

**Figure 17: Proportion of RBS customers that believe RBS is open for lending, Q2 2013–Q3 2013**



Source: SME Finance Monitor re-contact survey, Q3 2013

1. Full question: “To what extent do you agree with the statement “The bank is open for lending” about RBS Group (RBS/NatWest)”

### 5.6.1.2 CUSTOMER EXPERIENCE

**Customers’ experience of RBS’s lending-related processes does not always match RBS’s “open for lending” message:** As noted in Section 5.5 above, RBS has only recently begun to re-focus attention on its business development processes to drive lending growth. Approximately 3 out of 4 customers who approach the bank to discuss their financing needs do not ultimately end up with a drawn facility. In addition, a small but vocal minority of existing borrowers have had their facilities amended or withdrawn by the bank. These day-to-day interactions between SMEs and the bank are also a powerful communication tool, as each customer’s experience shapes their perception of RBS.

**RBS has not been successful at managing customer expectations:** RBS faced significant legacy issues that were so severe that they could not be fixed quickly. The Review did not identify any concerted communication effort by RBS to re-set customer expectations following the changes that needed to be made as a result of the financial crisis. Similarly, although RBS has clearly sought to address these legacy issues, there was limited evidence that the bank focused on making small but concrete improvements to the borrower’s experience that could quickly be delivered while these broader and longer term legacy problems were being addressed.

**Many customers have also not yet “felt” other improvements that RBS has made:** RBS has invested significantly in systems, tools, training and accreditation schemes. These improvements have been communicated to its customers and there appears to have been some encouraging feedback in the past 3–6 months.<sup>69</sup> However, RBS is not yet achieving its objective of providing a meaningfully better experience for its SME customers than its competitors. Many small business customers of RBS – like those of other banks – feel that RBS does not engage with their needs, delivering too many impersonal interactions and automated decisions.

<sup>69</sup> For example, improvements in internal customer satisfaction metrics.



**RBS has not been successful at managing the expectations of market stakeholders:** The mismatch between the expectations of its external stakeholders and the bank's own communications are themselves a problem for RBS. RBS shared with the Review many details of the communications it has had with market stakeholders. It is clear from these documents that RBS has frequently sought to explain its point of view in response to external criticisms. Yet it is clear that it has not actively addressed mismatches in expectations. Beyond the reporting of lending results highlighted above, a good example of this relates to approval rates. While RBS has focused on the fact that it approves at least 80% of all the applications it receives, it has failed to acknowledge the fact that many customers who approach it to discuss financing are "screened out" of the process before they submit a formal application. Market stakeholders such as the Government and Business Associations have been left confused by the divergence between what they hear from customers and what they hear from the bank.

### 5.6.3 CUSTOMER FACING STAFF

**RBS recognises the importance of communication to customer facing staff:** The message given to customer facing employees can make a large difference to how they interact with customers. RBS recognises this, and invests in regular communications with customer facing employees, including regular conference calls, senior management roadshows and leadership events. These communications have included a steady flow of lending-related initiatives since 2008.<sup>70</sup>

**Customer facing employees now recognise lending as the number one priority...:** As discussed in Section 5.1, despite the lending-related initiatives, lending was seen by customer facing staff as the third priority behind other important business needs (funding and risk management) during 2011 and early 2012. Following extensive communication internally, this has been reversed, and lending is now identified by staff as the most important business priority.

**...But are frustrated by lending-related processes:** The consultation exercise also highlighted some frustrations among customer facing staff about the credit processes that RBS uses. RBS has already recognised that there are significant improvements that could be made to these processes to improve the experience of both customer facing staff and customers themselves. However, the Review did not identify any concerted communication effort by RBS to manage the expectations of front line staff as to the timing and extent of the improvements being made, the speed at which they will be made, and why other or further improvements cannot be made. The interviews with staff conducted as part of the Review suggested that the resulting frustration undermines the confidence of customer facing staff.

**RBS has not developed information sets to support local lending-related communication:** At the start of each performance period, RBS establishes lending targets for each of the regions in its network. This forms part of the performance assessment process. However, as described in Section 5.5.1, business development for lending is not yet informed by high quality information and a strong central capability to use this information to change and improve how RBS seeks to develop new lending business. From interviews, the Review also observed that the available information is used inconsistently by management and customer facing staff, particularly in Commercial Banking (where the Customer Relationship Management system, already used in Business Banking, has yet to be implemented). RBS is therefore particularly reliant on "headline" communications (delivered via conference calls, road shows, events, etc.) to steer the lending-related actions of customer facing staff.

<sup>70</sup> Selected examples of lending initiatives include the Overdraft Price Promise (launched Q4 2008), the Manufacturing Fund (launched Q1 2010), the Customer Promise (launched Q2 2011), the Start-up Loan scheme (launched in partnership with the Princes Trust in Q4 2012) and the Working Capital Optimiser tool (launched Q2 2013).

## 6. RECOMMENDATIONS

RBS has started addressing a number of the issues outlined in this Review, particularly as they relate to the ongoing SME business. RBS has been focusing on:

- Building its business development capabilities
- Simplifying and streamlining the framework by which lending decisions are shaped
- Improving the skills of Relationship Managers
- Emphasising the overall primacy of the lending objectives

However, further progress is required for RBS to remove impediments to lending and better meet stakeholder expectations. Accordingly, nine initiatives are recommended which would help RBS meet its SME market objectives and the broader expectations of customers and external stakeholders:

- Two overarching recommendations to establish a coherent and realistic set of objectives for the SME business, with clear lines of responsibility for delivering them (Recommendations 1 and 2)
- One recommendation to instigate an inquiry into allegations about the way that RBS has treated customers in financial difficulty (Recommendation 3)
- Four recommendations for the ongoing SME business to improve the origination and conversion of lending opportunities (Recommendations 4 to 7)
- One recommendation to improve its communications with customers (Recommendation 8)
- One recommendation for the Authorities, including the Regulators, to work with providers of finance to establish an engagement process both to identify common problems related to financing SMEs and to develop appropriate solutions, an initiative in which RBS can play a leading role (Recommendation 9)

### 1. Ensure coherence between lending objectives, business strategy and constraints

- RBS must develop a set of realistic lending objectives for the ongoing SME business. This will require coherence between the lending objectives and:
  - The overall strategy of the business (e.g. the choice to be a Relationship bank, a desire to reduce Real Estate lending)
  - The numerous constraints that the business faces, both actual and anticipated (e.g. prudent lending standards, funding requirements, capital requirements, conduct standards)
  - The dynamics of the market in which RBS operates, and the actions of competitors
  - The prevailing economic conditions
  - The negative momentum in lending that RBS has created since the crisis began
- RBS should define an appropriate set of measures to track performance with specific quantitative targets against them. Some of these measures and targets should be made public

## **2. Ensure clear and simple lines of responsibility, and reduce organisational fragmentation**

- RBS must ensure that responsibility for the agreed SME lending objectives, and for all SME activity, is clearly and coherently assigned to a single and simple organisational umbrella. This requires that RBS seeks to remove or review the many organisational boundaries that have been created (e.g. Core/Non Core, Rainbow, GRG). Such actions will ensure that the attention of those responsible is clearly focused on SME customers
- Related to the above, RBS must address issues of “ownership” across the lifecycle of an SME (i.e. from the point when an SME first approaches the bank, through to the end of the business relationship)
- In particular, those responsible for the ongoing SME business, subject to appropriate treatment of timeliness and forbearance issues, must have full visibility and appropriate influence over the actions of the bank towards SMEs that find themselves in financial difficulty. RBS must establish and embed safeguards to ensure both that customers receive fair and appropriate treatment, and that RBS can evidence this

## **3. Instigate an inquiry into the treatment of distressed customers**

- RBS needs to address the concerns that have been raised by some customers and external stakeholders about its treatment of SMEs in financial distress and minimise the perceived conflict of interest within GRG. This would be best achieved through a forensic inquiry to substantiate or refute serious accusations that have been made

## **4. Improve customer experience**

- RBS should ensure that the experience of SMEs is improved, primarily via the simplification and acceleration of the lending process. Customers should experience interactions that are consistent and transparently communicated. A key enabler will be to ensure internal units house common and distinctive skillsets

## **5. Improve allocation of scarce resources**

- RBS should enhance its understanding of lending potential in different areas of the market (e.g. across industry sectors, regions, and channels – such as branch based and internet). RBS should improve its ability to assess the impact of re-deploying people or scarce financial resources from one place to another. Specific recommendations are to:
  - Develop a set of data, insights and metrics that can be used both by management and customer facing staff to monitor, assess and act on lending potential
  - Determine whether RBS’s customer facing staff are in the geographical locations where demand for new lending is greatest
  - Continue to investigate whether and how to use other methods (e.g. broker and internet channels) to originate new lending, and supplement RBS staff
  - Continue to investigate ways of extending the “specialist model” for particular sectors of the SME market more widely across the teams of customer facing staff across RBS’s regional network
  - Develop deeper insights into customer needs and the economics of different types of lending, and use this to improve both customer satisfaction and the bank’s return on capital (for example, whether it should become a provider of equity to growth SMEs or create a subordinated debt fund to meet the common SME requirement for growth capital that does not dilute the owners’ equity holding)

## 6. Improve confidence to lend

- RBS should take further steps to restore the confidence of staff when dealing with lending enquiries from customers and to address risk aversion. This will help to ensure that the bank is taking the risk which – in aggregate – it can support, and which is required to meet its lending objectives. Specific recommendations are to:
  - Monitor the quality of credit submissions in detail, to confirm that the training put in place is having a positive effect and to identify areas of further room for improvement
  - Instil a culture of continuous improvement in the development of underwriting skills
  - Begin to delegate more decision making power for lending to customer facing staff, linked to externally recognised professional qualifications, to act both as a development “ladder” and a confidence boost
  - Provide skilled staff with appropriate levels of support, both to free up marginal time for client focused activities and establish a greater sense of “mutual endeavour” between customer facing and credit orientated staff. This could be effected by changes to the organisation, team structure, performance assessment schemes and related measures
  - Extend and improve the schemes in place to provide staff with access to specialist lending experts, to act as sounding boards for complex or difficult lending opportunities
  - Develop processes and tools that increase the ability of customer facing staff to be confident in the amount they can lend to a customer, encouraging them to initiate conversations with customers about potential borrowing needs

## 7. Increase productivity

- RBS should develop the processes, tools and support offered to customer facing staff to become more productive and commercially effective. The bank should focus on both business development (finding and developing sources of demand for lending, stimulating interest, finding new clients, etc.) and the lending process (converting enquiries into lending applications, supporting customers through the application process etc.). Specific initiatives might include:
  - Testing the effectiveness of a dedicated “Business Development unit” (a team of staff dedicated to winning new customers and new lending business) to supplement its existing staff network
  - Providing more – and better – marketing and sales support for customer facing staff, and fostering a more productive link between these staff and “the centre”
  - Systematically capturing basic details on early lending discussions and their outcomes. This information should be part of a continuous improvement process that supports staff in their initial conversations with customers
  - Ensuring that conversations with customers include an exploration of their financing needs and make SMEs aware of other financing options that might be suitable to their needs, for example by “sign posting” providers of alternative finance

## **8. Improved communication strategy**

- RBS should rethink its communication strategy to bring its customers' day-to-day experiences of the bank more closely in line with their expectations. To this end, RBS should:
  - Improve the gathering and understanding of customer feedback, and use it continuously to assess performance, and improve processes and their delivery
  - Deliver discrete improvements to the borrower's experience that can quickly be implemented while longer term legacy issues are being addressed
  - Ensure that Relationship Managers invest enough time and have the right skills to deliver difficult messages honestly and transparently (such as declined application decisions, amendments to existing facilities, and the handing over of relationships in financial distress to specialists)

## **9. Engagement between Authorities and providers of finance**

- Authorities should instigate an engagement process, with a remit to address and find solutions to common issues. There must be a significant contribution by banks, but it would be vital that this is neither a "lobbying" exercise by the banks, nor an exercise in retribution by the Authorities. The aims would be to:
  - Find appropriate solutions to the key structural shortcomings in the SME market. For example, address the lack of a central repository of information about SMEs' creditworthiness, improve the availability and understanding of alternative forms of SME finance, and assess the implications of prudential standards on SME lending
  - Ensure appropriate representation of the different stakeholders in the initiative, and assign responsibilities to those best positioned to undertake the agreed actions
- Given its significance as a finance provider to SMEs, RBS should play a leading role in developing this initiative

## 7. ANTICIPATED OR DESIRED OUTCOMES OF RECOMMENDATIONS

The recommendations made in Section 6 should have three desirable outcomes if successfully implemented: more lending to SMEs by RBS; an improved perception of RBS amongst customers and stakeholders; and a greater understanding of the issues surrounding the financing of the SME sector.

It is expected that RBS will commit to objectives that capture the first two of these outcomes, and which are consistent with RBS's post-crisis market position and standards. RBS must identify metrics and indicators that adequately reflect the desired outcomes, and determine how transparent it should be with customers and stakeholders about its progress. To this end, some suggestions are offered below on potential indicators that could be used by RBS.

Indicators of lending volumes might include either absolute measures (such as flows of net lending or gross new lending) or relative measures (such as its share of flows of net lending or gross new lending, which measure RBS's performances relative to the market). They should also include reference to RBS's standards, for example: portfolio mix, risk profile and profitability. Additionally, RBS should monitor its lending productivity, using metrics such as return on investment from new lending activity or end-to-end conversion rates.

RBS already monitors customer satisfaction (e.g. overall satisfaction), and advocacy measures (e.g. Net Promoter Scores)<sup>71</sup> in order to track customer perception. It has also begun to track measures that reflect "input" (such as time spent with customers). It is suggested that RBS complement these with output metrics, including details on customer experience (such as time taken to complete the lending process), customer outcomes (such as improvements in financial performance due to borrowing), customer actions (such as attrition) and staff actions (such as the number of sick days taken).

Besides this RBS-specific data, the SME lending market would benefit from two data related developments. First, increasing the information available to Public Authorities, the financial services industry and SMEs themselves. This might include a business register, collateral register and credit database for SMEs. Second, building a comprehensive set of public statistics covering the SME sector's financing structure and capacity to support bank debt, and the volume of financing that is being supplied, across all product types and not only bank debt.

<sup>71</sup> Advocacy measures the extent to which customers would recommend or promote a brand or experience.

# APPENDIX A. TERMS OF REFERENCE

## Introduction

Over the last four years, RBS/NatWest has significantly restructured its business, in response to the events and immediate impacts of the 2008 financial crisis. Changes include: the separation of the Rainbow business in preparation for divestment; the creation of the Specialised Relationship Management unit to support customers who are beginning to feel cashflow/trading pressure; the creation of a Non Core Division to manage down exposure for selected assets; and the creation of a Real Estate Finance line of business within the Corporate Banking Division (CBD), to manage down RBS's exposure to the Commercial Real Estate market.

However, along with other banks, RBS/NatWest has also faced lingering doubts about its willingness to lend sufficiently to UK SMEs. Some of the criticisms have focused on the lending standards RBS/NatWest has set itself, which are manifested both in the capital and "risk appetite" that the bank makes available for SME lending and in the way that this is deployed via individual credit risk decisions.

Whilst RBS/NatWest will not return to the lending standards that were in place in the run up to the crisis of 2008 and must only grow its lending book safely and soundly, the bank does want to ensure that all of its key stakeholders understand and have confidence in both the lending standards it sets and the practices that its staff are using to deploy them.

RBS/NatWest has therefore appointed Sir Andrew Large, together with the management consultancy firm Oliver Wyman, to undertake an independent review of both its lending standards and the practices used to deploy them, for small and medium sized business lending.

RBS/NatWest will support the delivery of the review by providing access to individuals across the business, as well as to data and reports that are available and useful to the review itself.

The objective of the review will be to identify steps that RBS/NatWest can take to enhance its support to SMEs and the economic recovery whilst maintaining safe and sound lending practices. The review will also help to promote a common understanding of the way in which the bank makes its judgements and decisions on SME lending.

Sir Andrew and Oliver Wyman will therefore be asked to capture the key findings from the review, as well as conclusions and recommendations, in a report that will be made public. RBS/NatWest reserves the right to review the contents of the report to ensure that customer privacy will not be compromised and that competitively sensitive information will not be made widely available through its publication. Beyond this, Sir Andrew and Oliver Wyman will be required to author the report on an independent and objective basis.

## Objective

The objective of the review will be to identify steps that RBS/NatWest can take to enhance its support to SMEs and the economic recovery whilst maintaining safe and sound lending practices. The review will also help to promote a common understanding of the way in which the bank makes its judgements and decisions on SME lending.

The review will therefore provide an objective assessment of the lending standards and practices that RBS/NatWest uses in the SME market. This will cover the capital and risk appetite made available to this market, as well as the lending practices it deploys. As such, the review will:

- Assess RBS/NatWest's Risk Appetite and Capital Management frameworks and lending practices against common market practices, both to determine whether the approaches that RBS are using are in some way different or unique to those used by other banks

- Test the extent to which – in reality – RBS/NatWest has been willing to lend to SMEs and whether it is lending to those SMEs with conditions that are “reasonable” (i.e. unconstrained except by legitimate and necessary concerns related to prudence)
- Examine how RBS/NatWest’s lending standards and the lending process through which they are deployed are perceived by the customers who have experienced them, including both those who have been successful and those who have been unsuccessful in their applications to borrow
- Highlight any areas where RBS/NatWest could improve the way in which it sets its risk appetite within Corporate Banking Division and then deploys it through its lending practices, whilst maintaining appropriate lending standards and underwriting disciplines in order to grow SME lending safely and soundly
- Consider the views of wider stakeholders – e.g. customers, relevant business federations and Business Associations, Regulators and Government – in assessing the elements above and drawing conclusions for the final report

### **Scope**

The review will focus on lending to RBS/NatWest Business & Commercial customers in the UK, as currently housed within the Corporate Banking Division. The following limitations will apply:

- The review will not cover business lending to customers currently managed within the EU mandated divestment (i.e. Rainbow), Ulster Bank NI and Coutts portfolios
- The review will be limited to lending via overdrafts, term loans, trade finance, invoice finance (provided by RBS Invoice Finance) and asset finance products (provided by Lombard), as they relate to in scope UK CBD Business & Commercial customers
- The review will not consider market demand factors

### **Approach**

The review will draw on the following sources of information:

- Interviews with management and staff within Corporate Banking Division
- Documentation relating to the Business & Commercial, Trade Finance, Lombard and RBS Invoice Finance businesses and their lending activity, including (but not restricted to):
  - Management information reports
  - Policies and guidelines
  - Process maps, pricing discretions and credit approval frameworks
  - Project reports
  - Customer and staff survey templates and results
- Extracts from internal databases relating to the Business & Commercial, Trade Finance, Lombard and RBS Invoice Finance credit portfolios and their lending activity, including (but not restricted to):
  - Application flow, over time
  - Customer and deal characteristics (e.g. risk, sector, price, term), over time
  - Overdraft, term loan, RBSIF and Lombard portfolio data, over time
  - Samples of individual deal files, both underwritten and declined
  - Complaints and Business Hotline data

- External reports and datasets relating to the UK SME financing market, such as:
  - Bank of England and BBA data series
    - SME Finance Monitor data series
    - Trade association (e.g. FSB, CIB) reports
    - Academic papers and reports
- Primary research, undertaken specifically for the review, such as:
  - Customer surveys
  - Customer focus groups and/or interviews

RBS/NatWest expects the review to use these information sources (and others that may become apparent during the course of the work) to address the following areas:

- An assessment of the mechanisms RBS/NatWest uses to set, monitor and enforce its lending standards for SME lending today, and how they have evolved over the last five years. The assessment should take into consideration RBS/NatWest’s actual experience and lessons learnt in the Business & Commercial business since the crisis of 2008, as well as comparisons with market practices
- An analysis of Business & Commercial’s capacity, appetite and ability to lend to UK SMEs.
- An analysis of volumes along the end-to-end lending process (i.e. from customer approach to draw down), to understand if there are opportunities that are being missed at different points along the end to end lending process
- An historical analysis of how Business & Commercial’s lending portfolio has evolved over the five years since the onset of the 2008 crisis
- An assessment of how customers perceive the risk appetite of the bank, given their recent experiences

RBS/NatWest also expects Sir Andrew and Oliver Wyman to engage with relevant external stakeholders (e.g. PRA, FCA, HMT, BIS, SME Business Associations) to ensure that they have had an opportunity to provide relevant information to the review.

Furthermore, RBS/NatWest expects a dedicated website to be established through which SME customers can provide their perspectives and experiences as an input into the independent review process.

### **Timescales**

The exact date for the publication of the report will be dependent on the time taken to complete the review itself. However, broad expectations are as follows:

- July 2013: RBS/NatWest announces the commission of the independent review and makes this ToR public
- Summer 2013: detailed assessment of each area within scope of the review, as outlined above
- Autumn 2013: drafting of findings, conclusions and recommendations; completion of the report; release of the report via dedicated website

## **Governance**

RBS/NatWest's intention is to commission a review which will be undertaken on a truly independent basis by industry experts, to ensure that its assessment of the lending standards the bank uses in the SME market is thorough, objective and unbiased. Sir Andrew Large and Oliver Wyman have therefore been engaged directly by the RBS Group Chairman.

RBS/NatWest believes that commissioning this review will be the best way both to promote a common understanding between the bank and its stakeholders, and to identify potential improvement opportunities for the bank to work on. RBS/NatWest will therefore ensure that Sir Andrew and Oliver Wyman are provided with the support they require to access documentation, reports and data they require, and to meet with relevant individuals within the Corporate Banking Division and RBS Group. RBS/NatWest will also establish a governance structure to ensure that:

- Data protection is adequately enforced
- Customer privacy is not compromised
- Competitively sensitive information is not made publicly available

Sir Andrew and Oliver Wyman will be required to author the report on an independent and objective basis.

# APPENDIX B. PROCESS AND APPROACH

The major steps taken to deliver the Review were as follows:

1. Establish the evidence base on which findings and recommendations would be based (see Appendix D for a description of the workstreams delivered to produce the evidence base)
2. Verify the evidence base for accuracy with RBS and a range of non-RBS stakeholders
3. Synthesise initial findings and recommendations
4. Discuss RBS specific data with RBS to ensure correct interpretation of the factbase and to source additional information where relevant
5. Draft the Report
6. Publish Summary and recommendations (1<sup>st</sup> November)
7. Publish the full Report (25<sup>th</sup> November)

In conducting the Review, it was of paramount importance to ensure that governance structures were established to ensure that:

- The Review was undertaken on an independent basis and that its assessment of the lending standards the bank uses in the SME market is thorough, objective and unbiased
- Data protection was adequately enforced
- Customer privacy was not compromised
- Competitively sensitive information was not made publicly available

In addition to internal governance structures within the Review team, three layers of governance were established with RBS to ensure that these requirements were met:

- **Project Management Office**
  - Established to handle day-to-day liaison between the Review team and RBS
  - Ensured that the Review team had timely access to RBS information and stakeholders
  - Co-ordinating additional input into the Review, particularly with regards to non-RBS stakeholders
- **Technical Advisory Group**
  - The Technical Advisory Group was established under the following Terms of Reference:
    - To provide a forum for structured RBS input into the Independent Lending Review process
    - To help Sir Andrew Large and Oliver Wyman navigate the RBS organisation in order to complete the work with the best possible information
    - To enable RBS to ensure that information and data gathered from the business has been appropriately analysed and represented by the Independent Lending Review team
  - Its remit was limited to RBS specific information and concerns
  - The Committee was chaired by the Chief Risk Officer of the Corporate Banking Division
  - Membership consisted of relevant Oliver Wyman project leaders, the RBS Business & Commercial Board, and other RBS attendance as relevant (e.g. Group Strategy)

- **Senior Oversight Committee**

- The Senior Oversight Committee was established under the following Terms of Reference:
  - To ensure that the independent Review is undertaken in accordance with the Terms of Reference for the work
  - To monitor progress and address any major dependencies or “roadblocks”
  - To oversee the processes used to execute the independent review
  - To review the final report
  - To ensure that data protection is adequately enforced, and that customer privacy is not compromised
  - To ensure that competitively sensitive information is not made publicly available
- Its remit was limited to RBS specific information and concerns
- The Committee was chaired by Sir Andrew Large
- Membership consisted of Sir Andrew Large, relevant Oliver Wyman project leaders, the Chairman of the Board, the Chief Executive Officer of the Corporate Banking Division, the Chief Risk Officer of the Corporate Banking Division, the CEO of Business & Commercial, and a Business & Commercial Regional Manager

A final draft of the Review was also submitted to RBS Group Board for information in advance of publication.

In addition to these formal Governance processes outlined, every effort has been made to ensure that conclusions and recommendations have been made on an objective basis, independently of RBS and other stakeholders. For example:

- The Review team has consulted widely so that the views from outside of the bank are well represented, gathering the perspectives of customers and other stakeholders with an interest in RBS’s support of and lending to UK SMEs, in addition to the views of the bank’s staff and management. As well as speaking directly with representatives of each group, a consultation site was opened and surveys of both customers and staff were launched. A range of views have been encountered amid a considerable intensity of opinion. The Review has sought to separate “noise” from issues of substance and balance these competing points of view, however strongly held
- When working with data received from RBS, steps have been taken independently to verify its accuracy and completeness. Information received from the bank includes: anonymised databases of the bank’s lending to SMEs since 2008 and related activity (such as applications and complaints); documentation that communicates how the bank’s objectives, strategy and policies have evolved over time; and a sample of over 100 individual credit files that were selected independently by the Review team
- Multiple information sources have been used (including market data from the Bank of England and BBA, industry surveys and third party reports) to ensure that there is not an over-reliance on information received from RBS

# APPENDIX C. SOURCES AND BIBLIOGRAPHY

## C.1. SOURCES

A wide range of sources were used in conducting the Review. These include:

### **Independent Lending Review consultation**

- SME consultation
  - >800 responses to the public website consultation. This website was launched specifically as part of the Independent Lending Review, and was publicised both by RBS and the National Press to maximise the number of responses
  - >500 RBS customer survey responses, commissioned as part of the Independent Lending Review
  - Additional, anonymised, SME correspondence provided by the Department for Business, Innovation & Skills
- Market stakeholder consultation
  - >20 interviews with stakeholder groups including Government and Owners, Regulators and Supervisors, Business Associations and other relevant stakeholders
- RBS stakeholder consultation
  - >30 interviews with RBS senior management
  - >1,800 responses to the most recent RBS staff survey
  - >20 additional interviews with RBS staff (Relationship Managers and Credit Officers), including multiple site visits
  - RBS staff feedback via the RBS intranet site

### **RBS data and documentation**

- Portfolio data
  - Overdraft, term loan, RBSIF and Lombard portfolio data
  - Customer and deal characteristics (e.g. risk, sector, price, term)
  - Application flow
  - Complaints and Appeals data
- Sampled customer data
  - Samples of >100 individual credit files, both underwritten and declined
  - Detailed application data (including affordability metrics) from >100 applications from a pilot program in South West England
- Documentation
  - Board presentations, minutes, and strategy documents
  - Management information reports
  - Policies and guidelines
  - Process maps, pricing discretions and credit approval frameworks
  - Detailed declines analysis

- Documentation of RBS tools and systems
- Other data sources
  - Customer satisfaction survey results
  - Full Time Equivalent (FTE) employee data split by role and business unit, for the period 2008 to 2013

### **Market-wide data and documentation**

- Market data sources
  - Bank of England (BoE) and British Bankers Association market lending data and periodic publications
  - Other specific data sources (e.g. BBA SME lending appeals data, Professor Griggs OBE Annual Appeals Process Report data, Orbis companies database)
- SME survey data
  - SME Finance Monitor quarterly surveys
  - Charterhouse surveys
- Other publicly available secondary research documents on UK SME lending and related topics (see Appendix C.2), including
  - Trade association (e.g. Federation of Small Businesses (FSB), Confederation of British Industry) reports
  - Academic papers and reports

## **C.2. BIBLIOGRAPHY**

A range of publicly available secondary research documents on UK SME lending and related topics were reviewed in the process of conducting the Review. These include:

Albion Ventures, 2013. The Albion Growth Report.

Association for Financial Markets in Europe, 2012. Improving access to finance for small and medium-sized enterprises.

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The Confederation of British Industry, 2013. CBI Quarterly SME Trends Survey.

The Confederation of British Industry, 2013. Ripe for the picking: a guide to alternative sources of finance.

The Economist Intelligence Unit, 2012. Adapting in tough times.

The Open University, 2012. Quarterly Survey of Small Business in Britain.

## APPENDIX D. DESCRIPTION OF WORKSTREAMS

A comprehensive and detailed evidence base has been produced on which the findings and recommendations of the Independent Lending Review are based. These draw on the key sources outlined in Appendix C.

The evidence gathering process was structured into multiple workstreams. These are listed below:

**Table 5: Workstreams undertaken as part of the Independent Lending Review evidence gathering process**

	<b>Workblock</b>	<b>Workstream</b>	<b>Description of workstream</b>
1	Stakeholder consultation	SMEs	Consultation with existing, potential and former SME customers via public website, customer survey and supplementary case studies
		Market stakeholders	Interviews with key market stakeholders, including Government, Regulators and Business Associations
		RBS stakeholders	Interviews and consultation with RBS management and staff
2	Secondary research	SME surveys	Evaluation of third party SME surveys
		Additional research	Review of third party opinions and data, plus a detailed summary of the regulatory operating environment
3	SME lending volume analysis	Market data	Sizing of the overall SME lending market, exploring trends over time
		RBS data	Analysis of RBS's lending to UK SMEs, considered within the market context
4	Appeals and complaints	Appeals	Review of appeals processes and analysis of trends in number of customer appeals
		Complaints	Analysis of trends in volume and type of customer complaints
5	Credit standards	Policy review	Analysis of RBS's policy thresholds against both its existing loan book and a sample of recent applications
		Loan applications' review	Detailed review of sample of loan applications (referred to as "credit files")
6	Pricing and economics	Pricing	Analysis of RBS's pricing levels and processes
		Economics	Analysis of the profitability of SME lending for RBS and the market as a whole
7	Market affordability		Estimation of the level of bank debt that the SME sector can prudently support, based on an affordability analysis
8	RBS's strategic and operational decisions		Review of RBS's key strategic and operational decisions between 2008 and 2013, and the constraints within which they were taken
9	RBS's lending framework		Description of the framework that RBS uses to deploy credit to SMEs and manage existing customer relationships, including customers with deteriorating financial positions
10	The end-to-end lending process		Analysis of the four key stages of the lending process (Pre-contact; Initial engagement; Application, approval and appeal; Completion, contracting and draw down), comparing RBS against the market at each stage

The sub-sections of this appendix are organised using this structure and contain a description of the key components of each workstream. The descriptions are high-level and focused on the key processes followed; outputs from each of the workstream are not shown in this appendix (but are selectively referenced throughout the full Report in accordance with confidentiality and commercial sensitivity agreements).

## D.1. STAKEHOLDER CONSULTATION

### D.1.1. CONSULTATION: SMES

The Independent Lending Review sought the views of actual, former and prospective customers. A specific consultation exercise was established with SMEs to gather feedback for the RBS Independent Lending Review.

The SME consultation was used to help frame and focus the Review on the areas that customers deemed most important. It also helped in testing detailed hypotheses, such as the key sources of customers' complaints, their perceptions of RBS's willingness to lend to SMEs and their perspectives on the lending process, and the potential explanations behind such views.

In addition, other sources of customer feedback (e.g. BIS mail bag, Lawrence Tomlinson material) that were not obtained via direct consultation were also used, in order to capture the widest range of customer perspectives.

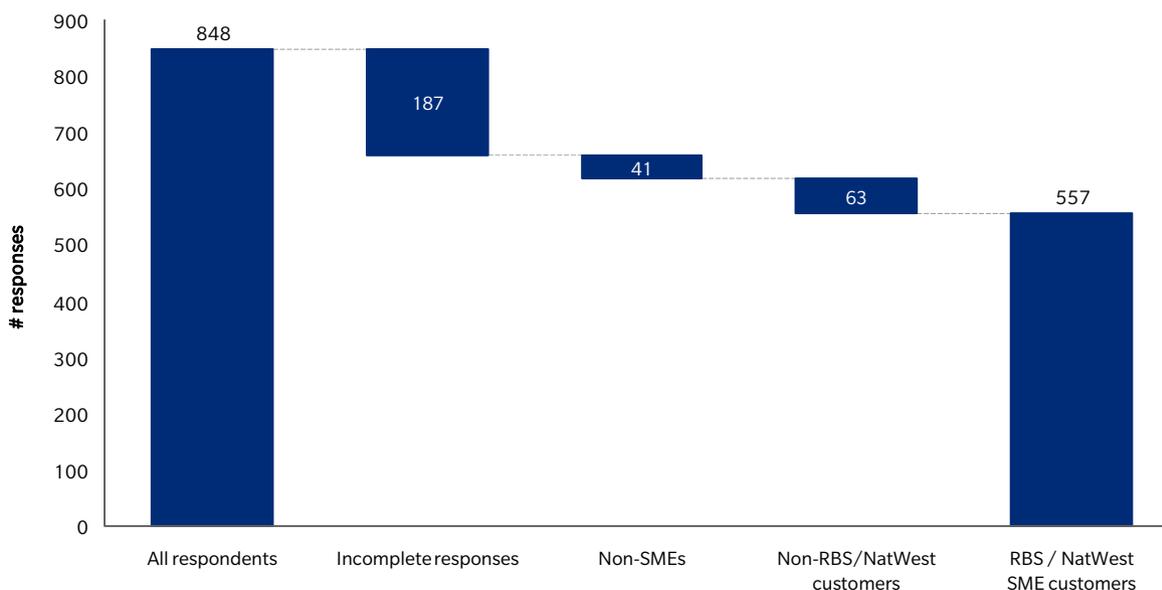
#### D.1.1.1. INDEPENDENT LENDING REVIEW PUBLIC WEBSITE

A dedicated Independent Lending Review website was launched on 7<sup>th</sup> August 2013 (<http://www.independentlendingreview.co.uk/index.htm>). The website contained links to the Review's Terms of Reference and a short structured survey designed to capture customer feedback.<sup>72</sup> The survey was accessible to any stakeholders that wished to contribute, regardless of whether or not they were a current RBS SME customer.

The website was promoted through an initial Press Release on 7<sup>th</sup> August and links on the RBS Group website. This was followed up by an email to ~64,000 members of the Telegraph Business Club, town hall events with local business customers led by RBS senior management, and communications with major Business Associations (e.g. Confederation of British Industry, British Chamber of Commerce, and Forum of Private Business (FPB)). The survey closed on 11<sup>th</sup> October 2013 so that the feedback could be collated and reviewed prior to the publication of the Summary and Recommendations Document. In total, 848 responses were submitted, of which 557 were completed responses from RBS SME customers.

<sup>72</sup>The website is now used to display the outputs of the Review.

**Figure 19: Independent Lending Review public website responses, Q2 2013–Q3 2013**



Source: Independent Lending Review public website (open from 7<sup>th</sup> August 2013 to 11<sup>th</sup> October 2013)

All survey responses were reviewed on an individual basis, as well as being used in aggregated analyses. When drawing conclusions from aggregate outputs, consideration was given to the fact that the set of responses received was unlikely to be wholly representative of the overall sentiment of the customer base (i.e. there is a skew in responses towards those customers that feel strongly about the issue, of which the majority will have submitted negative responses).

#### D.1.1.2. INDEPENDENT LENDING REVIEW RBS CUSTOMER SURVEY

A direct survey of RBS SME customers was commissioned as part of the Independent Lending Review. This comprised a large-scale customer telephone survey conducted by Business Development Research Consultants (BDRC) Continental, in partnership with the Review team.

The survey’s purpose was to provide the Review team with an additional source to inform the view of SMEs’ progress through the end-to-end lending process with RBS, as well as to provide an up to date barometer of customer sentiment on a range of topics related to RBS and its SME lending activity.

The survey drew its respondent sample from previous respondents to the SME Finance Monitor (see Section D.2.1.1 for further discussion of the SME Finance Monitor). SMEs that had completed a previous SME Finance Monitor survey between Q2 2012 and Q1 2013, identified themselves as banking with RBS, and also indicated that they were happy to be re-contacted, were considered for the survey. Over 3,000 SMEs met these criteria, of which 504 SMEs were surveyed on a randomly selected basis. The results were weighted to fairly reflect the overall distribution of SMEs within the RBS customer base.

As with the SME Finance Monitor itself, analysis and conclusions drawn from the Independent Lending Review RBS customer survey were discussed with BDRC Continental to ensure that they were fair and based on reasonable interpretations of the response data.

### D.1.1.3. ADDITIONAL ANONYMISED SME CORRESPONDENCE RECEIVED FROM EXTERNAL STAKEHOLDERS

In addition to the public website and SME Finance Monitor, other primary customer testimony was made available for consideration within the Review. Two sources were of note:

**BIS “mail bag”:** A total of 54 redacted case studies were provided by the Department for Business, Innovation & Skills. These typically took the form of letters written by MPs, relaying the concerns of their constituents about their relationship with RBS in the context of SME activities.

**Lawrence Tomlinson material:** On 25<sup>th</sup> October 2013, the Department for Business, Innovation & Skills (BIS) provided the Review team with material in relation to banks’ lending practice and treatment of businesses, put together by Lawrence Tomlinson in his role as Entrepreneur in Residence at the BIS. The material highlights “aspects of banks’ treatment of businesses which are of particular concern and the root causes of these issues”. It draws on primary evidence from customers and ex-bank employees.

Both of these sources were used to provide a deeper understanding of the issues that SMEs are facing, in particular to help crystallise some of the common themes of major complaint against banks (including specific complaints against RBS).

### D.1.2. CONSULTATION: MARKET STAKEHOLDERS

As part of the Independent Lending Review’s consultation process, meetings were held with a range of external stakeholders:

**Table 6: Market stakeholder interviewees**

Group	Organisation
Government and Owners	HM Treasury
	Department for Business, Innovation & Skills
	UK Financial Investments
Regulators and Supervisors	Bank of England
	Financial Conduct Authority
	Prudential Regulation Authority
Business Associations	Federation of Small Businesses
	Confederation of British Industry
	British Chamber of Commerce (BCC)
	Forum of Private Business
Other	EEF
	British Bankers’ Association
	Independent Appeals process

The purpose of these meetings was to ensure that a broad range of views and concerns from interested parties were captured and taken into account during the Review.

Meeting notes were captured and synthesised to identify the key points raised by external stakeholders, and the analysis and research conducted as part of the Review was directed to ensure that the key areas of stakeholder focus were considered appropriately.

## D.1.3. CONSULTATION: RBS STAKEHOLDERS

### D.1.3.1. RBS MANAGEMENT

In addition to the RBS Group Chairman, interviews were held with more than 30 members of the RBS management team:

**Table 7: RBS management interviewees**

Function	Title
Group	Group Chief Executive Officer (previous)
Group	Group Chief Executive Officer (current)
Group	Group Finance Director
Group	Group Head of Restructuring and Risk
Group	Deputy Group Risk Officer
Group	Group Director, Strategy & Corporate Finance
Group	Head of Communications, Group Chief Economist
CBD business	CEO, Corporate Banking Division
CBD business	Managing Director for Commercial Banking, Business Banking and Transaction Services
CBD business	CEO, Commercial Banking
CBD business	CEO, Business Banking
CBD business	COO, Business & Commercial Banking
CBD business	Head of SRM
CBD business	CEO, Transaction Services
CBD business	Managing Director, Invoice Finance
CBD business	Interim Managing Director of Lombard
Finance	Chief Financial Officer, Corporate Banking Division
Finance	Finance Director, Business & Commercial Banking
Risk	CRO, Corporate Banking Division
Risk	Head of Portfolio Management, Corporate Banking Division
Risk	Head of Portfolio Strategy, Corporate Banking Division
Risk	Head of Risk Change Services, Corporate Banking Division
Risk	Head of Risk Reporting, Corporate Banking Division
Risk	Head of Risk, Business & Commercial Banking (previous)
Risk	Head of Risk, Business & Commercial Banking (current)
Risk	Head of Risk, Commercial Banking
Risk	Head of Risk, Business Banking
Risk	Head of Risk, Customer Solutions Group
GRG	CEO, GRG
GRG	UK Head GRG
GRG	Head of Risk, GRG

These interviews were conducted in order to develop an in depth assessment of the current RBS lending framework (see Appendix D.9 for further details) and to understand in detail the key decisions made by RBS in the post-crisis years. The interviews were therefore a vital step in the process, ensuring the key historical and current workings of the RBS SME business were accurately documented and understood.

Detailed minutes of these interviews were recorded and shared with interviewees. Interviewees made amendments to minutes as required to ensure that all facts had been represented accurately and in an appropriate level of detail. Where possible, information obtained from interviews was cross-checked against other internal and external sources.

#### D.1.3.2. RBS STAFF

The Independent Lending Review team also received input from a broader pool of RBS staff as part of the consultation process. There were three types of input given:

1. Staff survey responses
2. Interviews with RBS staff
3. RBS staff intranet feedback captured internally by RBS, and passed on to the Review team

##### D.1.3.2.1. RBS STAFF SURVEY

Business & Commercial Banking conducts regular internal staff surveys as part of a “business as usual” process to track staff perceptions. The surveys are targeted at customer facing staff (Relationship Managers), Credit Officers and Specialist Relationship Managers. Questions are asked on a range of themes, including staff prioritisation and use of time, their perceptions of customers’ appetite for lending, and impacts of recent training programmes and initiatives, in addition to free-text questions seeking more detailed feedback and recommendations.

A further staff survey was conducted in Q4 2013, to expand the internal RBS consultation process further and capture up to date staff views in the Review. This survey provided the Review team with a “current view” of staff perceptions and an ability to track how they have changed over time (through comparison with similar surveys conducted in Q2 2012 and Q2 2013).

The survey undertaken in Q4 2013 built upon these previous surveys to cover specific areas of interest for the Independent Lending Review. Additional questions focussed on staff skills and training, interaction between Relationship Managers and Credit Officers, the extent to which RBS’s Policy & Guidelines have impacted the lending process, and views on how RBS could best increase prudent lending.

In total, 1,838 RBS staff members completed the Q4 2013 survey.

##### D.1.3.2.2. RBS STAFF INTERVIEWS

In addition to management interviews, the Review team conducted site visits to interview more than 20 members of RBS staff across:

- Business areas: Business Banking Connect, Business Banking Relationship Manager, Commercial Banking, Invoice Finance, Lombard, Specialised Relationship Management
- Staff roles: Business Managers, Relationship Managers, Senior Relationship Managers, Regional Directors, Credit Officers

The interviews were conducted to better understand how processes and policies are used in practice and to capture more qualitative insight beyond the responses to the staff surveys. The interviews also facilitated detailed walkthroughs of the processes, tools and information used to make lending decisions.

##### D.1.3.2.3. RBS INTERNALLY-COLLATED STAFF FEEDBACK

RBS’s internal intranet system enables its staff to comment on various articles published on the site. This feedback takes the form of both publicly posted comments and privately submitted feedback. Feedback relating

to articles relevant to the Independent Lending Review (such as the launch of the Review itself) was collated and anonymised by RBS before being passed to the Review team.

This feedback supplemented the other sources of RBS input gathered through the consultation process. The comments and postings were analysed by the Review team alongside the other available sources, and the sentiments expressed were used to direct further research, as well as being taken into account as part of the broader conclusions made within the Review.

## D.2. SECONDARY RESEARCH

### D.2.1. SME SURVEYS

In addition to the Independent Lending Review RBS customer survey, other pre-existing SME survey sources have been utilised for the Review.

#### D.2.1.1. SME FINANCE MONITOR

The SME Finance Monitor is an information source on financing for SMEs in the UK. Its creation followed the formation of the Business Finance Taskforce in July 2010, comprising CEOs and senior representatives of the UK's six largest SME banks (Barclays, HSBC, Lloyds Banking Group, Royal Bank of Scotland, Santander and Standard Chartered). The Business Finance Taskforce made a commitment to funding and publishing an independent survey to identify and track demand for finance and SMEs' perspectives on borrowing. SME Finance Monitor reports are independent, written and published by BDRC Continental, without influence sought or applied by any member of the Survey Steering Group. The latest SME Finance Monitor report can be found at <http://www.sme-finance-monitor.co.uk/>.

The SME Finance Monitor was drawn on in two primary ways for the purpose of the Review:

1. The data from the quarterly national survey was used to inform the Review's consideration of SME borrowing experiences and perceptions
2. As per Section D.1.1.2, a selection of willing RBS customers who had taken part in the SME Finance Monitor previously were re-contacted and asked to complete an additional survey as part of the Review's primary customer research

With regard to the quarterly national survey, for each quarter since Q1–Q2 2011 the SME Finance Monitor has surveyed approximately 5,000 SMEs about their previous borrowing events and future borrowing intentions.

The results from the four most recent quarterly surveys are combined to cover a 12 month period and weighted to reflect the overall profile of UK SMEs. The latest SME Finance Monitor report available to the Review team was the YEQ2 2013 Report, which is based on a total of 20,032 interviews from July 2012 to June 2013.

SME Finance Monitor data was analysed by the Independent Lending Review team to understand the experiences of and perceptions held by UK SMEs with regard to accessing finance, and how these have evolved over time.

The analysis was conducted using anonymised, respondent-level data, which BDRC Continental provides to each member of the Business Finance Taskforce, and enables a distinction to be made between RBS Group and non-RBS Group customers. Where relevant, conclusions drawn were discussed with BDRC Continental to ensure that they were fair and based on reasonable interpretations of the available data.

#### D.2.1.2. CHARTERHOUSE AND RBS INTERNAL CUSTOMER SATISFACTION SURVEYS

Charterhouse conducts a quarterly survey for the banking industry, comparing different UK banks across a range of perception, experience and satisfaction metrics for SMEs. This data, which covers the period Q4 2010 to Q2 2013 and is split by customer size (annual turnover of <£250 K, £250 K – £2 MM, and £2 MM – £25 MM), was made available to the Review team by RBS.

In addition, RBS runs an internal Customer Satisfaction Survey to produce a range of metrics that help it further understand customer experiences and perceptions. These were available on a monthly basis since May 2013.

These data sets were used to further gauge levels of satisfaction and dissatisfaction with RBS, and, with the Charterhouse data, to understand differences with other major high street banks.

It is noted that these metrics can be volatile, and often driven by non-SME customer experiences. As such, caution has been exercised in their use, with the results used as additional supporting information alongside other data sources.

#### D.2.2. ADDITIONAL SECONDARY RESEARCH

To ensure that the Review captured the widest possible set of viewpoints and concerns, a comprehensive secondary research exercise was undertaken.

The research covered articles and opinion-pieces from media sources, periodic releases such as the Bank of England's *Trends in Lending* publication, and 25+ in-depth studies and reports on UK SME lending and related topics.

This workstream also included a review of the Regulatory environment in which UK SME banking currently operates.

### D.3. SME LENDING VOLUME ANALYSIS

Detailed analysis was conducted on trends in SME lending stocks, flows of gross new lending, repayments and net lending. This was carried out both at the UK market level and for RBS specifically.

This analysis served two important purposes:

1. To obtain a full understanding of the trends in the overall UK SME lending market for gross lending, repayments and lending stock
2. To enable the Review team to place RBS's trends in lending in the context of the overall market, and to be able to identify the evolution of RBS's market share

#### D.3.1. MARKET DATA

Available market data relating to aggregate SME lending volumes was used extensively in the Review. This data came from two primary sources, the Bank of England and the British Bankers' Association, with small adjustments made to ensure the comparability of datasets where possible.

By combining the two data sources, market size estimates have been constructed for total lending to UK SMEs. Since these market level SME data sources are imperfect, particularly prior to mid-2011, additional information sources (e.g. BBA Small Business Survey data, BoE PNFC data, RBS internal data) were used to triangulate total UK SME market lending. Where both BoE and BBA data sources have been used, every effort has been made to account for differences in definitions between datasets.

### D.3.1.1. BANK OF ENGLAND (BOE)

The Bank of England collects and publishes data on lending from UK Monetary Financial Institutions (MFIs) to Private Non-Financial Corporations (PNFCs), which encompasses SMEs. Since August 2011 this data is available for SMEs specifically. This data is reported in the Form A8.1, as set out by the Bank of England.

The data comprises monthly flows of gross new lending, repayments and lending stock to SMEs. It is collected using Form LN,<sup>73</sup> which is issued to a panel of 19 lenders that together represent approximately 75% of the total stock of all UK MFIs to PNFCs. The BoE uses these responses to provide an estimation of the full market. For the purposes of the data used in the Independent Lending Review, the BoE defines the market of SMEs as PNFCs with a turnover of less than £25 MM per annum in their main business account. Based on best available definitions, the BoE data is taken to include Non-Performing Loans and Asset Finance lending, but excludes Invoice Finance lending.

From August 2011, BoE data has formed the basis of the Review's total market size estimations. Prior to August 2011, the data series is extrapolated through a series of triangulation points.

To supplement the publically available market data, RBS Form LN submissions were obtained and analysed, facilitating the calculation and analysis of market share by the Review team.

### D.3.1.2. BRITISH BANKERS' ASSOCIATION

The BBA publishes data on lending to businesses in the UK as far back as 2006. However, the data pre-July 2011 covered only businesses with an annual turnover of up to £1 MM per annum, a subset of the prevalent UK definition of SMEs as businesses with a turnover of less than £25 MM per annum.

Since July 2011, the BBA has published the quarterly report, "Banks' Support for SMEs" which provides monthly data on total flows of gross new lending, repayments and outstanding lending balances (stocks) to SMEs, split by sector. The data is collected from a Taskforce of 7 banks, Barclays, HSBC, Lloyds Banking Group (including Halifax Bank of Scotland (HBOS)), National Australia Bank UK (Clydesdale, including Yorkshire Bank), Royal Bank of Scotland Group (including NatWest), Santander and The Co-operative Bank. It should be noted that neither National Australia Bank or The Co-Operative Bank are members of the Business Taskforce.

The BBA SME data series covers businesses with a turnover of less than £25 MM, excluding financial sector businesses, clubs, charities and societies operating business accounts. It also excludes non-performing loans and Asset Finance lending.

BBA data has formed the basis of the "high street bank" market size estimations used in the Review. Estimations prior to July 2011 are made using a number of cross-referenced triangulation points, owing to the lack of a comprehensive dataset for this period.

As with the Bank of England's Form LN, the RBS submissions to the BBA as part of this Taskforce dataset have been collected and used as part of the analysis in this report.

<sup>73</sup> Banks submit data to the Bank of England using Form LN. The Bank of England collates all individual bank submissions and reports the aggregated output in Form A8.1.

## D.3.2. RBS INTERNAL DATA

RBS has provided a range of different datasets, covering different business units and types of information.

### D.3.2.1. DATA ANALYTICS

A series of analyses were undertaken to understand the changes in the RBS lending book, or “portfolio”, from 2008 to today. To facilitate this, a comprehensive data collection exercise was carried out across the business units included within the scope of the Review. This data comprised:

- B&C lending book data from March 2008 – June 2013
  - Includes loans and overdrafts
  - Data available on a monthly basis, for each customer and lending facility held
- Lombard, RBS Invoice Finance, and Commercial Cards lending book data from January 2008 – June 2013
  - Includes asset and invoice finance products, charge and credit cards
  - Data available on a monthly basis, for each customer and lending facility held
- Data relating to RBS’s participation in government lending schemes (e.g. Funding for Lending Scheme, Regional Growth Fund, Enterprise Finance Guarantee)

In order to provide a comprehensive, accurate and independent picture of how RBS SME lending has evolved since 2008, a detailed analysis of these multiple datasets was conducted. In order to conduct the analysis in a thorough, independent fashion and to provide flexibility in the analysis, “raw data” as listed above was collected and analysed, as opposed to relying on existing RBS management reporting systems.

The analysis process required interaction with a number of different RBS teams who provided data, verified the Review team’s understanding of the data, and validated analyses where appropriate. Data was provided in an anonymised format with personal identifiers removed, and transmitted from RBS to the Review team via a secure online “data room” set up for the purpose of the Review. Analysis was conducted in a secure “workbench” environment that met the required data security standards.

### D.3.2.2. DATA INTEGRITY

A series of validation processes were undertaken in conjunction with RBS both on the raw data provided to the Review team, and on the output of the analysis.

The purpose of these checks was to ensure that findings were accurate and correctly interpreted, understand any inconsistencies with other existing analyses or reports and agree a process to reconcile these.

Although the data came from multiple sources, a consistent process was used for all key datasets. This comprised three main process stages:

1. Data was reviewed to identify key trends, outliers and any other potential issues
2. Questions and issues regarding the data were raised with RBS and key outputs were compared to comparable figures in internal or external reports created by the relevant teams
3. Further comparisons were made against management reports used within RBS

The underlying causes for any differences observed in the second and third steps were documented and where relevant, figures were reconciled. In certain instances, differences remain between RBS’s internally and externally reported lending numbers. These differences were intentional and recognised as being due to differences in analytical approach.

All figures used in the report have been signed off by relevant RBS stakeholders.

## D.4. APPEALS AND COMPLAINTS

Analysis on the processes and data for appeals and complaints was conducted as part of the Review. Appeals and complaints are two important mechanisms by which customers can inform RBS that they are unhappy with a lending decision (complaints can also be made about other aspects of the banking relationship).

### D.4.1. APPEALS

The appeals mechanism is in place to allow customers to appeal against a rejected lending application that the customer believes should be reconsidered.

The RBS Appeals Process is available to customers who have had applications declined, but are not satisfied with this decision or their treatment more generally.<sup>74</sup> Customers who have had an application for lending declined will receive a letter from RBS, detailing its appeals process. It should be noted that businesses in support or recovery are not eligible to appeal, nor are customers who have received an offer of lending (even if not exactly in line with their application). If an eligible customer takes up the right to appeal, one of two processes will ensue:

- Where applications were processed on an automated basis and RBS's lending criteria were not met: RBS will sense check the application and review whether any additional information could be provided by the customer to support the application. If possible, the Bank will work with the customer to achieve a more desirable customer outcome
- Where manual application decisions were made and RBS's lending criteria were not met: RBS will review the decision, including obtaining any additional information from the customer using the "Four Eyes" principle<sup>75</sup>

As part of the Transparent Appeals initiative launched in April 2011, RBS complies with the minimum standards for banks' appeals processes, as laid out by the BBA Taskforce.

Appeals statistics – and the underlying process by which customers appeal – were analysed as an important part of the lending process. Appeals are often the last resort by which a customer can have a loan approved. Analysing the number and trend of appeal rates provides an indication as to customer perceptions of unfair credit decisions.

In the course of the Independent Lending Review, appeals data was closely analysed, considering appeal and overturn rates, split by size of application, for both RBS and the rest of the BBA taskforce banks. The available data covered all lending products (including Cards) to customers with an annual turnover of up to £25 MM. When conducting appeals analysis, the Review team were conscious to avoid misinterpreting outputs of cross-bank comparison exercises due to important differences between appeals processes, mechanisms and data definitions between the banks. Individual analysis of appeals cases was not conducted.

In addition, the Review team considered several other pieces of evidence:

- The annual Appeals Process report published by the Independent External Reviewer Professor Griggs OBE
- Site visit documents and action plans from external evaluations of RBS's appeals processes
- Expert input provided in meetings with Professor Griggs OBE and other external evaluators of RBS's appeals processes

<sup>74</sup> Applications declined due to breach of regulations/Government/AML factors/Sanctions are not part of the Appeals Process.

<sup>75</sup> "Four Eyes" principle: (1) the original decision will be reviewed by original decision maker and an additional person; (2) that person will be an experienced lender internal to the bank, but will not have been involved in the original decision.

## D.4.2. COMPLAINTS

RBS runs a complaints procedure through which customers that are not satisfied with any aspect of their banking relationship can submit a complaint for investigation by RBS.

Analysis of lending complaints statistics was conducted to help understand whether RBS's SME customers are becoming increasingly dissatisfied with the bank, and which aspects of the banking relationship – specifically the lending process – were of particular concern.

Complaints data covering the period 2007 to August 2013, including the region and category of complaint, was analysed in detail. Complaints were not however, reviewed on an individual case-by-case basis. However, the nature of both specific and systematic complaints against RBS were considered using other sources (e.g. the Independent Lending Review website and the anonymised SME correspondence received from external stakeholders), as above.

## D.5. CREDIT STANDARDS

The credit standards set and used by RBS to make lending decisions were analysed and tested using two lenses:

1. Analysis of the current RBS portfolio and recent applications against agreed credit thresholds
2. A detailed review of a sample of "credit files" (i.e. loan applications)

### D.5.1. POLICY REVIEW

Within its Policies and Guidelines framework, RBS has established a number of policies and thresholds used to determine the appropriateness of lending applications. Thresholds refer to the set boundaries within which Relationship Managers and Credit Officers operate when dealing with new or increased lending applications. Two important thresholds used are Debt Service Coverage<sup>76</sup> (DSC) and Loan to Value (LTV).<sup>77</sup> DSC is an affordability metric used to assess whether a customer generates sufficient earnings to service debt repayments. LTV is a metric used to determine the level of security attached to lending secured by customer assets. There are other quantitative thresholds and qualitative criteria involved in assessing loan applications, including term length and type of acceptable security.

The Review team analysed the distribution of DSC and LTV ratios used by RBS for both its current portfolio and applications received. This was conducted with the aim of assessing the suitability of RBS's current affordability and LTV thresholds and the effectiveness of their implementation by Relationship Managers and Credit Officers.

Application and portfolio data was analysed separately:

- Analysis of the existing lending portfolio was based on four separate datasets that enabled customer level calculations of LTV and DSC
- Analysis of recent applications received was based on two separate datasets in which LTV and DSC were calculated and recorded by Credit Officers and Relationship Managers

Table 8 below summarises the key analyses carried out.

<sup>76</sup> DSC refers to the ratio of Earnings to Debt Service Liability, where Debt Service Liability represents the total projected interest and capital repayments in the first year of borrowing. The earnings component of the metric can be measured on either an EBITDA or Net Cash Flow (NCF) basis. A DSC of 1 indicates that the company's EBITDA/NCF is exactly equivalent to its total yearly debt repayment (including interest and capital repayments), i.e. it is just capable of servicing the loan. A DSC of less than 1 indicates that the company's EBITDA/NCF is less than its total yearly debt repayment. A DSC of greater than 1 indicates that the company's EBITDA/NCF is greater than its total yearly debt repayment.

<sup>77</sup> The total proposed loan amount compared to the Market Value of land and buildings that the loan is intended to finance – a portfolio approach is adopted where a customer wishes to leverage up on equity held against an existing property.

**Table 8: Summary of internal affordability and threshold analyses**

	<b>Analysis scope</b>	<b>Description</b>	<b>Data sources</b>
1	Portfolio data	LTV and DSC (with earnings measured on a Net Cash Flow <sup>78</sup> basis) relative to RBS's current Policies and Guidelines	<ul style="list-style-type: none"> <li>• Existing Business &amp; Commercial loan book data from internal systems               <ul style="list-style-type: none"> <li>– LTV (38 K customer-level Business Banking entries, 71 K facility-level Commercial Banking entries)</li> <li>– DSC (~36 K Business Banking, ~24 K Commercial Banking customer-level); excluding Real Estate Finance</li> </ul> </li> </ul>
2	Application data	Distribution of LTV and DSC (with earnings measured on an EBITDA <sup>79</sup> basis) on formal applications relative to RBS's current Policies and Guidelines	<ul style="list-style-type: none"> <li>• Data collection pilot: 107 entries from a data collection pilot, capturing Business Banking, Commercial Banking, Lombard, Invoice Finance (not all of which included DSC and LTV metrics)</li> <li>• RBS internal analysis on 86 random applications Business Banking applications to Credit (from May 2013)</li> </ul>

## D.5.2. CREDIT FILE REVIEW

A set of 104 formal applications (“credit files”) were extracted from the RBS Relationship Management Platform (RMP) system. The decisions made on these applications were then reviewed in detail by a group of senior Oliver Wyman partners with a broad range of industry expertise.

Each case was reviewed individually and discussed in a cross-calibration exercise. The reviewers were asked to come to a decision, based on the evidence available in the files, as to whether they agreed or disagreed with the decision by Credit, and whether they supported the overall handling of the application by RBS. Input from each reviewer was cross-calibrated in two panel discussions to ensure consistency and fairness in each assessment.

Although selected at random, a set of filters was used to ensure that the credit files included a representative sample of cases, covering:

- Loans and overdraft facilities
- Commercial Banking and Business Banking customers (over the minimum turnover threshold)
- New and existing customers of RBS
- Applications for new lending and increases to existing facilities
- CRE-related and Non-CRE related facilities
- Appealed applications
- GRG and SRM cases

The outcomes of these applications were a mixture of approvals and declines by RBS.

Relationship Management Platform is the system that RBS uses to process SME lending applications that are over the minimum turnover threshold. RMP credit files contain details of the application, existing facilities held by the customer and related securities, analysis of customer financials and other information, correspondence

<sup>78</sup> Net Cash Flow from operating activities adjusted for tax paid, capital expenditure (net of related asset finance) and dividends paid.

<sup>79</sup> Earnings Before Interest, Taxes, Depreciation and Amortisation.

between Relationship Managers and Credit relating to the application, and the decision along with an explanation, made by Credit.

This exercise enabled the Review team to reach independent conclusions on both the quality of the RBS application process (and specific applications) and the appropriateness of resulting credit decisions.

## D.6. PRICING AND ECONOMICS

RBS's pricing of SME lending has been analysed relative to industry average price for both small and medium enterprises (and SMEs as a whole). RBS's cost of supplying such finance has also been estimated, and compared against pricing outcomes to assess the profitability (or "economics") of lending. The economics of RBS's SME lending has also been considered against estimated market average profitability.

### D.6.1. PRICING

RBS's pricing has been compared against market peers using data provided to the Department for Business, Innovation & Skills and published as part of the Bank of England's quarterly Trends in Lending Publication.

Specifically, the publication includes a monthly time-series of "indicative median interest rates on new SME variable-rate facilities" based on data provided by Barclays, HSBC, Lloyds Banking Group and Royal Bank of Scotland between 2008 and 2013, for Small and Medium businesses (up to £25 MM turnover). The Review compared RBS's own submission to this dataset against the aggregated market view, to understand the differences in RBS's pricing relative to its major competitors, and the evolution of this trend over time.

Additionally, the Review team considered the pricing tools used by Business & Commercial, including the Asset Pricing Calculator (APC) pricing tool used in Business Banking, the APC+ tool recently introduced in Commercial Banking, and the Risk Adjusted Return on Equity (RARoE) model used across RBS. Documentation of the different pricing tools was reviewed, and analysis of the tools themselves was conducted to assess the way in which they generated a target price (a suggested price based on input parameters such as facility amount, term, Loss Given Default (LGD) and Probability of Default), and the extent to which this target price fully reflected the cost of providing that facility. Additionally, the discretion levels (extent to which the staff member can deviate from the target price) afforded to RMs and their managers in pricing such facilities, and the extent to which this discretion was being exercised in practice (in terms of frequency, magnitude and consistency), was also reviewed. In conducting this analysis, comparisons were made between different tools, particularly in Commercial Banking following the recent introduction of the APC+ tool. The impact of pricing on lending volumes, and the extent to which RBS understands this relationship, was also considered.

### D.6.2. ECONOMICS

The economics of SME lending was considered from two perspectives:

- The aggregate profitability of total bank lending to SMEs at the market level
- The profitability of RBS's lending to SMEs

Understanding the economics of lending to SMEs is important for two reasons. First, it can be used to understand whether post-crisis increases to RBS's pricing are justified from a cost of supply perspective. Second, the analysis can be used to establish whether RBS – and the broader industry – is offering an economically viable standalone product, with a price commensurate with the cost to supply.

Please refer to Box 3 for a more comprehensive introduction to the economics of SME lending.

To better understand the profitability of lending to SMEs, a model was developed that compares the costs of supplying SME lending against the price at which the lending was given to the customer. Broadly speaking, the

cost of providing a facility can be decomposed into four components, which in turn depend on macroeconomic factors, regulatory requirements and facility specific characteristics.<sup>80</sup>

- **Funding costs:** The incremental cost (over base rate) to a bank of securing the funds that can then be lent to SME customers. Banks obtain funds from a range of different sources, including deposits from customers and debt from wholesale markets
- **Operating costs:** The operating cost associated with supplying, servicing and managing a bank's lending to SMEs (e.g. salaries, branches and IT systems)
- **Risk costs:** The loss that the bank expects to face if the borrower defaults, taking into account the likelihood of that default actually occurring. Customers that are deemed more likely to default, or facilities that are unsecured, have higher risk costs. Risk costs are estimated by the bank based on borrower and facility characteristics. It is important to note that risk costs represent an expectation of average losses through an economic cycle, rather than accounting losses in any given period
- **Return on capital:** Regulators stipulate a framework for calculating the minimum amount of capital that a bank must hold against lending commitments. Shareholders then have an expectation of the return that will be made on that capital. These expectations are sometimes expressed as the "hurdle rate" of return, and known as the "cost of capital"

These four components were used – utilising different assumptions – in assessing both market level SME lending profitability as well as RBS's SME lending economics.

The total cost to supply was compared against the average price at which new variable rate loan facilities were originated. This pricing data was taken from the Bank of England's quarterly Trends in Lending publication.

The analysis enables an estimation of the Return on Equity (RoE) generated by the "vanilla" SME lending activities of banks. It does not measure the overall RoE generated by the SME banking business, which includes deposits and transaction services in addition to lending activities (including asset-based and invoice financing).

In order to understand the RoE earned on RBS's whole SME business, business plans and internal estimations were used; no specific analysis was undertaken as part of the Review to estimate this.

## D.7. MARKET AFFORDABILITY

As per Box 1, the total debt capacity of UK SMEs was analysed over time.

This analysis estimates the level of bank debt that the UK SME sector can prudently support on a sustainable basis. This sustainable debt level can be then compared against actual levels of lending in order to assess changes in the amount of "excess lending" or the magnitude of the "financing gap",<sup>81</sup> over time.

The capacity for debt in the UK SME market was estimated using an affordability-based methodology, developed in conjunction with the International Finance Corporation (IFC). Under this methodology, affordability is measured in the form of a Debt Service Coverage ratio.

The key drivers of total market affordability are:

- SME cashflows: What is the value of net cashflows accruing to SMEs?
- Credit policies: How much are banks willing to lend against total SME net cashflows?
- Cost of credit: How much does a unit of credit cost?

<sup>80</sup> The following descriptions are a simplified view, intended only to provide an illustrative explanation of lending costs.

<sup>81</sup> Excess lending occurs where actual historical lending levels exceed the maximum sustainable level of debt, and a financing gap occurs where actual lending levels fall below the maximum sustainable level of debt.

SME cashflows are estimated based on turnover data sourced from the BIS, whilst the distribution of UK SME affordability ratios is estimated based on information from the Orbis global company database.<sup>82</sup> The cost of credit is modelled as the total economic cost of lending.<sup>83</sup> Each of these components can vary over time, with changes in these drivers having different impacts:

- As cashflows increase, SMEs can afford to service more debt
- As banks are less strict on affordability criteria, they are willing to lend more to SMEs
- As price decreases, SMEs can afford to service more debt per unit of cashflow

Both the cashflow available to the SME sector and the cost of borrowing can be modelled over time at an aggregate level. In combination, these two elements can be used to calculate the *maximum* amount of bank debt that the SME sector could conceivably support at a given price. This calculation takes into account the potential for base rates to rise in the future at any point in time. It does so by assuming both that only two thirds of the available cashflow is used to service debt repayments and that those debt repayments include a 3% 'buffer' on top of current base rates.

It is this sustainable level of lending capacity that is compared against actual lending stocks to determine the size of the "financing gap" or amount of "excess lending". A "financing gap" indicates that more money could be lent to SMEs than is currently the case – this could be for a number of reasons, including risk aversion or cautiousness of banks or indeed SMEs themselves.

To reflect changes in prudential and conduct standards (which encourage banks to price for risk and assess individual borrower affordability), the level of sustainable maximum debt can be modelled under different scenarios. Such scenarios might include using different affordability criteria (based on DSC ratios) and different pricing outcomes (e.g. historical prices as well as economic cost prices that fully reflect the cost to supply the lending). Prices can also be adjusted for changes to the base rate. These will alter the maximum sustainable debt level and consequently the resulting "financing gap" or "excess lending".

## D.8. RBS'S STRATEGIC AND OPERATIONAL DECISIONS

As part of the Review, the basis on which RBS's objectives for the SME business were set and the strategic and operational decisions made to meet them between 2009 and 2013, have been explored.

The purpose of this assessment was to understand the decisions made by RBS, the basis on which they are made, and the outcomes which they have resulted in. Conclusions were then drawn as to appropriateness of RBS's strategic goals, the extent to which they have been achieved, the impact of operational decisions on meeting these goals and the basis (including quality of supporting information and analysis) on which decisions were taken.

This assessment included a detailed review of a range of documents:

- Strategic plans and goals (including metrics used to measure and track them)
- Financial plans
- Board presentations and minutes
- Progress updates on key initiatives

<sup>82</sup> The analysis utilised Net Cash Flow, turnover, loan size and sector classifications from Orbis. In order to calculate DSC, loan values and NCF were taken from Orbis, and assumptions were taken on term and interest rate.

<sup>83</sup> Composed of risk cost, operating cost, funding cost, net capital cost. Capital cost includes capital held against Risk Weighted Assets (RWAs) for both credit risk and operating risk, and varies in accordance with regulatory changes.

- Management communications to staff

As a result, the Review team were able to understand:

- The strategic vision of the SME business
- The key decisions made used to deliver this, including:
  - Operational levers to be pulled, including but not limited to staff skills and incentives, staff allocation and productivity, pricing, risk appetite, processes for making individual customer decisions, and key investments made
  - Business model choices, such as participation choices with regard to product, geography, channel, and customer

## D.9. RBS'S SME LENDING FRAMEWORK

A separate document summarising RBS's lending framework was produced, outlining RBS's approach to SME lending and all of the key factors that influence it. The scope of this framework document extended to the approach used to manage existing customers, including those with deteriorating credit. This document was signed off by relevant RBS management and stakeholders to confirm its accuracy. It cannot be published due to the degree of commercially sensitive information that it contains.

The document was important in ensuring that the Review team had an accurate and complete understanding of the framework that RBS uses to deploy credit to SMEs and manage this credit thereafter.

The document includes a snapshot view of RBS's SME lending framework as at August 2013, and references material changes since 2008. It is structured into two sections:

- Summary of the current RBS SME lending framework
- Key changes to RBS's SME lending framework since 2008

The activities within scope of the Independent Lending Review were comprehensively documented. In particular, Business Banking (Connect and Relationship Manager), Commercial Banking, Specialised Relationship Management, Lombard B&C, RBS Invoice Finance and Transaction Services UK<sup>84</sup> were considered. SME activities within the Global Restructuring Group (GRG) and the Non Core Division were also assessed. As per the Terms of Reference of the Review, this document did not consider the processes used to employ SME lending in Ulster Bank, Coutts or the divested Rainbow business.

The contents of the document were factual and based on RBS documentation (e.g. policy documents, employee guidelines, divisional and business unit management information packs, financial and risk reports) and interviews with RBS management. Specific questions and queries were raised with relevant subject matter experts within RBS to cover any outstanding questions.

Prior to sign-off, the document underwent two rounds of quality assurance with representatives from Risk, Business & Commercial, Customer Solutions Group, Global Restructuring Group, Non Core Division and the Conduct Risk team.

<sup>84</sup> Lombard B&C, RBSIF and TSUK belong to Customer Solutions Group.

## D.10. THE END-TO-END LENDING PROCESS

The key stages of the lending process have been broken down and analysed for both RBS and the market. In particular, four stages have been considered:

- **Pre-contact:** A customer's assessment of its borrowing need and available sources of finance
- **Initial engagement:** Initial approach from the customer to the bank, or vice versa
- **Application, approval and appeal:** An initial approach may result in a formal application, which may be approved or rejected. In the case of a rejection, the applicant may choose to appeal the decision
- **Completion, contracting and draw down:** For approved applications, the customer may choose to use the facility (drawdown). However, the customer may choose not to make use of the facility if, for example, they have received a more attractive offer from a competitor, or if they no longer have a need for financing

Investigating the key stages of the lending process provides a clear framework for understanding the major points of customer interaction and potential drop out during the lending process. Furthermore, it provides a basis for identifying the success rate of lending enquiries (over-and-above simplistic application statistics), and a comparison of differences between RBS and the market average throughout the different stages.

In doing so, analysis was conducted at each stage of the lending process, including detailed analysis of applications, declines, appeals and drawdown from RBS internal data sources, as already explained in the Appendix. The pre-contact and initial engagement stages were analysed primarily using external sources, such as the SME Finance Monitor, the Independent Lending Review customer survey, and the Charterhouse annual Business Banking survey. External sources were also used to inform differences between RBS and the market in the later stages of the lending process.

Due to contractual agreements with data providers and the commercial sensitivity of some of the analysis, the full analysis is not shown in the Report. However, a high level comparison of conversion rates for RBS versus the market from the initial engagement stage is provided.

# APPENDIX E. ACRONYMS AND GLOSSARY OF TERMS

## E.1. ACRONYMS

**Table 9: Acronyms**

<b>Term</b>	<b>Definition</b>
APC	Asset Pricing Calculator
B&C	Business & Commercial
BB	Business Banking
BBA	British Bankers' Association
BDRC	Business Development Research Consultants
BIS	Department for Business, Innovation & Skills
BN	Billion
BoE	Bank of England
BRG	Business Restructuring Group
CB	Commercial Banking
CBD	Corporate Banking Division
CBI	Confederation of British Industry
CEO	Chief Executive Officer
CIB	Corporate & Institutional Banking
COO	Chief Operating Officer
CRE	Commercial Real Estate
CRM	Credit Risk Management
CRO	Chief Risk Officer
CSG	Customer Solutions Group
DSC	Debt Service Coverage
EBITDA	Earnings before Interest, Tax, Depreciation and Amortisation
EC	European Commission
EEF	EEF (formerly Engineering Employers' Federation)
EFG	Enterprise Finance Guarantee
EU	European Union
EWI	Early Warning Indicator
FCA	Financial Conduct Authority
FLS	Funding for Lending Scheme
FPB	Forum of Private Business
FSA	Financial Services Authority
FSB	Federation of Small Businesses
FTE	Full Time Equivalent
GRG	Global Restructuring Group
HBOS	Halifax Bank of Scotland plc
HMT	Her Majesty's Treasury
HSBC	Hongkong and Shanghai Banking Corporation Limited
IFC	International Finance Corporation
IT	Information Technology

K	Thousand
LGD	Loss Given Default
LTD	Loan To Deposit
LTV	Loan To Value
MBBG	Major British Banking Groups
MFI	Monetary Financial Institution
MM	Million
NCD	Non Core Division
NI	Northern Ireland
NPS	Net Promoter Score
OBE	Order of the British Empire
PD	Probability of Default
PNFC	Private Non-Financial Corporation
PR	Public Relations
PRA	Prudential Regulation Authority
RARoE	Risk Adjusted Return on Equity
RBS	Royal Bank of Scotland
RBSG	Royal Bank of Scotland Group
RBSIF	Royal Bank of Scotland Invoice Finance
REF	Real Estate Finance
RGF	Regional Growth Fund
RMP	Relationship Management Platform
RoC	Return on Capital
RoE	Return on Equity
RTS	Return To Satisfactory
RWA	Risk Weighted Assets
SME	Small and Medium Enterprise
SMU	Strategy Management Unit
SRM	Specialised Relationship Management
SRMBB	Specialised Relationship Management Business Banking
UK	United Kingdom
UKFI	United Kingdom Financial Investments
US	United States of America

## E.2. GLOSSARY OF TERMS

**Table 10: Glossary of terms**

<b>Term</b>	<b>Definition</b>
Assets	The money that a bank is owed. For example, when a bank advances funds to customers (i.e. lend them money) this is an asset on the bank's balance sheet
Balance sheet	A statement of the assets, liabilities, and capital of a business or other organisation at a particular point in time
Base rate	The official rate paid on commercial bank reserves by the Bank of England
British Bankers' Association (BBA)	The UK's leading association for the banking and financial services sector. It produces a range of SME statistics, notably through the quarterly <i>Banks' Support for SMEs</i> publication
Brokers	Intermediaries that work on behalf of businesses to find the specific financial product that the business is seeking
Business & Commercial (B&C)	Business Unit within RBS servicing RBS SME customers up to £25 MM turnover. It is the major part of the SME relationship banking business that RBS has retained, providing RBS's primary services to SME relationships. It reports into Corporate Banking Division
Business Banking (BB)	Business sub-unit within Business & Commercial, responsible for smaller SMEs (aggregated debt of up to £250 K and turnover <£2 MM)
Business Banking Connect	Responsible for servicing Business Banking customers with aggregated debt ≤£25 K. Connect customers are not assigned a Relationship Manager
Business Banking Relationship Manager	Responsible for servicing Business Banking customers with aggregated debt of between £25 K and £250 K, and turnover of less than £2 MM, These Business Banking customers (unlike Connect) are assigned a Relationship Manager
Business Development Research Consultants (BDRC)	Independent market research consultancy which conducted a large-scale RBS customer telephone survey on behalf of the Review
Capital	The difference between the value of a bank's assets and its liabilities. Bank capital represents the net worth of the bank or its value to investors. Banks are required by Regulators to hold a minimum level of capital to ensure that these institutions do not take on excess leverage and become insolvent
Capital costs	The cost of holding capital against lending. Regulators stipulate a framework for calculating the minimum amount of capital that a bank must hold against lending commitments. Holding capital incurs a cost as the capital cannot be used to generate returns from other opportunities
Collateral	Assets provided as security by the borrower to the bank, providing greater assurance to the lender
Commercial Banking (CB)	Business sub-unit within Business & Commercial, responsible for larger SME customers (those with aggregated debt >£250 K or turnover between £2 MM and £25 MM). Commercial Banking customers are serviced via Relationship Managers
Commercial Real Estate (CRE)	Commercial Real Estate is a business sector. The Commercial Real Estate sector comprises businesses involved in developing or investing in residential or Commercial Real Estate. RBS calls this "Real Estate Finance" to differentiate it both from lending to businesses involved in related activities (e.g. construction) and from lending to trading businesses secured on real estate assets (e.g. commercial mortgages)
Concentration limits	Limits on activity (e.g. lending) to a particular area or segment (e.g. Commercial Real Estate), intended to reduce exposure to this specific area or segment
Confederation of British Industry (CBI)	UK independent employers' organisation representing more than 240,000 businesses
Corporate	A business with an annual turnover of greater than £25 MM
Corporate Banking Division (CBD)	Division within RBS. It is the Division responsible for UK Corporate and SME Banking. Three primary Business Units sit within the Division: Business &

	Commercial Banking, Corporate & Institutional Banking, and Customer Solutions Group
Credit files	Information collated as part of an application for credit in order for a decision to be made. This includes: details of previous applications and existing facilities held; analysis of customer financials; correspondence between Relationship Managers and Credit relating to applications; and the decision along with an explanation made by Credit
Credit Officer (CO)	Makes decision to approve or reject credit applications. Not all credit applications require Credit Officer approval. Credit Officers are Risk function personnel
Credit policy	Stated conditions that set the terms under which banks will consider or approve applications of credit to customers
Credit scoring	An automated process to grade customer credit worthiness when applying for a credit, utilising available information sources
Customer Solutions Group (CSG)	Business unit within RBS's Corporate Banking Division. Comprises Lombard (Asset Finance), RBSIF (Invoice Finance), Transaction Services and Mentor (SME Advisory)
Debt Service Coverage (DSC) ratio	The ratio between a business's cashflow and its debt repayments (comprising both interest and capital)
Divested	Separate business within RBS (also known as Rainbow) to be divested under EC mandate, based on Williams & Glynn network. Once divested, Rainbow will be a standalone bank serving retail and business customers
Draw down	The point at which a customer first uses the facility to which they have been granted access
EEF (formerly Engineering Employers' Federation)	UK manufacturers' organisation providing business services, government representation and industry intelligence
Enterprise Finance Guarantee (EFG)	A UK government lending scheme intended to help small businesses that may otherwise struggle to access finance, under which the Government provides a guarantee to boost the credibility of loan applications by small businesses
Facility	An agreement between a lender and borrower, whereby a lender sets out the conditions on which it is prepared to advance a specified amount to a borrower for a defined time period. For example, a loan is often referred to as a "facility"
Federation of Small Businesses (FSB)	UK campaigning pressure group, promoting and protecting the interests of the self-employed and owners of small firms
Flow of gross new lending	The flow of new lending over a specific period of time (e.g. 12 months)
Forum of Private Business (FPB)	A UK forum providing small business support and advice
Full Time Equivalent (FTE)	A unit indicating workload of a given employee (e.g. an FTE of 1 describes a full-time worker)
Funding costs	The cost to a bank of generating funds that can then be lent to SME customers. Banks obtain funds from a range of different sources, including deposits from customers and debt from wholesale markets
Funding for Lending Scheme (FLS)	Lending scheme launched by the Bank of England and HM Treasury in July 2012 to incentivise banks and building societies to boost their lending to the UK economy by providing extended funding to banks and building societies, with the price and quantity linked to their lending performance
Funding gap	Refers to a situation in which a bank has assets (e.g. loans) greater than liabilities (e.g. deposits). The funding gap is the difference between the amount it has lent to customers and the amount it has borrowed from customers
Global Restructuring Group (GRG)	Business Unit within RBS. Responsible for the management of business customers in financial distress from across RBS Group, including customers from Corporate & Institutional Banking, Business & Commercial and Customer Solutions Group
High street banks	The set of banks that submit information to the BBA Business Finance Taskforce for use in the BBA SME datasets. The contributors are Barclays, HSBC, Lloyds Banking Group (including HBOS), National Australia Bank UK (Clydesdale, including Yorkshire Bank), Royal Bank of Scotland Group (including NatWest),

	Santander and The Co-operative Bank. The Co-Operative Bank and Clydesdale are not part of the Taskforce, but are included in the datasets produced by the British Bankers' Association, and are therefore included in this definition of high street banks
Impairment	Loans against which full repayments are not being upheld become impaired
Independent Lending Review (ILR)	A review commissioned by the RBS Chairman in July 2013 into RBS's lending standards and practices in the SME market
International Finance Corporation (IFC)	A global development institution focused on financing and providing advice for private sector ventures and projects in developing countries
(RBS) Invoice Finance (RBSIF)	Business Unit within RBS. The UK's leading provider of factoring and invoice discounting, providing debtor management services and financing options based on an SME's debtor book
Liabilities	What a bank owes. When banks borrow funds (e.g. when customers deposit money with them) this is a liability on the bank's balance sheet. Liabilities are used to fund assets (i.e. lending)
Loan book	The set of loans held by an organisation at a given moment in time
Loan To Deposit (LTD) ratio	Proportion of customer loans as compared to customer deposits held on the Balance Sheet
Loan To Value (LTV) ratio	The total proposed loan amount compared to the Market Value of land and buildings that the loan is intended to finance
Lombard	Business sub-unit within RBS. UK's leading provider of asset-based finance products and leasing facilities to SMEs looking to purchase business assets, such as Plant & Machinery, Vehicles or IT
Loss Given Default (LGD)	The amount of funds that is lost by a bank or other financial institution when a borrower defaults on a loan
Major British Banking Groups (MBBG)	A collection of British banks, comprising the banking groups of Abbey, Alliance & Leicester, Barclays, Bradford & Bingley, HBOS, HSBC Bank, Lloyds TSB, Northern Rock and The Royal Bank of Scotland
Micro SMEs	The smallest SMEs. Definitions differ by institution or publication. For example, Charthouse define micro SMEs as having annual turnover <£250 K
Monetary Financial Institutions (MFIs)	A statistical grouping comprising banks and building societies, as defined by the Bank of England
Net Lending	The difference between the aggregate stock of lending (or outstanding balances) from one point in time to another
Net Promoter Score (NPS)	A measure of company advocacy monitored and used by a range of companies and industries
Non Core Division (NCD)	Division within RBS. Created in 2009 to rebalance RBS Group's risk profile and enable the clean implementation of its strategy for the Core book, which is the ongoing business of RBS. At inception, it comprised distressed assets and those considered to be the most poorly priced (predominantly Real Estate Finance)
Operating costs	The costs associated with supplying, servicing and managing a bank's lending to SMEs (e.g. salaries, distribution networks, IT systems and processes)
Policy & Guidelines	Developed by RBS to manage lending quality. It comprises a "no exceptions" approach to Policy, and a supplementary set of Guidelines to indicate what a "good" lending decision might look like. There are different Policy & Guidelines documents within RBS for different business sectors
Private Non-Financial Corporations (PNFCs)	All corporations (and partnerships) whose primary activity is non-financial and that are not controlled by central or local government
Probability of Default (PD)	The likelihood of a default over a particular time horizon
Profit centre	Internal organisational boundaries defined to measure the financial contribution of a particular area of a larger organisation
Project Merlin	An agreement reached in February 2011 between the Government and major high street banks, under which lending targets were set for each bank (including RBS)
Prudential Regulation Authority (PRA)	A Regulator responsible for the prudential regulation and supervision of banks,

	building societies, credit unions, insurers and major investment firms
Rainbow	See Divested
Real Estate Finance (REF)	RBS sector comprising businesses involved in developing or investing in residential or commercial real estate
Regional Growth Fund (RGF)	A Government fund established in 2011 providing grants to support projects and programmes using private sector investment to generate economic growth and employment
Relationship Management Platform (RMP)	System that RBS uses to process SME lending applications that are over a minimum turnover threshold
Relationship Manager (RM)	The main interface by which RBS service SME customers. Relationship Managers are responsible for maintaining and developing existing customer relationships, and identifying new business opportunities
Repayment profile	A description of the schedule by which a facility will be repaid, both in terms of the length of the term, and also the distribution of payments across that term
Repayments	The total amount of money that is repaid over a certain period of time (e.g. 12 months). Repayments decrease the size of outstanding balances
Return on Capital (RoC)	The amount of net income received as a percentage of capital. In a banking context, this is broadly equivalent to Return on Equity (and in this report, is considered the same for simplification purposes)
Return on Equity (RoE)	The amount of net income received as a percentage of shareholders' equity
Risk Appetite framework	A framework implemented in RBS's SME business in 2011 in order to manage its overall risk profile. Risk Appetite defines the quantum of risk that an organisation is prepared to operate within
Risk costs	The loss that the bank expects to face if the borrower defaults, taking into account the likelihood of that borrower defaulting. Customers that are deemed more likely to default, or facilities that are unsecured, have higher risk costs. Risk costs are estimated by the bank based on borrower and facility characteristics
Risk Weighted Asset (RWA)	An asset's "risk weight" is a measure of its riskiness; the riskier the asset, the higher the risk weight. A "Risk Weighted Asset" is an asset adjusted for risk by the application of a risk weight. Calculation of Risk Weighted Assets is defined by Regulators, and used to support the calculation of minimum Regulatory Capital requirements
Royal Bank of Scotland (RBS)	Royal Bank of Scotland. Within the SME Independent Lending Review, RBS is used to represent the SME activities of the different RBS Group Brands covered in the Review, including both RBS and NatWest
Royal Bank of Scotland Group (RBSG)	Royal Bank of Scotland Group, comprising a number of divisions: UK Personal Banking, UK Corporate Banking, Direct Line Group, US Retail & Commercial Banking, Ulster Bank, Markets & International Banking, and Wealth (Private Banking)
Senior debt	Debt that takes priority over other more "junior" debt owed by a debtor. Senior debt has greater seniority in the issuer's capital structure than subordinated debt. In the event the issuer goes bankrupt, senior debt must be repaid before other creditors receive any payment
Slotting	A standard approach to calculate the riskiness of assets. Slotting has been introduced by the FSA for Commercial Real Estate exposures in the UK
Small and Medium Enterprise (SME)	Small and Medium Enterprises, defined in this report as those with an annual turnover of up to £25 MM
Specialised Relationship Management (SRM)	Business sub-unit within RBS's Business & Commercial unit. It is responsible for supporting customers that are starting to have financial or trading difficulties
Stocks	The total amount of lending outstanding at a given moment of time
Taskforce	Group set up by the British Bankers' Association following publication of the government's green paper <i>Financing the Private Sector Recovery</i> in July 2010. It is made up of the CEOs and senior representatives of the six largest UK banks: Barclays; HSBC; Lloyds Banking Group; Royal Bank of Scotland; Santander; and Standard Chartered. Note that Co-Operative Bank and Clydesdale are not part

	of the Taskforce, but are included in the datasets produced by the British Bankers' Association
Term	The time period over which a loan obligation is to be paid
Terms of Reference	A document detailing the objectives, scope, approach, timescales and governance processes under which the Independent Lending Review has been conducted
UK Financial Investments (UKFI)	UKFI manages the UK Government's investments in financial institutions, including Royal Bank of Scotland Group
Working capital	the capital of a business which is used in its day-to-day trading operations, calculated as the current assets minus the current liabilities
Working With You	An internal RBS program which seeks to ensure that Relationship Managers spend four days a year on site with their customers