Svenska Handelsbanken: Possible UK Subsidiarization

In this short report Scope examines the possible conversion of the UK retail branches of Svenska Handelsbanken (SHB) into a subsidiary, in light of the uncertainty surrounding the UK's future position inside or outside the Single Market.

As Brexit approaches, SHB (Issuer Rating: A+, Stable Outlook) is in a class of its own, as the largest passported retail branch banking business in the UK. SHB's strategy since entering the UK market in the 1980s has been to grow its branch network off the balance sheet of Svenska Handelsbanken AB in Sweden, rather than following the more usual model of setting up a separate subsidiary and branching out of it. SHB's operations in the other Nordic countries and in the Netherlands operate on the same lines. Thus to date SHB has avoided the need for a local capital base in the UK or in its other retail markets outside Sweden. It is primarily supervised by Sweden's Finansinspektionen rather than the UK's Prudential Regulatory Authority (PRA), with the Swedish National Debt Office being responsible for deposit insurance covering all of its branch customers. Such an approach means that liquidity, capital and many other important concerns can be and are dealt with in Sweden.

Although the UK is SHB's second largest home market after Sweden, accounting for 10% of FY16 operating profit and 12% of YE16 assets, the bank still has a relatively small share of the UK banking market. It has been able to grow as a challenger bank, without much advertising, often by taking away customers from the incumbent high street players. SHB positions itself to do personalised business in local branches, particularly with small business owners who demand a high level of service, although it also serves individuals Credit decisions are taken at branch level. and any follow-ups are also localised. This closely mirrors SHB's approach in Sweden. SHB currently has 207 UK branches, and (unlike larger competitors looking to close branches) is looking to open one more later this year.

The UK business is profitable (ROE 13.5% Jan-Sept 2017), albeit not yet with the strong efficiency level of the Swedish branch network. Scope views SHB's UK operation as positive for the credit, as it provides a cushion against any domestic downturn. We also note that .one of SHB's key credit strengths is its ability to manage asset quality through credit cycles. Although the non-Swedish operations have less longevity than those in Sweden, and asset quality therefore can't be judged over the same long period, so far there has been no cause for concern.

SHB has been able to operate through branches in the UK to date because Sweden and the UK are both within the Single Market. The provisions of CRD IV give Sweden, the home member state, the right to authorize a bank domiciled there to operate in the whole of the EU/EEA area (the Single Market), either through setting up a branch (without separate authorization) or the direct provision of services cross-border, in conjunction with appropriate product 'passporting' arrangements.

Passporting requires contact with the host country supervisor and reassurance from the home country counterpart, but doesn't involve the host country placing heavy regulatory burdens on the bank, of which the largest would usually be capital requirements. If the UK leaves the Single Market, Scope expects that the 77 banks currently based in the EEA area and authorized to take deposits within the UK will be dealt with on the same terms as presently apply to non-EEA banks – requiring at the very least separate branch authorization, and in some cases setting up of a subsidiary.

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Because it has over 200 UK retail branches, SHB's case is complex. Non-EEA banks can receive branch authorization allowing deposit-taking activities, provided that as a whole the bank meets the PRA's Threshold Conditions for authorization. In essence, the PRA would need to assess the home country's supervisory regime to be closely equivalent to that in the UK, and to accept the home country's supervision of the branch as sufficient[1]. However, most branches of foreign banks operating in the UK focus on wholesale activities, and the PRA expects new branches of non-EEA banks to do the same – which is clearly not true of SHB.

Further, the PRA would only be content for authorized non-EEA banks to undertake retail banking activities beyond de minimis levels if it received a very high level of assurance from the home state supervisor over resolution. Even more important in SHB's case, the PRA also takes into account the impact of a possible failure on financial stability, which includes access to 'transactional accounts'. The PRA expects new non-EEA branches to have insured deposits of less than GBP 100 mn. It also assesses that there is a possible risk to financial stability if the branch (in SHB's case the branch network) has more than 5,000 customers. In these circumstances Scope believes that the PRA is likely to request a subsidiary structure for SHB.

Planning is under way to deal with the possible need to set up such a subsidiary, and Scope believes that SHB is managing this with the appropriate degree of urgency. The Prudential Regulatory Authority asked banks for their contingency plans earlier this year, and SHB has responded.

We also note that, if the UK were to remain within the Single Market, a local subsidiary may not prove necessary. With a UK deposit base of GBP 9.1 bn at 3Q17, SHB is not yet large enough to be caught by ring-fencing rules, which kick in once core deposits (mainly from retail and SME customers) reach a 3-year average of GBP 25 bn.

Finally, SHB has said that although there are costs involved in setting up a new subsidiary in the UK, many of these would have eventually been incurred in any event. While the UK operation is profitable it is also SHB's largest non-domestic network and would benefit long-term from additional investment in governance and information systems, which could also help to improve efficiency.

[1] See Supervisory Statement SS10/14: Supervising international banks: the Prudential Regulation Authority's approach to branch supervision, September 2014

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