# BSA Response to CP16/22 - Implementation of the Basel 3.1 Standards

31 March 2023

Building Societies Association

# Executive summary

The BSA supports the overarching objective of the PRA, to align with the Basel framework for those 'internationally active' firms to which it applies, while taking opportunities to be more proportionate for Simpler Firms. We agree that the PRA can best meet its new secondary competitiveness objective by setting strong regulations which are stable over time to give firms certainty and predictability on the rules that apply to them. However, we highlight the disproportionate impact of Basel 3.1 on monoline mortgage lenders such as building societies, and the unintended impact this could have on product supply and customer choice. We also highlight where we believe that the PRA has not made the right choices in areas where it does have national discretion and these need to be reviewed against the empirical evidence of observed risk.

### Building societies' contribution to the UK economy

The BSA represents all 43 building societies, as well as 7 larger credit unions. Building societies serve almost 26 million consumers across the UK and have total assets of nearly £500 billion. Together with their subsidiaries, they have helped over 3.6 million families and individuals to buy a home with mortgages totalling over £366 billion, representing 23% of total mortgage balances outstanding in the UK. They are also helping over 23 million people build their financial resilience, holding over £342 billion of retail savings, accounting for 18% of all cash savings in the UK. With all of their headquarters outside London, building societies employ more than 51,500 full and part-time staff. In addition to digital services they operate approximately 1,300 branches, holding a rising share of financial services branches in local communities.[1]

Building societies are a key contributor to supporting the economy through the economic cycle and provide genuine diversity to the financial ecosystem. For example, in the decade after the financial crisis 2008-2017, the building society sector's share of new lending over the period was 43%. This compared to a share of stock of around 18% at the start of the period. As such, societies were able to support the housing market and economy at a time when the mainstream banks had largely withdrawn from the market. Since 2017, their share of net lending has returned to around 23%.

### Disproportionate impact of Basel 3.1 on building societies

The Basel 3.1 package has a disproportionate impact on monoline mortgage lenders, such as building societies both on standardised approach and IRB. While we support the lower risk weights for mortgages in the revised standardised approach, we also note that Pillar 1 will often remain over-calibrated for both standardised approach and IRB societies relative to observed loss rates. The increases are driven by the move to original valuation, the higher risk weights on certain mortgages such as self-build and holiday lets and the way that Pillar 1 requirements flow through the capital stack to Pillar 2a and buffers. Most societies were not anticipating capital increases as a result of Basel 3.1. If changes are not made, then they may have to re-prioritise other important investment initiatives in order to meet the increased capital requirements. The BSA is providing data separately to support these observations.

For IRB societies, the IRB floor has a disproportionate impact compared to a diversified bank, and this is acknowledged by the PRA itself for IRB societies in the consultation.[2] The PRA has stated that the purpose of the output floor is to capture model risk. We support the Basel

[1] BSA data as at Sept 2022

[2] Chapter 9, paragraph 9.26 "The PRA considers that mutuals with IM permissions may experience a relatively higher impact from the output floor, to the extent that internal ratings based (IRB) approaches continue to produce lower average risk weights relative to the SA"

Committee's work to reduce the excessive variability in IRB risk weights which is well documented for low default portfolios. However, low risk mortgage portfolios do not suffer to the same extent as others from the lack of available data. Societies have loss data going back to the 1990s, have back-tested their models and publish actual losses compared to forecast losses in their Pillar 3 disclosures.[3]

For a bank with a diversified portfolio, the impact of the output floor is smoothed across different portfolios. However, societies do not get this same offset because they have fewer IRB modelled exposure classes which generate very low risk weightings, and there are no higher risk portfolios to offset against which means the standardised approach floor will often be the driver of Pillar 1. We do not believe this is the intention of the Basel Committee given the framework only applies to internationally active banks which should not include domestic monoline mortgage lenders. A review of building society Pillar 3 disclosures reveals that IRB societies could face a near doubling of capital requirements (Pillar 1 + buffers) as a result of moving from Basel 3 to Basel 3.1. The main drivers of this doubling of capital requirements are: hybrid model changes implemented through SS11/13, the impact of the output floor, the change to original valuation and the scaling up of Pillar 1 through the buffers. While societies are able to absorb these increases, these regulatory changes in capital requirements will serve to reinforce the competitive advantage of the largest general purpose retail banks (the very banks that were deemed too big to fail in the 2008 financial crisis) at the expense of monoline mutual building societies. This is in direct conflict with the PRA's secondary competition objective and the requirement in FSMA for the PRA to have regard to the impact of prudential regulation on mutuals.

This doubling of capital requirements could incentivise a low risk building society in particular to move into riskier lending products to achieve a better risk-adjusted return on capital. The changes could also make longer-term fixed rate lending more expensive for consumers given that lenders need to allocate more capital to these products for the period of the fixed term. We propose that the PRA carefully considers whether it was the intent to create market conditions which favour short-term fixed rate lending with greater churn and hence less stability in the mortgage market.

### Competition and competitiveness, and the impact on mutuals

As already noted, the PRA currently has a secondary objective to facilitate effective competition and will gain an additional secondary objective in relation to international competitiveness with the passing of the Financial Services and Markets Bill. FSMA also requires the PRA to 'have regard to' the impact of its actions on mutuals. We note that since CP16/22 was published, the Government has indicated its intent to remove ring fencing requirements for certain UK subsidiaries of international banks, as they have limited investment banking operations.[4] This would mean that the output floor would no longer apply to those firms that are not captured by ring fencing. This situation must be corrected such that subsidiaries operating in the UK and in direct competition with UK building societies are subject to the same IRB output floor.

Also relating to competition, non-bank mortgage lenders are not subject to the Basel capital framework. We urge the PRA to consider extremely carefully, any actions that would give non-bank lenders a competitive advantage over building societies e.g. if risk weights are not risk-sensitive or not based on empirical evidence. Likewise, any measures that create friction in the mortgage market or impact the customer journey could lead to poor customer outcomes and a competitive advantage for non-bank lenders.

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[3] In general terms, actual losses are usually lower than forecast losses generated by IRB models as demonstrated in Pillar 3 disclosures

[4] See Government response to independent review on ring-fencing published as part of the Edinburgh reforms

The PRA should re-visit certain requirements that are not part of the Basel framework but that have a disproportionate impact on mutuals such as the PRA buffer and the leverage ratio buffer.

### Alignment to Government strategy on housing and net zero

The UK government has an ambition to support the building of 300,000 homes per year to reduce the nation's shortage of housing. The Bacon Review[5] makes recommendations for increasing self and custom builds (self-build) to capitalise on additional untapped demand in that space and help bridge the current building gap.

The Government's net zero strategy sets out policies to de-carbonise all sectors of the UK economy by 2050. Domestic dwellings are a significant contributor to carbon emissions, representing approximately 14% of the UK's total emissions. As such, the Heat and Buildings Strategy (England)[6] set out how the UK will decarbonise homes and reduce emissions from buildings as part of the path to net zero by 2050.

Self-build properties are typically built to very high energy efficiency standards. New builds in general achieve higher EPC ratings than existing buildings with over 80% (including conversions) achieving at least a B rating.[7] Most existing properties have a D rating or below.[8] Self-builds are even more efficient than typical new builds with the majority (54%) using renewable energy for the primary heating system.[9] Self-builders are also more likely to adopt innovative building methods that improve sustainability of the new housing supply.

The PRA's proposal to significantly increase capital requirements could significantly curtail the availability of mortgage finance to the self-build sector, which accounts for approximately 15,000 new homes built per year. This would rank the self-build sector as one the UK's top five development companies.[10] For comparison, the UK's largest developer – Barratt Developments – sold just under 18,000 homes in its year ending June 2022.

The BSA urges the PRA to carefully consider the impact of its policies on the Government's policies for housing and net zero. The current proposals imply that self-build has recently become significantly more risky. Higher capital charges will discourage this class of lending, or at the least make it significantly more expensive. The BSA has gathered data from its members that clearly demonstrates that self-build mortgages are lower risk than other owner-occupied mortgages, and we are sharing this data separately with the PRA. We therefore propose that the PRA adopts the Basel national discretion to treat self-build in line with owner-occupied mortgages.

### Basel 3.1 should support the smooth functioning of the UK housing market

The BSA recognises that the move to original valuation is part of the Basel 3.1 package. However, this is a significant problem in the context of the UK mortgage market and we therefore ask to PRA to consider a compromise approach to implementation as discussed below to avoid a cliff edge in January 2025. When UK borrowers enter into a mortgage contract they are signing up to a 25-40 year commitment. It would seem perverse to rely on that commitment being broken at regular intervals, absent any mechanism for indexing.

We encourage the PRA to consider very carefully the practical implications of Basel 3.1 and avoid causing distortions in the UK mortgage market, either in terms of competition, shifts in products or changes in practical aspects such as the approach to valuations. There is already a shortage of qualified surveyors able to undertake valuations. Any shift in regulatory

[5] See Bacon Review
[6] See Heat and Buildings Strategy
[7] See Bacon Review
[8] See ONS data on EPC
[9] See Bacon Review
[10] See Right to Build review

requirements, such as not allowing the use of automated valuation models (AVMs), would significantly increase demand for valuations and would introduce significant friction into the house buying process and ultimately result in increased costs to consumers.

Buy-to-let lending is an integral component of the mortgage market and we call on the PRA to allow a pragmatic approach to the '3+1 property rule' that is proportionate to the risk, not unduly onerous and aligned to the PRA's portfolio landlord definition in SS13/16.

### Links to the Strong and Simple framework

The BSA represents all 43 building societies, many of whom will not be subject to the full Basel 3.1 regime. However, we are mindful of precedents that may be set with potential read across to the new 'Simpler Firms Regime' given that the details of this regime have yet to be published. Our comments consider aspects that could ultimately be relevant to all societies.

We encourage the PRA to publish its next CP on capital for Simpler Firms so that they can decide, with sufficient planning time, whether to adopt the regime or whether to implement Basel 3.1. This choice can only truly be made once both options are made transparent.

### Risk weights should be based on empirical evidence

We welcome the PRA's invitation for firms to provide data to support arguments. We are providing this data separately to clearly make the case that arrears, possessions and losses on self-build and holiday lets are lower than for more traditional owner-occupied and buy-to-let lending.

### Timelines and practical implementation

We note the tight timelines between now and the implementation date of 1 January 2025. During this time, the PRA needs to publish its final rules and conduct a further consultation on Pillar 2. It will also need to issue firms with revised Pillar 2 TCRs and conduct model reviews for IRB changes. Firms will need to upgrade their risk management and regulatory reporting systems. For firms that use third party vendors, the optimum timescale is 18 months (from publication of the policy to implementation i.e. July 2023 for a start date of January 2025).

### The BSA supports open engagement with the PRA

The BSA welcomes the open engagement we have had during the consultation period with the PRA. We stand ready to provide ongoing support and data as required in the coming period and beyond. We have structured our response in line with the 12 chapters in CP16/22 and the questions posed. We only answer those questions that are relevant and material to our members.

When the PRA publishes its policy statement we request that **the revised rules are published in tracked changes** to aid the industry given the significant size of this consultation.

# Chapter 2 - Scope & levels of application

The BSA strongly supports the PRA's 'Strong and Simple' initiative. We were previously comfortable with the £15bn threshold proposed in CP5/22 and we do not object to the increase in the threshold to £20bn. However, we are concerned that as the threshold increases and includes larger firms it could then inadvertently limit the appetite of the PRA to be bold in its proposals. We encourage the PRA to be bold with its proposals and not to feel constrained by the wider scope of application, as recent events have shown that a strong regime does not need to be unduly complex.

At the same time, we think that all static thresholds in the regulatory framework should be subject to periodic review. Given the blunt nature of thresholds and the higher inflation environment in recent times, we believe the PRA should commit to periodic review of thresholds given that many firms will remain simple and non-complex despite a degree of organic balance sheet growth. We also believe the PRA could streamline thresholds so that there are fewer thresholds that apply across different areas.

***Q1: Do you have any comments on the PRA's proposals for the Transitional Capital Regime?***

The BSA strongly supports the PRA's Strong and Simple project as a 'Brexit dividend' now the UK has left the EU. We welcome the policy intent behind the Transitional Capital Regime. We agree that Simpler Firms should not need to implement Basel 3.1 before subsequently migrating to the new regime (or 'digging up the road twice'). However, our current concern is that the alternative Simpler Firm capital regime is not yet known. This creates a strategic conundrum for Boards and leadership teams of building societies. As societies prepare forward-looking financial plans they will want to consider whether the Simpler Firm regime is indeed the best option rather than the full Basel 3.1. For a 3-5 year planning horizon, it is currently impossible to make that call.

The PRA has stated that the Basel 3.1 standardised approach to credit risk and credit risk mitigation will likely be the starting point for the Simpler Firm regime. This adds to the impetus for smaller firms to run the Basel 3.1 calculations to understand the impact. Over time, societies may start to run parallel calculations of their Pillar 1 approach based on the current requirements and Basel 3.1. This means that the longer the PRA takes to publish its Simpler Firm capital proposals, the more likely that firms choose to adopt Basel 3.1 in the intervening period for commercial reasons depending on the composition of their mortgage portfolio.

We propose that the PRA considers adjusting the Transitional Capital Regime such that it is more of a 'glide path' rather than the proposed 'stand still' approach which creates competitive issues between different mortgage lenders. For example, the Transitional Capital Regime could include aspects of the new credit risk standardised approach as part of a transition to the Simpler Firm regime, but without implementing the full Basel 3.1 package across other risk types e.g. operational risk.

***Q2: Do you have any comments on the PRA's proposed Simpler-regime criteria?***

The BSA is supportive of the Simpler Regime criteria as set out in the consultation.

The BSA particularly welcomes the revisions to the domestic activity criteria. The previous limit of >85% of exposures located in the UK was linked to a COREP return that meant that ex-pat mortgages would be based on the location of the borrower not the property. As we have set out in our response to CP5/22, these loans are more domestic than international in nature and occur when a borrower lives and works abroad for a period of time but continues to repay the mortgage in the UK with UK funds, such as from rental income. We therefore welcome the revised approach to refer to the FCA MLAR return which treats such loans based on the location of the property i.e. the UK even if the borrower is abroad.

The BSA also welcomes the proposed smoothing by using a 3-year average. This avoids a situation where a society crosses a threshold for only a limited time.

The BSA is currently reviewing the trading book threshold to ensure that it works as conceived. We understand that it is not the PRA's intent to preclude smaller societies from opting into the Simpler Firm Regime as a result of hedging using interest rate swaps and will work with the PRA to ensure the criteria are fit for purpose.

# Chapter 3 - Credit risk standardised approach

The BSA is commenting on the proposed new standardised approach on behalf of all of its members not just those that will adopt Basel 3.1. This is because the PRA has stated that it will use the credit risk standardised approach as the starting point for developing its new Simpler Firm Regime. As such we are mindful of potential read across between the two regimes.

In general, the BSA supports the revisions to improve the risk sensitivity of the standardised approach to credit risk. However, as currently drafted, some of the proposals could have a **considerable and disruptive impact on current market practices**, the smooth functioning of the housing market and would ultimately increase costs to consumers if not amended. We urge the PRA not to implement Basel 3.1 in a way that would result in significant practical consequences for the broader housing industry without the need being validated by empirical evidence. The PRA should also be mindful of practical implementation challenges, such as any requirement to monitor **the number of properties held by a buy-to-let landlord**. Any purist approach here may be un-implementable and hence we believe a 'best efforts' approach aligned to the current PRA portfolio landlord definition would be more appropriate and proportionate to the risk.

We identify two specific mortgage products that the PRA should review urgently given that even draft regulations in published consultations can change market dynamics for long-dated products like mortgages. The two products are **self-build mortgages and holiday lets**. The proposed significant increases in capital requirements are not aligned to observed performance metrics on these portfolios. We are submitting data separately to the PRA which clearly demonstrates that these products show lower arrears, possessions and losses compared to mainstream mortgages. We also propose the PRA reviews the impact of original valuation on lifetime mortgages.

***Q3: Do you have any comments on the PRA's proposed approach to the use of external credit ratings and the proposed due diligence requirements?***

The BSA supports the use of external credit ratings. Credit rating agencies are regulated by the FCA to ensure that their activities "are conducted in accordance with the principles of integrity, transparency, responsibility and good governance in order to ensure that resulting credit ratings used in the UK are independent, objective and of adequate quality." As such, while the proposed due diligence requirements may be proportionate for larger firms, we believe they could be excessive for smaller societies. As such, we propose that the PRA should not require significant due diligence requirements for firms on the Simpler Firm Regime over and above counterparty risk management as envisaged in SS20/15. We believe it would be disproportionate and inappropriate to expect a smaller firm to be able to perform a better analysis of a counterparty's creditworthiness than an FCA-regulated credit rating agency.

***Q7: Do you have any comments on the PRA's proposed changes to the external credit rating approach (ECRA), the proposed introduction of the standardised credit risk assessment approach (SCRA), for exposures to unrated institutions, and the proposed treatment of covered bonds?***

Building societies have exposures to institutions held in their treasury portfolios. These are held for liquidity management purposes. We support the lower risk weights set out in Article 120 for short term exposures of less than 3 months. However, we disagree with using original maturity to determine whether the exposure is short term and can benefit from the lower risk weight. This would penalise firms from holding slightly longer dated exposures as they would be risk-weighted higher for the whole life of the exposure even if they were only over the three months for a very short period.

***Q13: Do you have any comments on the PRA's proposal that the value of the property shall be measured at origination and on the proposed approach to determining origination value? Do you have any comments on the proposed prudent valuation criteria?***

As set out in the Executive summary above, Basel 3.1 should support the smooth functioning of the UK mortgage market. When UK borrowers enter into a mortgage contract they are signing up to a 25-40 year commitment. It would seem perverse to rely on that commitment being broken at regular intervals, absent any mechanism for indexing.

We understand the logic of attempting to remove cyclicality from capital requirements. However, the proposed approach is non-cyclical in a rising market but procyclical during any market downturn given the need to revalue properties when "there is a significant decrease in the market value of the property as a result of a broader decrease in market prices." This is the worst of both worlds and could cause financial stability issues during a market downturn.

The BSA does not support the use of original valuation for calculating LTVs. Societies will need to understand the current value of properties for their own risk management purposes as well as for accounting purposes and IRB. As such, the shift to original valuation adds complexity as most firms will need to store two different valuations on their systems – the real valuation and the one for standardised approach regulatory capital calculations.

If the PRA insists on using original valuation, it recognises itself in the consultation that there could be practical challenges to ascertaining the original valuation of every loan in a lender's current portfolio, particularly for loans that are very old. The PRA suggests a 'best efforts' approach but this could result in a very patchy implementation with firms with better record keeping being penalised with higher capital charges. We propose that the PRA considers allowing firms to use the up-to-date valuation until 1 January 2025, at which point they would then cease any future regular re-valuations unless one of the other conditions for a revaluation is met. This would provide a natural transition period to smooth the capital impact of transferring from a portfolio on current valuation to one on original valuation (see our comments above on the disproportionate impact of Basel 3.1 on the sector).

We support the PRA's proposals to allow societies to re-value a property at the point of a re-mortgage i.e. a product switch. We also note that the proposals are ambiguous on what valuation methodologies are acceptable, and we therefore assume that current market practice will continue to be permitted. Building societies currently take a risk-based approach governed by their internal policies. There is a general market trend towards increasing levels of automation across the industry.

**The BSA is strongly of the view that the PRA should align its approach to current market practice for property valuations. Any changes to current market practices could have serious implications for the smooth functioning of the mortgage market. This would increase friction in the house buying process, resulting in reduced levels of competition, and create conduct risks with additional costs inevitably being passed to the consumer.**

As such, we believe that the PRA rules on property valuation should mirror the existing article 208 of onshored-CRR text "institutions may use statistical methods to monitor the value of the immovable property that needs revaluation." Any departure from this approach must be evidence-based and consider unintended consequences.

We encourage the PRA to avoid causing distortions in the UK mortgage market, either in terms of competition, shifts in products or changes in practical aspects such as the approach to valuations. There is already a shortage of qualified surveyors able to undertake valuations. Any shift in regulatory requirements, such as not allowing the use of automated valuation models

(AVMs), would significantly increase demand for valuations and would introduce significant friction into the house buying process and ultimately result in increased costs to consumers.

***Q14: Do you have any comments on the PRA's proposed approach to risk-weighting real estate exposures?***

BSA members support the choice by the PRA to use the 'loan splitting' approach for owner-occupied mortgage risk weights. This has a smoother risk weight profile as shown in the chart 2 of chapter 3, compared with a 'whole loan' approach. However, the use of the 'whole loan' approach for buy-to-let properties adds a layer of complexity by having different calculations across the two portfolios. This could result in operational complexities, particularly for loans that qualify for the '3+1' exemption but then need to switch from loan-splitting to whole loan approach during the life of the loan. We encourage the PRA to consider using a consistent loan splitting approach across both owner-occupied and buy-to-let products when it is designing the Simpler Firm Regime.

## Buy-to-let

The BSA welcomes the exemption that allows buy-to-let landlords with a limited number of properties to be risk-weighted in line with owner-occupied residential mortgages i.e. those not materially dependent on cash flows generated by the property. The approach utilises a national discretion in the Basel framework and it is within the PRA's gift to set.

As a general concept, we believe that thresholds on similar topics within the PRA Rulebook should be aligned where possible. This reduces complexity and the risk of implementation errors. Deviations should only be made where there is strong empirical evidence of additional risks if thresholds are aligned.

The PRA's Supervisory Statement SS13/16 sets a '4 property' limit which determines whether a buy-to-let customer is deemed a 'portfolio landlord.' A footnote elaborates "Firms may use their judgement when determining how to verify the number of mortgaged buy-to-let properties the borrower has. The PRA recognises that there are a variety of suitable ways to do this including using credit bureau data." So a similar approach should be permissible for capital purposes, such that the determination is made once at the point of loan origination and on a 'best efforts' basis. This would also alleviate the issue identified above whereby a firm needs to switch from loan splitting to whole loan approach during the life of the loan.

**The BSA is of the view that the approach to determining the number of properties held by a buy-to-let landlord should be aligned to the approach in SS13/16 and SS20/15.**

The BSA accepts that the PRA would want firms to reassess periodically the number of properties held by a borrower but not create an onerous process around this and not introduce unnecessary friction into the market. As such, we propose that this should be reassessed at the point it would be reassessed in any case, such as when a borrower applies for an additional mortgage or a further advance.

## Self-build mortgages and holiday lets

Building societies typically run low-risk and hence low-margin business models. In part this comes from legal and regulatory restrictions as well as a cultural desire to best serve their members. However, one way in which they supplement the lower margin business model is with certain products that are not necessarily more risky, but can command a higher margin because of the specialist underwriting skills involved. For smaller societies this might include manual underwriting and local knowledge. This provides additional income streams and a small degree of well-controlled diversification to help margin management and sustainability.

We agree with and support the more risk-sensitive calibration of the Basel 3.1 proposals. At the same time, **we do not believe that the current proposals are appropriate across all products and we highlight self-build mortgages and holidays lets as two such areas that**

**require review** for the reasons set out in the executive summary. For holiday lets, the PRA should consider the type of property and whether it can be easily re-purposed as an ordinary dwelling.

**The BSA urges the PRA to re-consider the current proposals for self-build mortgages and holiday lets. Societies have experienced lower arrears and loss rates on these two products when compared with prime residential mortgages and we therefore strongly disagree with the PRA's view that these are riskier products that require a significantly higher risk weight (3-5x times higher) and that holiday lets are treated as commercial. Furthermore, for self-build, the proposals could be counter to the Government's housing policy given self-build represents around 15,000 units a year, and climate change objectives for net zero emissions as these properties tend to be more energy efficient. We propose that the risk weight for self-build is aligned to owner-occupied and for holiday lets is aligned to buy-to-let (including the 3+1 exemption).**

With regard to the valuation that should be applied to self-build properties, the BSA will be happy to have a discussion with the PRA to gain a common understanding on how valuations are applied through the phases of the build thereby reflecting "modifications that unequivocally increases the value of the property."

## Commercial lending

Some building societies provide development finance for residential properties. For IRB, these are captured under the slotting approach and subject to the new risk category 'high volatility commercial real estate', with the associated higher risk weights, but with lower risk weights available for <2.5 years maturity. For the standardised approach these are classified as land acquisition, development, and construction exposures (ADC) and risk weighted at 150% with no corresponding discount for shorter maturities. This creates a significant competitive distortion between the IRB and standardised approach risk weights even though neither are based on internal models. We call on the PRA to review the justification for these differences in line with its secondary competition objective. We also highlight the importance of such lending to support the government's house building strategy. As such, the PRA should be mindful of how its requirements may support or hinder government strategy. This could be an area for review as part of the Strong and Simple project.

## Equity release

A number of building societies have equity release loans on their balance sheet, as part of a closed book. The switch to risk weighting these products according to the original valuation will lead to a fundamental increase in Pillar 1 capital requirements. The loans are typically low LTV at origination, but no repayments are made. In the current approach the LTV will be reducing over time as property prices rise, while under the proposed approach the interest will be accrued with a static original valuation which will have the opposite effect of increasing LTV. Loans can be very long dated as they often remain in place until the property is sold, either if the borrower dies or moves into alternative accommodation. The BSA accepts that the risk on these loans is complex, and when house prices fall the LTV calculation is procyclical. Under the current approach, firms perform a stress test under Pillar 2a and this will need to be adjusted to take account of increases in the pillar 1 treatment.

The BSA proposes that the PRA considers an alternative approach for these products. One option could be grandfathering of the current capital treatment given they are in run-off (i.e. 35% risk weight based on indexed LTV), and there are other options we are happy to explore. However, regardless of whether the PRA addresses the issue in Pillar 1, crucially the Pillar 2 approach will need to be adjusted so the overall capital against these products is the same as currently, and the stresses that are applied use current valuation as the starting point and hence aren't increased beyond 'severe but plausible.'

# Chapter 4 - Credit risk IRB

The BSA welcomes the proposals to adopt a more pragmatic approach to its review and approval of IRB models. This is an important change to support effective competition. In addition to this change of approach, we would also request that the PRA treats firms consistently in terms of the timing. So where firms are set a timeline to achieve compliance with aspects of the requirements then these should be applied consistently across different firms.

The BSA understands and recognises the Basel Committee's desire to reduce the levels of variability across firms' IRB models. This is particularly relevant for more difficult to model portfolios where there is a lack of data on which to build effective models (so called 'low-default portfolios'). We recognise that many of the proposals in Basel 3.1 are designed to constrain model inputs and outputs and thereby reduce model variability.  However, we also note that the PRA has chosen to introduce additional constraints over and above those in the Basel framework. Some of these have already been implemented through the hybrid IRB changes introduced through SS11/13 and further constraints are proposed. For a retail mortgage portfolio, while defaults are low, there is sufficient history and data for societies to develop robust IRB models and societies have been modelling mortgage portfolios for almost two decades, with data going back to the 1990s. Low risk weights are driven by the low probability of default and also the low loss given default due to the existence of robust collateral in the form of residential property. As such, we question whether the number of constraints that are super-equivalent to the Basel requirements are really necessary and whether the regime is now significantly more complex than it needs to be. Furthermore, the output floor will often be binding for a low risk mortgage lender. This means that when IRB models are being used more for internal risk management purposes than for determining capital requirements it further brings into question why so many constraints are necessary and useful.

***Q16: Do you have any comments on the PRA's proposed implementation timelines?***

We note the PRA's intention to communicate firm-specific timetables for submitting IRB model change applications. We also note that the PRA will be constrained by the capacity of its technical teams to review firms' models. We understand that the PRA will likely take a risk-based approach to its review work, but we would also suggest that the PRA is careful not to put the mutual sector at a disadvantage relative to other firms and prioritises its resources accordingly. This should be applied to IRB-aspirant firms as well as existing IRB firms so as not to put them at a competitive disadvantage by putting them at the back of the queue.

***Q17: Do you have any comments on the PRA's proposals for permission to use the internal ratings based (IRB) approach?***

The BSA welcomes the proposal to adopt a more pragmatic approach to its review and approval of IRB models, such that areas of non-compliance that are non-material should not prevent a firm from adopting IRB. This is particularly important, as the PRA notes, for IRB aspirant firms to ensure effective competition with firms already IRB approved that might not be fully compliant with every aspect at all times.

***Q19: Do you have any comments on the PRA's proposed restrictions on the use of the IRB approach?***

As mentioned above, we question whether the number of restrictions are necessary and useful, particularly for building societies with lower demonstrated model risk and that are already likely to be constrained by the output floor.

***Q20: Do you have any comments on the PRA's proposed approach to roll-out, permanent partial use, and reversion?***

We welcome the PRA's proposal for dropping the full use requirement and support the measures to mitigate the risk of cherry picking.

***Q21: Do you have any comments on the PRA's proposals relating to the 1.06 scaling factor and to the 1.25 asset value co-efficient of correlation multiplier?***

We support the removal of the 1.06 multiplier as a welcome point of simplification. We understand that the multiplier originates from QIS analysis and an aim to keep the overall level of capital in the system broadly the same at the point of implementation of Basel II. However, that aim was not achieved and the 1.06 has little purpose in the IRB formula, so should now be removed.

***Q27: Do you have any comments on the PRA's proposed PD, LGD, and CF or EAD input floors?***

See above comments on the overall complexity of the approach.

***Q30: Do you have any comments on the PRA's proposals to EAD estimation?***

Article 182.1(g) requires conversion factors are estimated based on information as at 12 months prior to the point of default. This is inconsistent with PD and LGD estimates where the point of default is at any point in the next 12 months rather than at precisely 12 months. This could lead to inconsistencies in EL and RWA calculations. Our view is that there should be consistency in measurement and modelling across all risk estimates.

***Q32: Do you have any comments on the PRA's proposals for specialised lending?***

We would welcome more guidance on the use of the slotting approach. Specifically, the requirements for the preferential 'strong' or 'good' categories if "the institution reasonably considers that the obligor would be able to be refinance the exposure in a severe but plausible stress in the refinancing market." We believe that re-financing risks in a severe but plausible stress should be captured in Pillar 2B rather than Pillar 1.

# Chapter 5 - Credit risk mitigation

Building societies are not generally impacted by the proposals in the credit risk mitigation chapter 5 of CP16/22. However, one area where we would welcome more clarity is the treatment of mortgage indemnity guarantee (MIG). Many societies take out MIG for higher LTV lending and this is a supervisory expectation as set out in SS20/15 the Building Society Sourcebook which does not apply for other mortgage lenders. Currently many societies purchase MIG for risk management purposes and to comply with the Sourcebook but most do not take a capital benefit. The BSA welcomes the PRA's statement in paragraph 5.104 that MIG can be treated as eligible unfunded credit protection where the eligibility criteria are met. We would welcome more guidance from the PRA to enable societies to apply the requirements in a way that is not unduly onerous. We also believe this is an area for potential simplification under the Strong and Simple initiative.

# Chapter 6 - Market risk

Building societies do not typically hold capital for P1 market risk requirements, as derivatives are only entered into for hedging purposes, any FX risk is below the 2% own funds threshold and interest rate risk is considered as part of the Pillar 2 assessment. The BSA is not therefore commenting on chapter 6 of CP16/22.

# Chapter 7 - Credit valuation adjustments (CVA)

Building societies will typically have a small CVA requirement, which is less than 1% of a society's current total capital requirement for those societies that have a CVA impact. For societies that have under £88bn of notional non-centrally cleared derivatives contracts they should be able to use the alternative approach. We would like the PRA to confirm that this option is available given they are well within the £88bn threshold.

# Chapter 8 - Operational risk

The BSA supports the alignment of the new standardised approach to operational risk with the Basel framework. We note the PRA's decision to set the internal loss multiplier to 1. This avoids a situation where a society's capital is based on historical tail-event losses that are no longer relevant and often not comparable across firms, and we support this philosophy to set capital based on the current and future business model rather than being anchored to the past.

For the largest societies currently on the standardised approach to operational risk (TSA) the revisions will likely increase pillar 1 operational risk requirements given that the multiplier increases from the current 12% for retail to 15%. For societies of less than £0.88bn turnover the multiplier is 12%. We agree with the philosophy that larger organisations are proportionality subject to larger amounts of operational risk given the increased complexity of their operations. The same isn't necessarily true for 'large and simple' organisations like building societies.

The income related measure now adopts an 'absolute' perspective and on a wider range of profit and loss line items versus the current calculation; for example, the absolute profit or loss from ineffective hedge accounting shown in the P&L will be included in the income related component of the calculation. This will increase the overall operational risk charge, particularly in times of interest rate volatility.

We also welcome the PRA's statements in chapter 10 that where there are changes in Pillar 1 then there will be an equal and opposite change to Pillar 2a so as to ensure that there is no double counting. As such we understand that the total nominal amount of capital held for operational risk of Pillar 1 + Pillar 2a should be unchanged. We encourage the PRA to increase the transparency on how it models operational risk when it sets Pillar 2a for firms. This helps firms to understand, and where necessary, improve their own risk management techniques rather than be incentivised to adopt a minimal approach given the PRA will set the number regardless.

***Q47: Do you have any comments on the PRA's proposed implementation of the standardised approach (SA) in the Basel 3.1 standards for operational risk capital requirements?***

We support the operational risk charge for Pillar 1. Our main concerns as explained above are the overall levels of operational risk capital for Pillar 1 + Pillar 2a.

***Q48: Do you support the PRA's proposal to set the internal loss multiplier (ILM) equal to 1?***

Yes, we support the ILM being set to 1 for consistency and comparability purposes.

# Chapter 9 - Output floor

The BSA understands that the IRB floor is a fundamental component of the Basel framework, and is designed to capture model risk and excessive RW variability between firms. We would argue as above that the IRB floor is significantly more penal to monoline mortgage lenders, as the floor will more likely bite more of the time compared to a bank with a wider range of products with higher modelled RWAs. The reason why mortgage model outputs are low is because of the low risk of losses. The modelled PDs and LGDs vs actuals are confirmed through back-testing and are disclosed under Pillar 3. The IRB societies generally show that modelled PDs and LGDs are more conservative than actual PDs and LGDs demonstrating that model risk isn't particularly significant for building societies, and yet the new standardised approach output floor will be the driver of the pillar 1 for much of the time.

***Q49: Do you support the scope and levels of application of the PRA's proposed output floor? Do you have any additional evidence on the potential impact of these proposals with respect to different activities or particular business lines?***

As explained in the executive summary, the output floor has a disproportionate impact on monoline mortgage lenders, and we do not believe it is the intent of the Basel Committee to drive domestic monoline mortgage lenders to a near doubling of their capital requirements when moving from Basel 3 to Basel 3.1. The BSA has separately provided its analysis of the penal impact of the output floor on monoline mortgage lenders.

In terms of the scope and levels of application, the proposed changes to the ring-fenced banking arrangements will mean that some UK subsidiaries of international parent banks will no longer be subject to any output floor in the UK. This would give them a competitive advantage on mortgage lending compared to UK lenders. This needs to be corrected.

***Q50: Do you have any comments on the PRA's proposal that when the output floor is activated 'floored' RWAs should be used wherever relevant in all elements of the capital stack? Do you have any additional evidence that is relevant to this proposal to inform the PRA's analysis?***

This is an important point that has the potential to further exacerbate the penal capital treatment of monoline mortgage lenders in Pillar 1 by also applying the floored Pillar 1 amount as inputs into Pillar 2a and buffers. The PRA itself identifies as part of its FSMA mutual obligation analysis that mutuals may experience a higher impact of the output floor. Our analysis aligns to this view. We do not agree with the PRA's view that "mutuals model risk may be amplified by specialisation in residential retail mortgages." To the contrary, we believe that the specialism and significant data set coupled with compelling back-testing would suggest the opposite is true. Furthermore, following hybrid/temporary model adjustment (TMA) rollout IRB societies are being required to deduct increased excess expected losses from capital, offsetting the perceived capital benefit of modelled approaches against standardised mortgages. We, therefore, believe it would be better to use the unfloored RWAs to feed into other calculations given that is the more accurate reflection of the risk, and model risk is captured by other risk mitigants such as model governance, data adequacy and back-testing. **The buffers are supposed to be buffers not hard requirements and making them multiply up by using the floored RWAs as an input means that the result is arguably double-counting and overlap of risk capture within the different parts of the framework.**

***Q51: Do you have any comments on the PRA's proposed transitional arrangements including the proposal to not apply the discretionary transitional cap?***

The BSA supports the PRA's choice not to adopt the national discretion transitional cap. As the PRA explains it would create a cliff edge at the end of the transitional period. We are against all cliff edges and the purpose of transitional arrangements is to avoid cliff edges with a smoother implementation. As such, the cliff edge that is more significant to building societies is the one that will occur on 1 January 2025 when mortgage lenders will be required to change the valuations of all the properties on their portfolio from current value to original value (assuming the PRA retains original valuation as per the consultation). Not only will this be a complicated project to implement by tracing back all original valuations which may not be recorded, particularly for older loans, but it also creates a sudden jump in capital requirements at that point relative to capital held for mortgages under IRB. As such, we propose that current valuation is used on 1 January 2025, but at that point, the valuation ceases to be increased in line with the new requirements unless one of the circumstances arises such as a product switch.

# Chapter 10 - Pillar 2

The BSA notes that chapter 10 does not contain any specific new policy proposals, and that the PRA intends to review its Pillar 2A methodologies more fully in 2024. We look forward to engaging in future consultations on Pillar 2. However, chapter 10 highlights a number of important topics which we support discussing early to ensure the approach is fit for purpose. The PRA correctly highlights that changes to Pillar 1 under Basel 3.1 will also flow through to Pillar 2. However, **we do not concur with the PRA's view that the impact of the changes to Pillar 2 will be "relatively modest,"** at least not for building societies. As mentioned above, IRB societies will be impacted by the standardised approach floor which will often be binding. As such, if Pillar 2A and the buffers are calculated using the floored Pillar 1 capital as an input then the increase in capital required to meet Pillar 2 and buffers will be significant. The same argument will apply to standardised approach societies given the higher risk weights.

The BSA welcomes the statement that "the PRA would not double count capital requirements for the same risks in Pillar 1 and Pillar 2A." However, given the generally more opaque approach to setting Pillar 2A, there is inevitably some scepticism as to whether this will happen in practice. We propose that the PRA's Policy Statement is very clear on this point.

We believe that the current Pillar 2A approach to credit risk in particular throws up a number of challenges that the PRA will need to review very carefully:

- For IRB mortgage lenders we believe the over-calibration of Pillar 1 by way of the various input and output constraints including the overall output floor should negate the need for any Pillar 2A credit risk capital add-ons for low-risk mortgage portfolios.
- For standardised approach, the IRB benchmarks published in the PRA's Statement of Policy are based on Basel 2 IRB models and will need to be revised. Given that the purpose of Pillar 2a is to provide a more accurate analysis of risks not adequately addressed in Pillar 1, we propose that the **IRB benchmarks should be un-floored.** Again we would question whether the majority of societies would need a Pillar 2a capital add-on given the improved risk sensitivity in Pillar 1 coupled with the various other drivers such as the move to original valuation.
- Concentration risk capital add-ons are calibrated according to Basel 2 IRB risk weights. Again, the increases in Pillar 1 for building societies calls into question the ongoing relevance of these additional capital add-ons. Furthermore, the demographics of many geographical areas have changed over time, with the

increases in hybrid working following the pandemic. So having concentrations in certain geographies may no longer indicate heightened risk in the same way as it did at times in the past when certain localities might be more prone to the loss of a single large employer.

- The UK implementation of buffers is more complex than in any other jurisdiction. Only the UK sets a PRA buffer and a leverage ratio buffer, neither of which are components of the Basel framework. We view buffers as an area that is ripe for simplification and we welcome Sam Wood's speech 'Bufferati.' Our view is there should be one simply calculated buffer which is aligned to the Basel approach.[11]

PS22/17 allows standardised approach firms to offset Pillar 2A risks (the 'refined approach') to reflect the over-calibration of the standardised approach to credit risk under Pillar 1. The proposed Basel 3.1 changes are intended to provide a more risk sensitive approach. CP16/22 notes that "the PRA proposes to significantly reduce the SA risk weight, from 35% to 20% for some residential mortgage exposures" and that this would "significantly reduce any high degree of conservatism of the SA compared to IRB models." However, this is not a straight forward discount from 35% to 20% because the 20% risk-weight is proposed to be based on original valuation whereas the 35% is based on current indexed valuation. In this respect, the new calculation of LTV is in fact less risk sensitive as the valuation does not reflect the current market value. With this in mind, as well as the above points raised above we believe it is important to **retain the refined approach offsets as set out in PS22/17**. This is important to satisfy the PRA's secondary competition objective. While Basel 3.1 does reduce the significant gap between capital requirements for standardised approach and IRB, it does not eliminate it and this is an important ongoing consideration.

The move to a new Pillar 2 regime ahead of 1 January 2025 presents a challenging timeline. Firms are already making judgments about how the future will look in their 3-5 year business plans, ICAAPs and stress scenarios. The BSA would welcome further guidance from the PRA on the assumptions that firms should make in terms of their ICAAP and stress scenarios given Basel 3.1 is currently still under consultation but the PRA has committed to faithfully implement the Basel framework. We also recognise that the PRA will not be able to review individual ICAAPs and set capital requirements ahead of 1 January 2025. To the extent that the PRA develops a mechanical mapping exercise to translate existing TCRs into Basel 3.1 TCRs, we would welcome transparency on the approach so the industry is both clear on the approach but also able to assist in review the methodology to test it for unintended consequences.

# Chapter 11 - Disclosure (Pillar 3)

The BSA acknowledges the logic for adjusting Pillar 3 disclosures to reflect the Basel 3.1 requirements, and the maintaining of frequency requirements based on the size and listing status of firms. We understand that the PRA's approach is to make a limited number of changes while ensuring that the disclosures provide transparency on a firm's compliance with the new standards.

However, since its inception, Pillar 3 has not proved effective at achieving the desired policy intent of market discipline. We know that disclosures are rarely read, and more likely to be used for competitor analysis or academic reasons than by investors that are able to apply

[11] As originally conceived the Basel buffer was one buffer but being calibrated through differing components. For non-systemic, non-internationally-active firms, a single capital conservation buffer of 2.5% could achieve the intended policy objectives while reducing complexity in the framework.

market pressure. **We strongly welcome the PRA's proposals to remove large parts of Pillar 3 for Simpler Firms as set out in DP4/23. We would propose that a similar review is performed for mid-tier building societies that will likely count as 'large and simple' under the PRA's Strong and Simple initiative.**

There is also some cross-over and read-across to our comments made on regulatory reporting, with respect to implementation, process from interpretation to launch, and pressure on scarce resource timelines, as it is highly likely that Pillar 3 changes will need to be worked on alongside regulatory reporting changes.

# Chapter 12 – Reporting

The BSA acknowledges that regulatory reporting will need to change to reflect the new requirements, calculations and disclosures for Basel 3.1, as set out in the consultation. We appreciate the PRA sharing these proposed reporting templates and instructions at this stage, so that firms can consider, understand and commence their implementation plans at an early stage.

A minimum of 18 months will be required to ensure that societies and the broader ecosystem can consider, develop, test and implement the required changes to templates (from publication of the policy to implementation i.e. July 2023 for a start date of January 2025). This ecosystem will need to involve firms, technology venders, BoE reporting mechanisms and validation, and firm risk management and governance processes.

One aspect of regulatory reporting that is often of higher risk relates to the interpretation and application of complex or judgemental areas. To assist with this, we recommend that a 'Q&A' capability is initiated by the PRA and run over the implementation timeframe and on an ongoing basis as was previously the case with the EBA.

The amount of regulatory reporting initiatives that are and will be underway during 2023 and 2024 is significant: Transforming Data Collection ("TDC"), Banking Data Review, Basel 3.1, Strong and Simple all require input from firms with that input likely to come from the same number of scarce experts. We believe a road-map covering all these initiatives would be useful to ensure that priorities are sequenced accordingly, given the 1 January 2025 Basel 3.1 implementation date.

We would also like to highlight the risk of a two tier world with larger firms gaining greater support and prioritisation from e.g. software vendors than firms on the Simpler Firm regime.

# Chapter 13 - Currency redenomination

The BSA welcomes the measures proposed to ensure that all the various thresholds are in £Sterling. We had understood that this would be the case previously as part of the EU Withdrawal Act and hence we are working on the basis that the changes are tidying up of currency that was not previously corrected through the onshoring process. As such, we do not anticipate any changes of substance rather than to reduce the need for firms to monitor currency movements on an ongoing basis and we therefore welcome the replacement of such references into £Sterling.

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