The Strong and Simple Framework : a definition of a Simpler-regime firm

BSA response to PRA CP 5/22

July 2022

Building Societies Association

General

The BSA maintains its vocal, warm and consistent support for PRA's overall Strong and Simple ("S&S") initiative. We accept it will take some time to finalise and put in place, but we want PRA to have sufficient space and time to be able as far as possible to get the new regime right at first attempt. We support starting with the lowest of any tiers (i.e. smallest / simplest firms) first, though we remind PRA that what we will call "large but simple" firms also aspire to gain some benefits from the overall S&S initiative. We appreciate it is difficult to comment fully on definitions while policy content is still to come, but we endeavour to do so, constructively. The CP 5/22 proposals are broadly in line with what the BSA called for in our detailed response to DP 1/21, so we have no need to repeat previous arguments, which should be taken as read. We support PRA's openness to using the FSMA-based waiver/modification procedure where appropriate, and we put forward a further instance where it might prove useful.

Proposals – size

We support the maximum size for a simpler firm of £15 billion. This is comfortably above the minimum of £5 billion we had called for. We also support basing the calculation on a 36 month average to avoid flip-flopping due to size fluctuations. We agree that a ceiling of £15 billion gives the larger prospective S&S societies adequate room for growth, especially in an environment of higher inflation than for some time. We also look forward to the real prospect of elements of simplification for simpler domestic firms above the £15 billion ceiling but still sub-systemic – what we referred to above as Large but Simple firms. Several large societies fall into this category, and may make their own individual responses to CP 5/22.

Relevant to these larger firms, though strictly outside the immediate field of CP 5/22, we also use this response as a vehicle to draw PRA's attention to another area where proportionality could usefully be improved in the short term. Under regulation derived from Basel via the EU, firms' Pillar 3 disclosures are required to step up to greater frequency and (for the half year) more detail as the firm passes €30 billion and becomes a "large institution". The additional compliance burden is considerable, but large societies can demonstrate that utilisation of these Pillar 3 disclosures is poor – very few stakeholders access the information – so the benefit is hard to see. Were PRA to relax these requirements or raise the €30 billion ceiling, it could prove a quick win for the strong and simple concept.

PRA could also address at the same time whether weekly reporting of the PRA 110 is really necessary for firms just above the same €30 billion ceiling. This is, we understand, a local PRA decision. We can provide PRA with more information about the resource burden involved on both matters.

Domestic UK

The BSA fully agrees that the S&S regime should be for UK domestic firms only, with the simpler firm definition excluding those firms with genuinely overseas business that is material. There are two reasons for this. First, firms doing overseas and cross border business are almost by definition more complex, and therefore not suited to the S&S regime. Second, perhaps more importantly, PRA is committed to proper implementation of the Basel framework for all large and/or internationally active banks for which it is applicable – so there is no scope to offer S&S to "Basel banks".

We entirely respect the PRA's need to remain compliant, in both spirit and letter, with the latest Basel accords. The scope question allows for some flexibility, since (as explained in a publication[1] by the Financial Stability Institute) *"While the Basel standards are designed for 'internationally active banks', that term has intentionally never been defined by the BCBS. This provides flexibility for national authorities to determine the scope of application of relevant Basel standards"*. But we are not looking for some convenient interpretation based on

[1] https://www.bis.org/fsi/publ/insights11.pdf

sophistry – rather we hope to show that the alternatives we propose are a truer application of the spirit of the distinction between purely domestic and internationally-active banks than the definition proposed in the CP. Relevant to this point is the following observation from the same FSI document: *"Indeed, one of the fundamental objectives of the BCBS, starting with Basel I, has been to minimise the competitive inequality of internationally active banks."* We return to this later.

We have also read with interest the Basel Committee's most recent publication[2] on proportionality. This indicates, amongst other things, that the development and application of simpler, more proportionate regimes to domestic non-Basel banks is already fairly widespread in other (non-EU) jurisdictions.

But there are two aspects of the definition that we would strongly ask PRA to revisit and change. First, a small point -to count exposures located in the four nearby overseas territories closely linked to the UK (Jersey, Guernsey, Isle of Man and Gibraltar) as being an extension of the UK. Societies have a long involvement in these territories and this business is not truly international, more an offshoot of their UK business.

Second, much more importantly, building societies are concerned about a substantial part of what they regard as their domestic UK business falling to be classified as "overseas". We cover this in the paragraphs below.

Mortgages for UK expatriates

Turning now to the specific case of home mortgages to UK expatriates, we examine whether the various features of this business make it genuinely "international" and the society therefore "internationally active".

The usual proposition is that a UK borrower needs to finance or refinance a normal UK residence for a period when that borrower is temporarily employed, or otherwise located, abroad, while retaining the long term connection to the UK. Sometimes the borrower's family will continue living in the property, in other cases – more commonly – the property is tenanted while the borrower remains abroad, but may be intended for ultimate occupation on return to the UK.

Expatriate mortgages of this nature are typically introduced by UK-based mortgage brokers, and negotiated and concluded entirely in the UK, as societies generally do not have (but do not need) authorisation to undertake real cross border business in the main jurisdictions in which expatriates may be based. Nor are societies in competition with international banks keen to do some of this business – such competition as there is comes mainly from other societies. We infer that international banks regard this mortgage business as domestic UK and something which they may not have the requisite permissions to offer.

Finally, where (regrettably) enforcement is necessary, this is done in the same way as for a resident borrower – the society seeks possession through the UK's courts, with the borrower not required to be present.

We appreciate, too, that this domestic / international distinction is not primarily predicated on a view of relative risk. Nevertheless, PRA may find the experience of our members involved in expatriate mortgages reassuring. Our members tend to find that this part of their mortgage book performs better than average, with lower delinquency and losses. This is attributed to the element of self-selection in expatriate workers – they tend to be skilled, professional, mobile and highly employable, to a greater extent than the average UK based worker.

For all the reasons above, we would argue that the nature of the expatriate mortgage business is, on balance, much more truly domestic than international, notwithstanding the "immediate obligor" basis proposed in CP 5/22.

We also appreciate, and commend, the PRA's preference to base the distinction on a data item that is already collected from banks and building societies – so as to avoid extra costs. The challenge is to find a way of adapting the distinction to better cater for expatriate mortgages, without affecting the great majority of banks who are well served by the sourcing from the stated COREP line item (COR001a, table C09.04). We would add in passing that we also appreciate that the COREP basis sensibly does not look at liquid assets, so societies who might hold

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[2] High-level considerations on proportionality : https://www.bis.org/bcbs/publ/d534.pdf

debt instruments issued by e.g. foreign governments, multilateral development banks, or major foreign banks operating in the UK would not have to count this against their 15%.

The territorial distinction between where the immediate obligor and the ultimate risk are located arises in mortgage lending more than in unsecured personal or corporate lending. So, our first suggestion is that, as an alternative to the COREP line item, for mortgage lenders (only) that wish to use this option, the data source could instead be the MLAR (which they all complete): the domestic / international distinction could be based on line A3, which covers all loans to customers, within which loans on non-UK property would be reported in line A3.5: this could be done either as an option in the criterion as drafted in sub-paragraph (2) of the Annex or offered in parallel as a general modification by consent. Neither of these routes need involve much individual work by firms (or PRA) to get the benefit of the flexibility.

Failing that, we think the fall-back remedy is for PRA to permit (at individual firm level) a modification of the eventual rule that would allow UK expatriate mortgages to be assessed on an ultimate risk basis instead.

While the modification route does involve additional effort for the firm concerned, it makes proper use of a mechanism built in to the FSMA for just this kind of situation. Section 138A applies two statutory tests before a modification can be directed by PRA:

(i) *Compliance by a firm with the unmodified rules would be unduly burdensome or would not achieve the purpose for which the rules were made; and*

(ii) *The direction would not adversely affect the advancement of any of the PRA's objectives.*

If the PRA accepts the BSA's case that the true nature of expatriate mortgages is domestic rather than international business, then the first part is arguably satisfied – in this limited context, the unmodified rule is not achieving its purpose. Moreover, compliance with the unmodified rule would be burdensome for those engaging in this business. From our analysis above, as expatriate mortgages are of better than average credit quality, we think the second part can also be satisfied – the modification would not adversely affect the advancement of PRA objectives, in this context individual firm safety and soundness, financial stability, and competition. The last – competition- would actually be furthered.

Other criteria

We agree with the other proposed criteria: limited trading activity; no IRB approvals; and no provision of clearing, settlement or custody services. The maximum allowance for trading book business under the CRR is a reasonable starting point, though the absolute figure of £44 million might need adjustment if inflation persists! Similarly, we agree that simpler regime firms should be able to develop IRB capabilities, but would not lose S&S treatment until ready for the formal step of regulatory approval for use of the fully fledged IRB model. We also agree with the PRA's analysis in paragraph 2.16 regarding clearing etc services. But we welcome the ability for societies to continue to be able to provide either savings and / or mortgage administration services without losing simpler regime status. We would also welcome confirmation (in the policy statement following this CP) that societies providing payment / current accounts to their customers would be included as simpler-regime firms if otherwise eligible.

As regards these criteria, we agree that they are appropriate as they stand for the lowest/simplest tier of the eventual S&S regime – but not necessarily for any higher tier such as for Large but Simple firms. IRB modelling approval in particular is unlikely to be a suitable exclusion criterion for Large but Simple firms when this next tier comes to be scoped.

Standalone firms / groups

We very much agree with PRA (paragraph 2.23) that the S&S regime should apply to small banks and building societies, not small units of larger groups. The limited allowance for S&S subsidiaries within groups in paragraph 2.24 is reasonable, as is the case by case approach using waiver / modification envisaged for foreign bank subsidiaries in paragraph 2.26.

Optionality

In our earlier response, we supported two-way optionality on inclusion within the S&S regime. We are content with the proposal in para 2.27 that S&S will be the default regime for in-scope firms. And we agree that both (i) the firm may be able to decide to exit S&S, and (ii) that PRA may assess eligibility on a case by case basis where required – though we hope these latter instances would be rare.

Transitions

We look forward to PRA's further proposals on how to facilitate initial opt out (for fast growing firms within reach of the size ceiling), and other transitions whether planned or unexpected / temporary.

Ahead of the introduction of S&S we very much welcome the assurance that PRA is seeking flexible and sensible coordination with the Basel 3.1 reforms (paragraph 1.12), so that S&S firms could remain on current requirements until S&S is ready (without first implementing Basel 3.1) and also that those which wish to proceed directly to Basel 3.1 may do so even if eligible for S&S. This should avoid the unnecessary burden of sequential changes.

Conclusion

The BSA and its members look forward to further constructive engagement with the PRA team as the S&S framework develops, and in particular will be happy to discuss in more practical detail our proposals for modifying the UK/foreign distinction.

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