Asset encumbrance

BSA response to PRA CP 24/19

January 2020

Building Societies Association

Summary

The main proposals in CP 24/19 are reasonable, and will improve clarity and transparency. The specific application to building societies looks, in our view, somewhat over-engineered in places, and could be cut back and simplified. The proposed text amending SS 20/15 is not objectionable, but some appears to be superfluous. And the specific context of building societies' funding profiles and business means that the general policies now proposed must be applied proportionately. We explain why in the remainder of this response.

Context : building societies

The BSA's 43 member societies are all predominantly funded by the retail savings of individuals, as required by the Building Societies Act. This is modestly supplemented, particularly at larger societies, by prudent use of wholesale funding from appropriate markets. Some of this is raised on a secured basis (covered bonds, repo, and use of Bank of England "Red Book" facilities), and some on an unsecured basis (corporate and local authority deposits, interbank and intersociety lending, CDs and FRNs). Societies operate quite satisfactorily under the explicit and sensible guidance already in SS 20/15 (as shown in the baseline text in Appendix 3 to CP 24/19). Given this context, and the generally low levels of encumbrance, any general expectations introduced through CP 24/19 should be applied proportionately to building societies and should not add unnecessarily to their administrative burden.

Detailed comments

There is a further important point of context at the present moment. Societies' levels of encumbrance from normal funding operations have been temporarily elevated, in many cases, solely because societies responded to official encouragement and made use of, for instance, the Funding for Lending Scheme and the Term Funding Scheme, which were only available on an encumbered basis. Both schemes are now closed for drawings, the FLS is now largely repaid, and the TFS is gradually being repaid from now on, with peak repayments in 2021. On the latest figures, a wide range of smaller societies that would normally not use secured funding still have TFS outstandings[1] on advantageous terms. But the steady –state picture of very low, or zero, encumbrance at many societies could well reappear.

There are also good and specific reasons why SS 20/15 put central bank encumbrance in a separate category from market encumbrance. For societies on the simplest financial risk management approaches, encumbrance (other than under the TFS – see above) is rare or negligible. On the administered approach, only central bank encumbrance is envisaged – and this, too (absent TFS), would be exceptional rather than routine. But even these societies will need to draw on their access to Bank of England facilities from time to time to demonstrate that this remains fully operational in case of a funding stress. So also for matched approach societies, which will in addition experience some low levels of (involuntary) encumbrance purely as a result of needing to collateralise their handful of outstanding swaps, and may also repo liquid assets with the market from time to time, again to demonstrate that this too remains operational. But there will be a preference to use central bank facilities in a stress, rather than resorting to market repo, to avoid any signalling to the market.

One definitional clarification point has indeed been raised by an "extended" society, regarding the use of the term "market counterparties", where we need to be quite sure that this does not include central banks. In paragraph 4.92, central bank facilities are treated as being one part of "secured funding markets". On the other hand, the wording in paragraph 4.93 is reasonably clear : financial markets counterparties are referred to under (a) and central banks quite separately under (c). The same is true of paragraph 4.140 on the administered approach. However in paragraph 4.163, "extended" societies may be confused by the drafting – in the first sentence they are told to set internal limits on normal encumbrance, including to central banks, and then told that they should not encumber more than 20% with market counterparties – and this is re-emphasised by the redrafting in Appendix 5. The deletion of the exclusion of central bank encumbrance adds to the confusion. We suggest that the words in brackets be restored in both places, as shown below in paragraph 4.163 :

Normally, extended approach societies would not be expected to encumber more than ~~this would not be expected to exceed~~ 20% of balance sheet assets with market counterparties (that is, excluding assets encumbered under facilities provided by the central bank), ~~and there may be sublimits by type of exposure~~

There is also one specific drafting point regarding the new wording proposed for extended approach societies in paragraph 4.163 and again in the Appendix 5 table at the very end of the CP. It is fundamental to the whole structure of the SS 20/15 "approaches" material that it is non-binding and non-exhaustive. So the additional wording (particularly the text beginning "It is for each society….. in two places) designed to underline this point – while well-intentioned – risks being counterproductive, as it inevitably suggests that all the other "approaches" material in SS 20/15 is less non-binding / non-exhaustive than is presently understood. We are happy to engage with PRA to make some improvements to the SS 20/15 amendments.

Finally, there is another practical issue relating to regulated covered bonds. While large societies that issue RCBs clearly need to plan forward their collateral availability in any case, each RCB issue is also directly subject to FCA supervision under the RCB Sourcebook, including as to whether it is adequately (over-)collateralised, from time to time. At the same time, PRA may be keen for the society to reserve more unencumbered collateral for contingencies. We urge PRA and FCA to ensure there is appropriate coordination of their respective expectations in this area.

[1] https://www.bankofengland.co.uk/markets/funding-for-lending-and-other-market-operations

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Our members have total assets of over £400 billion, and account for 23% of the UK mortgage market and 19% of the UK savings market.