Pillar 2 Liquidity

Our response to PRA CP 21/16

August 2016

Building Societies Association

Introduction and context

We welcome this consultation, and the PRA's engagement with BSA members on this subject at a meeting on 22 June. We appreciate that the Pillar 2 issues are being spread across 2 CPs. We agree that final decisions on the whole package should be taken in the round, after the second CP.

We also note that the UK's impending departure from the European Union ("Brexit") means that the EU Regulations that currently determine the landscape – such as the liquidity and funding elements of the CRR and its delegated Acts – will (unless intentionally extended under UK law) cease to be binding at Brexit, and this may – indeed should -create scope for greater proportionality in the UK's own requirements. We think PRA should examine the LCR / NSFR regime, especially the associated reporting, and consult with affected institutions, to see what improvements could be made for the future, particularly for smaller, domestic institutions.

General points

The BSA supports robust and effective liquidity requirements, whether under Pillar 1 or Pillar 2, to ensure the safety and soundness of our members, and thereby the protection of their customers. As building societies' core business involves a high degree of maturity transformation (stable short term savings deployed to fund long term mortgages), our members have always taken liquidity extremely seriously, and through and since the banking crisis have maintained high levels of liquidity. Nevertheless, liquidity does involve an **opportunity cost**, as resources tied up in liquidity cannot be used for lending to the real economy.

So it is important to consider the aggregate impact, and internal consistency, of the contents of both CPs, as PRA intend – and PRA should be especially vigilant for instances of inadvertent double-counting. Although currently building societies, having complied with the pre LCR FSA/PRA liquidity regime, are massively liquid when measured on an LCR basis, correct calibration of Pillar 2, and avoiding potential double counting, still matter for the future.

We therefore support the PRA's plan to assess the aggregate system-wide calibration described in paragraphs 5.16 to 5.18, and the importance of cost-benefit analysis (paragraphs 5.19-5.21), both as promised for the second CP.

Detailed comments

Range of liquid assets

While the LCR buffer must be held in HQLA only, **other liquidity resources have a major role in societies' meeting the OLAR and should also be fully recognised under Pillar 2**. Two important examples are (i) contingent liquidity, available where societies have pre-positioned acceptable collateral at the Bank of England against which drawings can be made under the "Red Book" or other, temporary, facilities ; and (ii) substantial credit balances held by smaller societies at call at their principal clearing bank in order to cover, fully or in part, their intra-day risk.

Intra-day risk

We agree with PRA that whether a bank is a direct participant in payment and settlement systems is a key characteristic for assessing intra-day risk. Indeed, as explained on 22 June, the BSA contends that **the nature and scale of intra-day risk faced by settlement banks is fundamentally different from that faced by other banks relying on agency banking.**

A settlement bank carries out daily a large volume of transactions on behalf of its agency banking clients, as well as its own transactions. A non-settlement bank, such as even a major building society, only deals with its own transactions. Their exposures to settlement activity and risks are opposite, though complementary, so some of the corresponding risks are almost mirror images of each other.

As far as building societies are concerned, intraday flows are relatively more predictable than for a settlement bank, or even a universal (non-settlement) commercial bank. The society will remit a predicted amount of cash for mortgage completions, and will (possibly on certain days in the month only) collect a tranche of monthly mortgage repayments by direct debit. Wholesale funds flows may be significant, but again maturities and re-financing plans will be known in advance. Building societies readily recognise the more limited intra-day risks they run, and many smaller societies choose to mitigate these completely by holding credit balances at their principal clearing bank exceeding normal gross outflows.

We are not opposed in principle to the suggested metric of maximum net debits plus stress uplift, nor to mitigation of the double duty risk by calibrating intra-day risk separately, but we caution that many societies – being indirect participants -are (as recognised by paragraph 3.14) unable to calculate their maximum net debit position *because their settlement bank cannot give them the necessary real time information*. Basel Principle 8 applies, like all of the Basel framework, only to large, internationally active banks, for whom it makes sense. We think a simpler approach to medium and smaller non-settlement banks such as most building societies should be possible.

A major source of intra-day and short-term liquidity risk to BSA member societies comes in fact from their necessarily heavy reliance on their clearing bank(s) - as was seen during 2012 and again in 2015 when the same major High Street bank experienced serious outages. Indeed, even the Bank's own RTGS system suffered a serious outage on 20 October 2014. Nor can this risk be mitigated in a conventional Pillar 2 manner simply by holding more liquidity resources.

We think that there is a valid question overall, which perhaps PRA could address in the second CP, as to whether the most efficient route to reduce intraday risk and consumer detriment at the aggregate, system-wide level may be to set and monitor higher resilience standards for settlement banks, rather than to pass the burden of mitigation on to other (non-settlement) banks and building societies.

We also think there is potential for unintended consequences at the aggregate level from some of the measures applied to individual banks, both settlement and non-settlement. One member has recently reported that its clearing bank, we think in response to PRA action, has changed the way its daylight exposure limits operate across the several accounts the society holds with that bank. Now the overall intraday limit operates as a (gross) cap on each individual account, ignoring credit balances in other accounts, which become – in effect – "trapped pools" of liquidity. Where a society has, for greater resilience, more than one active clearing bank relationship, the impact of these trapped pools worsens, as credit balances with one clearer cannot cover daylight exposures with another.

Cashflow mismatch

We agree that there are near-term cashflow mismatch risks which the LCR does not capture – both the risks of net outflow spikes *within* the 30 day LCR period (as illustrated in Charts 1 and 2) and the risk of cliff effects just *beyond* the 30 day horizon (noting in passing that FSA/PRA's own pre- LCR policy operated on a 90 day horizon). Societies are already conversant with the measure of "survival days", which we take to be what is meant at paragraph 5.9 (ii). Some combination of items (i) and (ii) in that paragraph, applied proportionately, might make sense. We look forward to the PRA's more detailed proposals.

Debt buyback

PRA explains (paragraph 4.6) the liquidity risk from non-contractual requests for debt buy-back as an instance of franchise viability risk : where a firm takes actions beyond its legal obligations in order to preserve its reputation. Building societies are of course already conversant with franchise viability risk in the **retail savings** context – a savings account may specify 90 days' notice but the society may be faced with a customer request for immediate access. This risk is now captured in Pillar 1 as a result of the more complicated metrics for the stability of retail savings under the LCR Delegated Act.

In the **wholesale** context of debt buy-back, societies generally take a firm line, as was mentioned at our 22 June meeting. Major societies refuse, as a matter of principle, to buy back their CDs early, nor are they secondary debt market makers, nor do they permit the breaking / early repayment of fixed wholesale deposits. So it is important that this strong, prudent behavioural position is properly reflected in any Pillar 2 assessment.

Non-margined derivatives

This is another aspect of franchise viability risk, but is even more remote for building societies. By law, building societies may use derivatives to manage their, or their customers', intrinsic risks, but cannot run a business writing and transacting derivatives for others. So, in all situations, the society is the client, not the provider. And non-margined derivatives will in future be rare, on account of the provisions of EMIR and CRD 4 regarding both mandatory central clearing and risk management of non-cleared trades.

Conclusion

As stated above, the BSA supports robust and effective liquidity requirements, whether under Pillar 1 or Pillar 2, to ensure the safety and soundness of our members, and thereby the protection of their customers. The proposals in this CP make a reasonable start in addressing under Pillar 2 those risks not captured by the LCR and NSFR. But we underline the very significant differences between on the one hand building societies, and on the other hand universal commercial banks, especially settlement banks. Consequently, some of the content of the CP is less applicable , or not at all applicable, to most of our members. We are very happy to continue engagement with the PRA as the Pillar 2 liquidity policy develops, and also discuss how, post-Brexit, the LCR / NSFR and reporting landscape might be adapted to work better for building societies.

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We fulfil two key roles. We provide our members with information to help them run their businesses. We also represent their interests to audiences including the Financial Conduct Authority, Prudential Regulation Authority and other regulators, the government and parliament, the Bank of England, the media and other opinion formers, and the general public.

Our members have total assets of over £330 billion, and account for approximately 20% of both the UK mortgage and savings markets