Refining the PRA's Pillar 2A capital framework

Response from the BSA

May 2017

Building Societies Association

Introduction and summary

The Building Societies Association (BSA) is pleased to respond to the PRA's CP 3/17 about refining its Pillar 2A framework. We broadly welcome the PRA's proposals, particularly the intention to use Pillar 2 creatively to redress the current disadvantage under Pillar 1 for most building societies and smaller banks, whose capital requirements may prove higher than their true underlying risk justifies. Building societies are well capitalised, but these proposals are nevertheless a modest but useful move in the right direction.

General comments

We agree with the rationale for the PRA's proposals outlined in paragraphs 1.6 to 1.15 of the CP. We note that the Basel Committee's proposals to revise the Pillar 1 approaches for credit risk, both standardised and IRB, remain mired in disagreement between the US and Europe. The BSA has criticised several aspects of these Basel reviews, especially some of the detail of the changes to the standardised treatment of residential real estate exposures. As no early progress is now expected in Basel, we support the attempt to use Pillar 2A, to the limited extent possible, to mitigate excessive Pillar 1 requirements.

We also support the attempt to mitigate some of the unintended consequences of the interaction of expected loss impairment models under IFRS 9 and the regulatory capital framework. At international level, poor forward planning and absence of joined-up thinking has created a chaotic scene around these IFRS 9 interactions, with discriminatory effects for standardised users. We therefore applaud the PRA not only for identifying the problem early but also for attempting to address it on an interim basis with available tools.

Finally we also support the updating of the calibration of the table of IRB benchmarks. The publication and maintenance of this table is an extremely useful piece of transparency, as it makes quite clear, beyond argument, the relative conservatism of the present Pillar 1 risk weights in the residential mortgage book.

Detailed points

Riskier lending ?

The BSA respectfully diverges from the PRA over one element of its analysis, though we think this divergence is not material to the PRA's proposals which, as explained above, we very much support. The PRA outlines again in the CP the concern it has expressed in other fora as to the allegedly riskier lending (high LTV lending is specifically mentioned in paragraph 1.8) by the majority by number of building societies that use the standardised approach. We think the PRA in this, and in other conversations, tends to overstate both the differential riskiness of lending categories, and the significance of risk weight differentials within residential mortgages in driving the lending mix. The result is an oversimplified and possibly misleading narrative of smaller building societies' risky lending. We think it could be more accurate to look at the same situation the other way round, recognising that the IRB approach may create excessive incentives for low LTV lending.

As regards high LTV lending, we see the main driver being societies' **historic, and principled, focus on first-time buyers**. Building societies were founded to overcome a market failure in housing provision and housing finance for working people. BSA members remain true to that mission today, and –given the difficulty in accumulating sizeable deposits – there is a need for initial high LTV lending. But this is almost always on a repayment basis, so the current LTV reduces as the loan is amortised. Building societies moreover tend to mitigate their high LTV risk through some form of mortgage indemnity insurance, so the net risk to the society from this type of lending can be substantially reduced (and the involvement of the insurer adds another safeguard to the underwriting process).

So, over the post crisis period 2009 onwards our members appear to have devoted – safely and prudently - a higher proportion of their lending to first time buyers than did the rest of the market, while representing only a fifth of the overall mortgage stock. But building societies, generally, did not follow the egregious behaviour of one or two large banks who prior to the 2007-08 crisis flaunted e.g. 125% LTV mortgages without any effective restraint from the regulator. In this respect, building societies were less part of the problem, more part of the solution.

The second explanatory factor, among smaller societies, is their ability to undertake personal rather than automated assessments of non-standard mortgage applications, thereby serving groups of borrowers who might otherwise be excluded from buying their home (as "computer says no").

This is true of several sub-categories, or lending "niches", which are not separately identified in the benchmarks table. For instance, building societies lead in the financing of self- or custom-build homes. Following a BSA initiative in 2015, building societies have largely led the way in removing discriminatory age limits in lending to older borrowers. And some building societies are active lenders on shared ownership properties, a form of housing tenure that already forms a significant proportion of the flow of new build units in high cost areas such as London.

For these reasons, we doubt that the proposals (which we nevertheless support) will significantly change standardised users' lending mix also towards low LTV and generally "plain vanilla" lending – conventional mortgages to conventional borrowers on conventional properties. In overall public policy terms, we doubt it is even desirable for all lenders to shift their focus here, leaving these other categories of borrowers under-served.

IFRS 9

In paragraphs 1.11 to 1.14 PRA correctly identifies the discriminatory upset to standardised firms' capital situation relative to IRB (both from the double-counting of expected losses within the SA, and the partial offset under IRB) caused by IFRS 9 interactions, and has come up with helpful interim solutions, pending a sorting out of the problem at international and EU level.

Benchmark tables

Turning to the IRB benchmark tables, apart from general support for updating the calibration, we make the following observations. As previously, the benchmark RWs for buy to let are somewhat higher, but not by much, compared with owner-occupied loans in the same LTV band. What is noteworthy is that across the LTV range up to 90%, the benchmark RWs for BTL remain below the currently applicable RW under the SA. This undermines some of the theoretical argument in the previous Basel CPs for loading much higher RWs on income producing residential real estate exposures , of which BTL is probably the main category in the UK. An interesting further question is whether the data pools from which the IRB benchmarks have been derived come from lenders who either do not use mortgage insurance, or use it less than building societies do.

Clarifications

We have a slight concern over the potential reporting burden (paragraph 2.6). In principle, it is not unreasonable for the PRA to obtain more regular information to allow it to carry out the estimation described at paragraph 2.5, and thereby reduce the variable Pillar 2A add-ons in appropriate circumstances. What is more difficult to assess, especially for smaller societies, is the trade-off between a modest capital benefit and the additional reporting burden. We suspect that routine reporting of – in particular – the FSA 077, with all the extra checking and quality control needed before formal submission, could prove a greater burden for the smallest societies than the absence of the element of capital relief which they might, but are not certain to, receive through the better calibration of Pillar 2A. We appreciate that only "significant" firms (see Appendix 3) are to be required to submit the extra returns annually, with other smaller firms only on a "regular and proportionate basis". The term "significant", as defined in the Pillar 2 Reporting material in SS 32/15 (updated) maps exactly (in the language used[1]) onto PRA's impact Category 1, as defined in its banking supervision approach document. That should mean only Category 1 firms will be required to submit these extra returns annually. Provided this interpretation is correct (and something PRA should clarify in its policy statement) and the submission requirements for small firms really are proportionate, we think societies will accept this need for regular information.

One member has drawn our attention to a couple of other points in paragraph 2.5 that are worthy of clarification. First, we take it that the reference to "maintaining capital in excess of the amount necessary…." means the combined Pillar 1 and Pillar 2A amount, as (under the SA) it is typically the Pillar 1 component - as the CP has already analysed – that typically gives rise to the excess. Paragraph 2.5 also makes clear that fixed elements of Pillar 2A (e.g. for pension or IT risk) will be unaffected, but doesn't – we think – specify whether the excess can be used to reduce other *variable* Pillar 2A add-ons, or only those relating to credit risk.

Finally, while we understand the PRA's encouragement for firms to use the specialised lending benchmark for their material CRE exposures (which for the most part building societies do not have anyway), we think there is some scope for confusion as to what is supposed to be

[1] 'significant firm' means a deposit-taker or designated investment firm whose size, interconnectedness, complexity and business type give it the capacity to cause very significant disruption to the UK financial system (and through that to economic activity more widely) by failing or by carrying on its business in an unsafe manner.

covered by “CRE”. Commercial real estate exposures should mean exactly that – loans or other exposures secured on *commercial* (not residential) *property*. But the PRA’s guidance on terms used in the returns FSA 071 to 081 has specific definitions that include some residential real estate exposures within e.g. “CRE investment” and “CRE development”. The overall definition of CRE also indicates that it covers only non-retail exposures – does this mean only those above the CRR retail exposure threshold of € 1 million ? Further clarity would be desirable.

One other area for clarification has been mentioned to us in relation to CRE. The revised benchmark tables show a sharp increase to the upper range RW for CRE, taking it (in Table A) well beyond the maximum of the “slotting” range of RWs under CRR Article 153 (5) whose use paragraph 2.17 encourages for SA firms for ICAAP/ Pillar 2 purposes. So it would be useful to clarify that there is no presumption that where the calculated SA capital charge falls below the upper range benchmark level, the CRE book is under-capitalised, nor that this gives rise to any notional capital deficit.

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The Building Societies Association (BSA) is the voice of the UK's building societies and also represents a number of credit unions.

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 £345 billion, and account for approximately 20% of both the UK mortgage and savings markets