Building Societies Association

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Response to the PRA's Pillar 2 consultation CP12/25

About the Building Societies Association

The Building Societies Association (BSA) represents all 42 UK building societies, including both mutual-owned banks, as well as 7 of the largest credit unions. Building societies and mutual-owned banks have total assets of almost £650 billion. They hold residential mortgages of over £485 billion, 29% of the total outstanding in the UK. They are also helping 23 million people build their financial resilience, holding over £485 billion of retail deposits, accounting for 23% of all such deposits in the UK. Building societies and mutual-owned banks account for 47% of all cash ISA balances. With all their headquarters outside London, building societies employ around 52,300 full and part-time staff. In addition to digital services, they operate through approximately 1,300 branches, holding a 30% share of branches across the UK.

Executive summary

The BSA welcomes the work by the PRA to make transparent their thinking around how they will implement Pillar 2 under the Basel 3.1 framework. We also note that a number of components of the approach will be relevant for Small Domestic Deposit-Taker (SDDT) firms too. We are therefore commenting from the perspective of both Basel 3.1 and SDDT societies alike.

We note that CP12/25 is phase one of two consultations. We appreciate the PRA taking the decision to split this work into components such that the industry can input as soon as possible and not wait for a full package. That said, the additional components will likely be material for many firms, impacting on how they conduct their business as well as how much capital they must hold. As such, the sooner the PRA can publish its phase 2 consultation the better, such that firms and supervisors are well prepared for full implementation of Basel 3.1 and SDDT on 1 January 2027. As a minimum, it would be useful to know the anticipated date of the second consultation publication. The BSA is strongly in support of meeting these timelines and avoiding any further delays (with the exception of the market risk component where we support the delays to ensure that PRA resources are prioritised to credit and operational risk and Pillar 2, including for SDDTs).

Overall, while we welcome the consultation, we feel that the proposals are unnecessarily complex in places. The BSA does not believe that complex rules are necessarily better than simple ones, particularly for measuring risk which is difficult to measure with precision, and can often fall into the trap of 'spurious accuracy' where market participants wrongly take comfort from complicated calculations that add complexity but not accuracy nor certainty. We also note the risk in Pillar 2A of excessive layering of capital requirements in a potentially duplicative way, and this can be particularly penal to low-risk business models such as building societies.

We also feel that the PRA should strive to increase the transparency of its approach to Pillar 2 wherever possible, in line with the FSMA requirement[1] to default to transparency and publish relevant information unless there is good reason otherwise. This is the stated intention in places in CP12/25, however, certain areas remain opaque, such as the use of the PRA's own model to set Pillar 2A capital requirements for operational risk which is neither referred to nor described in either the SoP or SS31/15, even though it has a material impact on firms' capital requirements.

Credit risk

IRB benchmarking data

The BSA notes that the PRA is proposing to cease publishing the IRB benchmarking tables. While we understand the rationale that these may no longer be needed for the purpose of calculating Pillar 2A for credit risk, including use of the current 'refined approach' to offsetting, we do not understand why the PRA would cease to publish consolidated data relating to IRB exposures for more general risk management purposes. Also, the BSA argued to retain the refined approach in its response to CP9/24. As mentioned above, the regulators are required under article 3B(g) of FSMA to share firm data, so we encourage the regulator to continue to make this consolidated data available. Where there is more limited information, such as LGD where a foundation IRB approach is taken, the PRA could publish PD tables, which would still be useful information to firms and to the markets more generally. It could also be more aligned with a future approach to regulatory reporting, where firms upload granular raw data to a reporting platform which then displays the data templates in the same format to firms and supervisors and can also include industry averages and peer group averages for comparison. As such we think any step by the regulator to discontinue publishing data is against the grain of movement towards improved and more transparent regulatory data.

Proposal 1 and 2: RW add-ons for exposures to governments, central banks, local authorities and unconditionally cancellable retail commitments

CP12/25 is proposing two new systemic methodologies for the treatment of exposures to central governments, central banks, regional governments, local authorities and retail unconditionally cancellable commitments. While the BSA supports the simplicity of the approach and the flexibility to tailor according to actual experience by including the add-on in Pillar 2A rather than increasing risk-weights under Pillar 1, we question the calibration, which if generally applied in a blanket approach to all firms would amount to gold-plating compared to the Basel Pillar 1 standard. We also encourage the PRA in its implementation of the approach to be mindful of overall 'layering up' of capital requirements in a disproportionate way compared to the actual risks. The 10% UCC CCF in particular appears quite punitive compared to the Basel 3.1 Pillar 1 requirement.

[1] See FSMA Article 3B(g) the desirability in appropriate cases of each regulator publishing information relating to persons on whom requirements are imposed by or under this Act, or requiring such persons to publish information, as a means of contributing to the advancement by each regulator of its objectives; and 3B(h) the principle that the regulators should exercise their functions as transparently as possible

On a point of detail, the CP isn't clear on how the calculation of the retail UCC capital charge when working out the nominal volume of capital to be taken through Pillar 2A. There are two ways to interpretate this, either through applying the 8% Pillar 1 to calculate requirements, or through firm specific P2A%.

Proposal 3: Credit scenarios

The BSA would like to challenge whether it is proportionate and therefore necessary to retain the use of credit scenarios under Pillar 2A. Given the conservative calibration of the standardised approach (relative to IRB) plus the further stress scenarios under Pillar 2B, we question the value of additional scenario analysis under Pillar 2A. We propose that a more proportionate approach would be to only require scenario analysis for certain high risk loan portfolios, in line with the approach proposed under SDDT.

In terms of guidance, not withstanding the above, the BSA broadly supports the intention of providing additional information on credit scenarios as set out in the proposed updated SS31/15. However, the guidance is high-level and we feel it could go further, for example on time horizon and severity of scenarios. The PRA could give examples of the type of idiosyncratic stresses that would give rise to a more severe peak to trough impact than a typical macroeconomic stress that are considered through P2B. This would provide useful benchmarks to better understand the PRA's expectations.

We also support the proposals to continue to allow the use of proxy IRB models where available. The PRA should be open to other types of analysis given the philosophy of Pillar 2, where it is the responsibility of firms to satisfy themselves that their capital is adequate and it is the PRA's role to review and challenge firms' approaches.

While we welcome the greater transparency on credit scenarios, we also ask the PRA to take particular care in this area, where the implementation of the approach can result in excessive layering up of capital requirements for essentially the same risk. Any given credit exposure can only default once and the PRA needs to be mindful of how much capital overall is required through the capital stack through Pillar 1, Pillar 2A, Pillar 2B and the combined Basel buffers. Any increase in Pillar 2A will multiple up through the modelling of Pillar 2B. Many BSA members now feel that the overall levels of capital required for low-risk mortgages is excessive and there is arguably some double-counting between the stress scenarios in Pillar 2A, credit concentration risk add-ons and the severe but plausible stresses in Pillar 2B.

The BSA welcomes the edits to SS31/15 that make clear that the scope of application excludes SDDTs. This is important to ensure that the expectations are not deemed 'best practice' for smaller firms. This avoids gold-plating across the industry which would undermine proportionality and the aims of the SDDT.

Proposal 4: Reporting

The BSA supports the proposals to streamline FSA076 and decommission FSA077 and FSA082. However, as set out above, and in line with previous comments that the BSA has made in our responses to other consultations[2], we believe that the Transforming Data Collection project should be considering a new approach to regulatory reporting where firms upload granular data. This approach would allow the PRA to get all the data it needs and for it to publish industry averages to improve transparency. So, while we support the removal of old-style template returns that are no longer needed by the PRA, we also support more transparency around data in general. We believe it would be best for the PRA to publish industry data, including data on IRB modelled exposures which would be akin to the current IRB benchmarking data. This would also allow the PRA to retain the refined approach[3] to ensure that the difference in capital requirements between standardised approach and IRB firms is not excessive over time.

Operational risk

We note that the PRA is not proposing any changes to its approach to operational risk under Pillar 2A, but it is updating its materials to improve transparency of the methodology. Included in this is updated expectations on the use of operational risk scenario analysis and the contents of the ICAAP for operational risk.

We also note in paragraph 3.4 of CP12/25 "the PRA expects most firms' total operational risk capital requirements would remain unchanged due to the implementation of Basel 3.1 standards and/or the proposals set out in this chapter, although the distribution of firms operational risk capital requirements across Pillar 1 and Pillar 2A may change." We welcome this statement given that policy and implementation need to be aligned for Pillar 2A to avoid gold-plating and excessive layering of capital calculations through the implementation process, particularly where supervisors and decision-makers are generally incentivised to act conservatively rather than proportionately.

We support that the updated SS31/15 clearly states that its scope does not include SDDTs. There is always a risk that guidance that is designed for large firms is assumed to be 'best practice' for all firms thereby undermining the principle of proportionality. As such we welcome the PRA being very clear on how its expectations vary for different groups of firms.

We understand that the PRA currently continues to use its own model to calculate operational risk capital add-ons for firms and often firms do not have a clear understanding of how the numbers assigned by the PRA under Pillar 2A have been derived. This drives the wrong incentives for firms who would like to better understand what enhancements the PRA feels should be made to their own calculations of operational risk. Unfortunately, if a number is assigned without firms being able to understand where that number has come from and why it differs from a firm's own calculations then there is no opportunity for firms to learn from the process or improve their own calculations. If the PRA is continuing to use such an approach, then this should be set out in the SoP as a fourth option in paragraph 4.15 alongside the three estimates C1-C3. This should include more details on the PRA's

[2] See BSA responses to CP7/24 and CP9/24

[3] See BSA response to CP9/24 where we do not agree with the proposals to remove the refined approach

operational risk modelling and calculations in line with the FSMA requirement to be transparent in its approach as referred to above.

Proposal 1: Expectations on scenario analysis

We welcome the additional guidance in the updated SS31/15 on operational risk. However, the list of expectations in paragraph 2.18C appear to focus mostly on gross operational risks rather than taking into account the quality of operational risk management and the effectiveness of controls. While we understand the need to develop scenarios that consider the impact of the failure of controls, this should also reflect any findings on the effectiveness of controls from a firm's risk and controls self assessment (RCSA) so that scenarios are not isolated and detached from reality but more tailored to the actual net risks in the firm.

Proposal 2: Updates to expectations

Paragraph 3.10 of CP12/25 proposes the factors that the PRA considers when setting Pillar 2A for operational risk, which are mirrored in 4.9A of the SoP. As above, we believe that more emphasis should be placed on the quality of a firm's operational risk management and the effectiveness of controls, such that any capital add-on is based on net operational risk rather than gross operational risk. Add-ons should reflect actual levels of risk rather than being used as a punitive measure if scenario analysis is considered not to meet the PRA's expectations. In the latter case, it would be better to give firms feedback on how to improve their scenario analysis rather than a punitive capital add-on which smaller firms can be stuck with for a number of years even after perceived weaknesses have been resolved, while their actual management of operational risk may be sound.

In a similar vein we do not believe it is always appropriate to base capital add-ons on historical operational risk losses. While it can be a useful input, quite often the loss event will lead to a firm improving its controls to prevent future similar losses. This is another reason to base add-ons on the assessment of controls not losses per se. Finally, peer group analysis, while useful, is not an appropriate indicator of operational risk in any particular firm and well-run firms should not be penalised by weaknesses found in peers. Taking these factors into account, we think paragraph 4.16 of the SoP should allow supervisors flexibility to discount specific operational risk losses referred to in paragraph 4.15(ii) where the firm can demonstrate that similar losses could not occur in the future due to improved controls.

Paragraphs 4.9B – 4.17A of the SoP sets out expectations for significant firms. We propose that the PRA adds the clarification "these expectations are not relevant for SDDTs and should not, therefore, be considered best practice other than for significant firms."

Proposal 3: Good practices for operational risk measurement

As above, we welcome guidance but would like the PRA to be clearer in what is applicable to significant firms and to be more explicit where it is not relevant to SDDTs. In the absence of such a clarification, we believe there is a significant risk of gold-plating by treating the requirements designed for significant firms as 'best practice' for all firms, in cases where it is not proportionate to do so. Naturally the

PRA retains the ability to ask individual firms for any information it deems appropriate but to the extent that this applies more broadly across firms, then it would need to be subject to the usual consultation and cost-benefit-analysis. As noted in paragraph 3.20 of CP12/25 the current CBA does not cover SDDTs.

Proposal 4: Updated reporting instructions

We support the proposed changes to the reporting templates, but again ask the PRA to be clearer that only rarely might it request non-significant firms to submit the information, so that it doesn't become the norm. Any such any shift to require a broader group of non-systemic firms to submit this information than set out would require full consultation and cost-benefit-analysis. As noted in paragraph 3.20 of CP12/25 the current CBA does not cover SDDTs.

Pension risk

The BSA supports the proposals to update the approach to pension risk. Pension risk capital add-ons including for SDDTs can be particularly penal under the current regime where it can be impossible to update the add-on even after the risk has been reduced simply because a smaller society is on a 4-year SREP review cycle and the PRA does not have capacity to conduct review work. This is neither proportionate to the risk nor is it aligned to the PRA's competition objective. We agree with the statement in paragraph 4.2 of CP12/25 that pension risk has fallen markedly for most firms in recent years and we therefore welcome the proposed changes to streamline and simplify the approach.

Proposal 1: Remove the PRA's two stress scenarios

The BSA supports the removal of the two stress scenarios.

Proposal 2: Reduce Pillar 2A assessments for fully bought in or sufficiently well-funded schemes

The BSA supports the proposals to reduce the number of data entries in FSA081 for schemes that are fully bought-in or sufficiently well-funded. We also agree that schemes with a funding ratio of at least 130%, which is very conservative, do not need to submit FSA081.

Market risk

The BSA is not commenting on proposal 1 on the market risk methodology. Building societies are not permitted to have a trading book as per the restrictions in the Building Societies Act.

Counterparty credit risk

We support proposal 2 to update information that explains the PRA's counterparty credit risk approach.

Cost-benefit-analysis

Paragraph 1.14 of CP12/25 states "the cost benefit analysis panel was not consulted because the expected impact of these proposals is below its materiality threshold." This appears to be based on analysis of the impact versus the current approach, given the methodologies are broadly similar or the impact is designed to be similar on average.

The BSA would argue that Pillar 2 is always a very material component of capital requirements for most firms particularly given the inbuilt flexibility it gives to the PRA to apply supervisory judgment. We also note that the changes in Pillar 1 under the new Basel 3.1 framework will be material and therefore it seems unlikely that changes under Pillar 2 will also be immaterial. This also underplays the impacts on individual and groups of firms, because when impacts are aggregated and averaged across firms this can mask very material changes for certain firms with certain business models. We also note the comment in paragraph 2.91 of CP12/25 "Overall, the PRA expects more firms may have credit risk add-ons in Pillar 2A in the future due to the removal of the benchmarking methodology and the introduction of the two systemic methodologies." Again, it then goes on to discuss average add-ons without considering the range of add-ons which are likely to be material for some firms.

We believe that the PRA should develop a more nuanced approach to its cost-benefit-analysis in order to capture the impact of Pillar 2A for mutual business models and mortgages in particular, given the currently excessive layering of capital requirements for these low-risk exposures. We also believe the analysis should be from first principles i.e. compared to if no Pillar 2 requirements were in place, rather than comparing the incremental changes vs the existing approach.

As such, while we note the comments made in CP12/25 that suggest that CBA is difficult in this area, we do believe that CBA is an essential part of the policy-making process and should have been shared with the CBA panel for something as significant as changes to Pillar 2 capital requirements.

Impact on mutuals

CP12/25 states that the proposed changes are not expected to be any different for mutuals. It also states that certain changes might affect mutuals less. We agree that the changes to market risk and counterparty credit risk will be less for mutuals because building societies are prevented by primary statute from having trading books. However, we would not agree that the changes to credit risk are any less relevant to mutuals. The Pillar 2 framework in general can be a very significant impact for building societies. Residential mortgages are a low default portfolio where capital requirements are many multiples higher than losses even on a stressed basis. As such the impact of the changes will be extremely relevant for mutuals and potentially more so than for banks where banks have more diversified loan portfolios.

The BSA is calling for the impact on mutuals to be considered earlier in the development of new prudential policy rather than at the end of the process, where it can feel like a tick-box approach.