Non-systemic UK banks : the PRA's approach to new and growing banks

BSA Response to CP 9/20

October 2020

Building Societies Association

Introduction

The BSA welcomes the opportunity to comment on CP 9/20. Although the proposals apply only to a specific category of banks, there are two important reasons why they are relevant to building societies. First, **fair competition** : societies need to be satisfied that new and growing banks will not have unfair regulatory advantages that affect those markets – principally mortgages and savings – where they may compete with societies. Second, **implicit cross-subsidy through the FSCS** : where new and growing banks have a greater propensity to fail, these failures represent a cost burden to building societies and other banks through levies to cover the compensation of protected deposits.

General comments

We welcome much of the content of CP 9/20. It is clear both from the proposals in the CP, and from the PRA's timely and thorough thematic work[1] on the 20 fastest growing deposit takers, that all was not well in the new bank and challenger sector, and corrective prudential action was urgently needed. The PRA is to be commended for making a start in this area. The main question is, not whether the proposed SS is needed, but whether it goes far enough?

Our two general comments of principle are (i) that some of the measures proposed for new and growing banks only, can and should be made available - where appropriate -to established (non-systemic) banks and building societies ; and (ii) to re-iterate that any new building society should benefit from the same gradualist approach as is applied to new banks.

Risks from new and fast growing banks

The BSA has always supported firm but proportionate prudential regulation, fully in line with the PRA's declared primary aim of promoting the safety and soundness of firms. Building

[1] Letter setting out the findings from the PRA's review of fast growing banks

societies are not in the business of taking undue risks to maximise short-term profits – instead they offer superior long-term value to their members from genuinely sustainable businesses.

The BSA has also opposed the oligopolistic monoculture of the "too big to fail" high street banks, arguing for more competition and diversity. So it is essential that the banking market remains open to prudent new entrants. But this should not introduce excessive risk to be carried (through the FSCS) by established deposit-takers such as building societies. A situation where high-risk new entrants are effectively parasitical on sound, established building societies is neither fair nor sustainable. The importance of *effective* competition, as per the PRA's secondary objective, is not necessarily well served by maximising the number of new entrants.

The PRA's Fast Growing Firms review was timely and necessary, and its findings caused some surprise and concern in our sector. Building societies are accustomed to prudent behaviour, and their freedom of manoeuver is in many cases closely circumscribed by the far tougher and more demanding regime in SS 20/15 "Supervising building societies' treasury and lending activities", so the weaknesses catalogued in Melanie Beaman's excellent and comprehensive letter of June 2019[2] made astonishing and sobering reading. We reproduce some examples from that letter in the box below :

Most FGFs were overly optimistic about the potential impact of a stress scenario on their business

Many FGFs did not demonstrate an understanding of the stress drivers for their business, were unable to explain the assumptions made in their stress testing models, and/or to analyse the sensitivities of their business models to these assumptions.

Risk appetite frameworks were still evolving and generally reflected the particular FGF's stage of development and maturity. Risk appetite statements of these FGFs tended to be high level and did not fully capture risks or include sufficiently granular metrics to enable the level of risk to be adequately monitored.

Many FGFs had untested collections capability and it was unclear to us how effective their plans for scaling up collections activity would be under stress. In some cases, forbearance practices were not in line with industry standards; poor practice could potentially mask the level of arrears, delay appropriate recovery actions and thereby impact overall book performance in a downturn.

Some FGFs displayed weaknesses in underwriting of commercial loans. We observed a number of instances of weak financial analysis, limited evidence of challenge and high levels of lending outside of policy (on the basis of exceptions)

[2] ibid.

Content of proposed SS

The broad content of the SS looks entirely sensible, so far as it goes. Particularly useful, we expect, will be Tables 1 and 2, and the exposition in chapters 3 and 4. This material, well-prepared as it is, does also prompt the question – why is it in fact necessary ? Why, in fact, were the **FGFs covered by the review apparently so predisposed to the weaknesses** identified ? That would be worthy of exploration, too.

Although outside the PRA's direct remit, the importance of conduct risks could also be given greater consideration in the SS, given the potential for significant conduct failings to affect solvency. Fast growing firms that are under pressure to demonstrate increasing volumes and profitability may be incentivised to put less weight on compliance. The SS might highlight how the PRA will ensure internal governance arrangements are appropriate, and how it will liaise closely with the FCA on the supervision of fast growing firms.

New societies

For various reasons, it has been much more difficult in recent years to set up a new building society than a new bank – the last new society was established in 1980, and only three in the last sixty years. For the purposes of this response, we address only the question whether the gradualist "mobilisation" approach outlined for new banks is available as of right to a putative new society as well. We think it must be, and this should be confirmed in the final SS.

Since building societies generally operate on the basis of internally-generated capital (retained earnings), they are unlikely to be found in the "fast growing firms category" – indeed, not a single society needed to be covered in the FGF review mentioned above.

Solvent wind-down

We fully support the **normalisation and de-stigmatisation of solvent wind-down** as a suitable exit route for (inter alia) new –ish banks, though we think it also has far wider application, as explained below.

We completely agree with PRA (SS, paragraph 5.1) that ***"it is crucial they have the ability to exit the market in an orderly way, if required. This includes having a solvent wind down plan in place, to provide the potential option of winding down the business should other recovery options be exhausted."***

We comment in passing on terminology : the terms "orderly exit" and "orderly failure" are not interchangeable – while every failure is an exit, the reverse is far from true. In some places the SS may need editing to make this clearer.

Orderly exit is preferable to (even orderly) failure for several reasons. Orderly exit can be achieved in various ways – such as sale of the business as a going concern, subject to new controller approvals – but for the purposes of this CP we focus on solvent-wind down – i.e. the business effectively goes into run off: the process is described in SS paragraph 5.6 .

First, orderly exit enables optimum realisation values for assets, rather than a fire sale – so it does not destroy value.

Second, normalised and de-stigmatised exit via solvent wind-down contributes to financial stability by avoiding any appearance of crisis or lack of confidence : liabilities will be continue to be repaid on demand or maturity, with no need for panic or runs.

Third, avoidance of the modified insolvency route (with FSCS payout) conserves the FSCS resources (which ultimately derive from levies on sound building societies and banks) for more egregious cases. Overall, this means less of an FSCS tax on prudent building societies. (Again, in passing we note that paragraph 5.1 refers to a new or growing bank failing in an orderly manner without exposing public funds to loss : in fact, for a new / growing bank, the formal resolution option would almost certainly be modified insolvency, which requires FSCS funding, but not public funds – but FSCS funds (representing a tax on other deposit-takers) are equally worthy of protection as public funds.)

Fourth, avoidance of an insolvency route means no value-destruction from fees soaked up by insolvency practitioners : the BSA knows from experience in the Dunfermline BS resolution that these fees proved very costly indeed and the destruction of value was very substantial.

Fifth, since orderly exit is not failure, it removes part of the threat to directors of the bank that they might be subject to criminal sanctions[3] for causing the bank to fail. Indeed, once solvent wind-down has been normalised and de-stigmatised, this should prove a powerful incentive for new / growing banks to follow this route sooner, rather than gamble on recovery and hanging on till insolvency is inevitable.

So, while we support solvent wind-down as an orderly exit route for new and growing banks, we think it should definitely not be limited, but clearly signposted to other categories of non-systemic banks. For example, if an established challenger bank, that is no longer in the initial five year growth phase, gets into difficulties, then – as envisaged in Table 1 – orderly exit through solvent wind-down must remain an option. The text of the SS should be edited to make clear that solvent wind-down is applicable to established banks too : all the five arguments above apply, *mutatis mutandis*, to established banks as to new / growing banks.

Finally, although it is most unlikely – for reasons explained above – that a building society should get into such difficulties, the option of orderly exit through solvent wind-down should be equally available to it, as to an established or new/growing bank. We do not think any legislative or regulatory change is needed – simply that PRA uses the final SS to normalise and de-stigmatise solvent wind-down generally , and make clear that it is theoretically applicable to building societies as well as banks.

The BSA is happy to work with PRA to identify any actions that would be needed to facilitate the normalisation and de-stigmatisation of solvent wind-down as theoretically applicable to a building society.

[3] Section 36, Financial Services (Banking Reform) Act 2013

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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 £420 billion, and account for 23% of the UK mortgage market and 19% of the UK savings market.