BSA Response to CP4/23 – The Strong and Simple Framework: Liquidity and Disclosure requirements for Simpler-regime Firms

30 May 2023

Building Societies Association

Executive summary

The BSA is a strong supporter of the 'Strong and Simple' project and welcomes the proposals included in CP4/23, while also believing that the proposals could go further. We agree that the emphasis is rightly on 'Strong' as well as 'Simple.' We do not subscribe to the view that complex rules are somehow better or more robust. We believe that simple rules that are easy to understand and easy to implement are superior to pages of complex rules that are more prone to misinterpretation or implementation issues. Simple rules work best if coupled with sound risk management and smart supervisory oversight.

Overall, it's hard to disagree with the various proposals in CP4/23 to introduce more proportionality into the regime for Simpler firms, in particular where certain superfluous requirements are dropped. However, there is a sense that the PRA has taken the existing requirements and looked to streamline the requirements, rather than take a holistic view on what requirements are necessary. For example, the ILAAP template is useful guidance but still requires an ILAAP to be completed annually with all the associated governance and controls. More streamlining and proportionality would have positive benefits for risk management. The BSA accepts that the responses to DP1/21 showed a preference for a 'streamlined' rather than 'focused' approach to capital calculations given the desire not to hold a 'simplicity premium' in the calibration. However, this need not translate across all areas of the framework.

Based on early consultations and communications, societies were expecting a range of proportionality benefits across a number of aspects, with resourcing and cost management being key beneficiaries and operating model also benefitting. We believe that the proposals within CP4/23 will only lead to relatively limited benefits, primarily in opportunity cost savings across resourcing and governance. This needs to be set against the potentially significant increases in capital requirements for credit risk if the PRA implements the proposals as set out in CP16/22 for Basel 3.1. These increases result from the change from current to original valuation, higher risk-weights for holiday lets and self-build mortgages and the scaling up effect through the capital stack through pillar 2 and buffers.[1]

The BSA would favour a more radical approach. We propose that the PRA puts more emphasis on a societies' own risk management documents that are developed by the firm, for the firm and drafted in a way that is most useful to the firm rather than being primarily for the regulator. We discuss this in more detail below. As such, we encourage the PRA to be more radical with its proposals for simpler firms to deliver genuine change. This is preferable rather than broadly sticking to the existing regime while removing certain marginal requirements for only marginal benefits.

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[1] See [BSA Response to CP16/22]

The BSA has long argued for the removal of pillar 3 disclosure requirements which are rarely read, and have not provided any tangible evidence of market discipline. Silicon Valley Bank was subject to Pillar 3 reporting but largely avoided any real scrutiny until only days before its failure. We do not view the removal of pillar 3 disclosures as a de-regulatory weakening, but rather a removal of superfluous requirements that do not meet the objective for which they were designed, and we strongly support this.

Building Societies are currently subject to the 'Building Society Sourcebook' SS20/15 which includes various constraints on their activities. Banks including start-up banks that have only a limited track record and hence less mature risk management processes are not subject to the same constraints. CP4/23 does not include any proposed amendments to the sourcebook and the PRA has not communicated any timelines for reviewing the sourcebook and the ongoing appropriateness and calibration of the limits that it contains. The BSA believes that a fundamental review of the sourcebook is long overdue and should be a key component of the Strong and Simple project.

A priority area for review should be the rationale for, and associated levels of fixed lending and administered balance sheet mismatches permitted. The rationale of margin flexibility, particularly as societies cannot easily raise capital, makes sense in theory, but a body of evidence shows that the actual level of margin flexibility is significantly less in practice due to real-life fixed versus administered price differentials, pricing responses to base rate changes and customer and competitor actions.

BSA members urge the PRA to publish its second consultation on capital requirements for Simpler firms as early as possible. Firms are preparing 3-5 year business plans where one of the key inputs – the simpler firm capital regime - remains unknown. If a Board member asks its executive team if the firm should adopt the simpler firm regime or Basel 3.1, it is currently impossible to make that determination. A further aspect to this is that if a firm chooses to adopt the proposals in CP4/23, then is it by default also opting to adopt the future simpler firm capital requirements without having seen them? Or can a society implement the simpler firm requirements for liquidity and disclosure but Basel 3.1 for capital?

Finally, while not within the scope of the Strong and Simple project, the BSA continues to campaign to take smaller building societies outside of the scope of 'Public Interest Entity (PIE)' status. PIE requirements drive unnecessary additional review and governance requirements and hence associated costs, and arguably duplicate assurance that is more appropriately captured under SMCR.

Implementation

The PRA has stated in CP4/23 that it wants to give eligible firms sufficient time to consent to a rule modification enabling them to become Simpler-regime firms and prepare to implement the simplifications. They have suggested this would be in early H2 2024. Given that many of the proposals relate to dropping certain requirements, BSA members do not foresee problems in implementing the changes from that time. The PRA has also stated that the modification will be available at least six months earlier which we welcome as it will avoid societies continuing with requirements that will subsequently be dropped. This is especially true for Pillar 3 disclosures where societies prefer not to have to prepare these disclosures one final time before the rules come into force.

However, the corollary to dropping requirements sooner is that in early 2024, firms will not have sight of the capital aspects of the simpler firm regime. This raises the question of whether a firm would be applying for a modification from just the liquidity and reporting aspects of the rulebook or also from capital aspects without knowing what the alternative to Basel 3.1 capital requirements will be. The BSA requests that the PRA is clearer on the timelines that are applicable in this regard and whether firms are permitted to partially adopt or fully adopt all aspects of the Simpler-firm regime.

Q1: Do you have any comments on the proposed implementation date and whether it would strike an appropriate balance between allowing firms to implement the measures set out in this CP quickly and providing sufficient time to implement the measures?

As mentioned above, our main concern is the interaction between the proposals in this CP and the phase 2 capital CP and the modification.

Q2: Do you have any comments on potential future changes to the content, clarity, and presentation of PRA rules and policies that could help to achieve the aims of Strong and Simple?

We support the PRA looking to reduce the complexity of the capital regime and particularly buffers. The sooner the PRA can publish proposals the better to aid firms with their planning. In this regard, it is worth reflecting that any 'strength' in the Pillar 1 requirements is then grossed up through the capital stack such that smaller societies hold proportionately more buffer capital as a result.

Q3: Do you have any comments on the PRA's proposals for the scope and level of application for the simplifications set out in this CP?

As per the BSA's responses to CP5/22 and CP16/22, we support the changes to the scope to refer to MLAR definitions of international lending based on the location of the property rather than the location of the borrower who might be abroad. We also support the averaging across quarters to avoid firms temporarily being captured. We do not object to the increased threshold from £15bn to £20bn but hope that this does not limit the PRA in any way to be less bold in its proposals than might otherwise be the case.

The criteria for trading book exposures should include a clarification that ‘banking book versus trading book’ designation is the basis for threshold consideration, and not any other potential basis; for example, Finrep reporting definitions or classifications of trading assets or certain derivatives entered into as economic hedges.

Net Stable Funding Ratio (NSFR)

Building Societies are constrained by ‘nature limits’ as set out in the Building Societies Act. One such nature limit is the wholesale funding limit that prevents a society from holding more than 50% wholesale funding. This limit is designed to preserve the key purpose of a building society which is to accept retail deposits from its members and to lend to borrowing members. As such it is not possible for a building society to exceed 50% of non-retail funding. The BSA welcomes the PRA’s proposals for a new Retail Deposit Ratio (RDR) which is aligned to the wholesale funding nature limit in the Building Societies Act, so the 50% should never be exceeded.

The calculation of NSFR for a building society is not intrinsically complex, and most societies will have already automated the process and integrated it into their risk reporting systems and controls. However, we welcome its removal given it is not a particularly useful metric for building societies as discussed above with the predominantly retail-funded business model as dictated by the limits in the Building Societies Act.

Q4: Given the simplified approach to stable funding under the simpler regime that is set out in this chapter, do you have any comments on the appropriateness and proportionality of the proposed approach to the sNSFR?

We welcome the removal of the NSFR as proposed.

Pillar 2 liquidity

The BSA welcomes the proposals to not generally require pillar 2a liquidity add-ons while retaining the powers to do so in certain circumstances. Our view is that this will make formal what currently happens in practice for building societies. As such this is more of a clarification than a change, and we do not therefore expect the change to result in any increased level of proportionality in the framework. The PRA will retain the ability to make liquidity add-ons for outlier firms or firms where they have particular liquidity concerns. That said, we understand that firms are still required to make an assessment of liquidity risks under pillar 2a and document these in the ILAAP.

The BSA notes that there are no proposed changes to the LCR in CP4/23. While relatively straight forward to calculate, the LCR is not the most useful ratio for building societies given the assumptions that are included aren't very realistic. Societies currently define their own OLAR calculation with their own assumptions. The PRA could place more attention on OLAR than LCR and give clearer guidance on its expectations for OLAR for similar business models such as a Simpler regime building society.

ILAAP document template

The resources associated with putting together an ILAAP are one of the most significant regulatory burdens for smaller firms. This is in terms of the required specialist expertise, management oversight, governance and external specialist resources including regulatory advice and internal audit. While the BSA welcomes the concept of templates to make it clearer to firms what the PRA expects, we think these proposals fall short of delivering the philosophy of a 'strong and simple' regime.

ILAAP template

The ILAAP template included in the appendix of CP4/23 includes headings and a degree of guidance for firms which is useful. However, it stops short of providing more detailed guidance on the expected ILAAP content, and the annual frequency is retained. It notes that the section describing the business model could mirror that in other documents i.e. the PRA is endorsing duplication.

We do not believe that simpler firms should need to produce an ILAAP annually. Most Simpler building societies have established business models that do not change significantly over time, and therefore an annual ILAAP is not proportionate to the liquidity risks faced.

The PRA could give more guidance on the kinds of stress scenarios that firms should adopt. The largest banks are provided with the Annual Cyclical Scenario (ACS) which is extremely detailed and smaller firms are also encouraged to consider this too. The PRA could go further in defining the kinds of scenarios it expects to see for Simpler-firms while still allowing firms to include their own idiosyncratic scenarios and tailoring to capture unique business model risks.

All that said, we believe societies could produce one suite of stress scenarios which could be referenced in different regulatory contexts e.g. ICAAP, ILAAP and the recovery plan. It could also be closely aligned to the stresses used to satisfy the going concern statement in the annual report and accounts. Similar but separate stress scenarios in different documents for slightly different purposes leads to a less coherent framework overall and confusion on how the various components interact and fit together.

A more radical approach

The BSA favours a holistic review of all regulatory documents with a view to merging, streamlining and removing duplication. As a key principle, the firm's suite of Board-approved policies and risk framework documents should have the primary purpose of being useful to the firm. There could be one single and short regulatory document that is prepared for the regulator and approved by the Board that sign-posts where to find the information that the PRA needs to perform its own assessment. The regulatory document could have short sections on liquidity, capital adequacy and recovery planning to explain which stress scenarios are relevant and demonstrate, for example, compliance with the overall liquidity adequacy rule (OLAR). A template could be developed for the combined document, reflecting priority risk areas, stress scenario guidance and recommended analysis structure. There should be no need for a separate ILAAP document with sections describing liquidity risk drivers and risk management as these would be duplicative of the firm's liquidity and treasury policies. Likewise there would be no need for an ILAAP to include a discussion of the business model, but rather there would simply be a link to the society's financial plan.

If such an approach were adopted then the components could be spread out over the year e.g. risk appetite, stress testing, policy documents. This would avoid pinch points for staff currently involved in producing ICAAP, ILAAP and recovery plans, as well as avoiding Boards becoming overloaded with too much regulatory information at one Board meeting.

Liquidity reporting

Building societies currently face a significant suite of core liquidity and funding-related regulatory reporting. Our hypothesis is that liquidity calculations and associated reporting, namely LCR and PRA110, has been deemed 'material by nature' by the PRA and therefore not considered for any proportionality proposals in this CP. Two changes have been proposed; removal of NSFR (discussed earlier in this response) and removal of some ALMM template reporting requirements.

BSA Members urge the PRA to consider, as a minimum, reducing the current granularity in the PRA110. Smaller societies do not typically face peak liquidity risk within the 30 day horizon, or cliff risk past 30 days.

The EBA carried out a significant study into the costs associated with supervisory reporting requirements, with one of its recommendations being the removal of the requirement for small and non-complex institutions ('SNCI's) to populate and report a number of ALMM templates (C68/69/70). We welcome a similar approach being proposed by the PRA, with the proposal to exclude Simpler-regime firms from having to report 4 of the 5 ALMM returns (C67/69/70/71).

The likely benefits are relatively small; the EBA study estimated a reduction of 2-3% of a SNCI's reporting costs as a result of the ALMM template exemptions – an annual saving of around £5-£12k per SNCI. This amount means that any cost saving will be an opportunity cost saving, allowing scarce resources in finance and risk to spend a higher proportion of their time on more value-adding activities. While this is welcome, actual cost savings are unlikely to be material.

Regulatory reporting continues to be an area where a lack of proportionality puts unnecessary pressure on likely Simpler-regime societies in terms of governance, resourcing, prioritisation and costs. For example, Finrep includes multiple templates requiring granular information, much of which is memorandum in nature; BoE statistical and MLAR returns have to be completed at individual firm level with no thresholds or tolerances; and there are individual and consolidated reporting requirements for firms which effectively operate at group level only. A holistic approach to assessing the full suite of regulatory reporting, as part of Strong and Simple, may be the most practical and insightful; the recently launched Banking Data Review initiative may represent the best mechanism to perform this holistic review in conjunction with the various phases of the Strong and Simple framework development.

Pillar 3 Disclosures

The BSA has long made the case for the removal of Pillar 3 disclosures. We therefore strongly support this proposal by the PRA to drop these superfluous disclosures that are rarely read and do not meet the original policy intent of market discipline. We would also note that market participants did not pick up problems using pillar 3 disclosures for the recent bank failures in the US such as Silicon Valley Bank. We encourage the PRA to drop Pillar 3 disclosures as soon as possible so that Simpler firms don't have to produce one final set of disclosures before the changes are implemented in 2024.

The PRA is proposing to retain certain existing disclosures for any firm that issues listed securities. The metrics included in these forms could more usefully be included in the firm's annual report and accounts in a standardised format so that market participants can be confident that they are calculated consistently across firms for comparative purposes.

Q5: Are there any factors or stakeholders the PRA has not identified or considered sufficiently in respect of the proposed exclusion of non-listed Simpler-regime Firms from Pillar 3 requirements?

The BSA is only aware of a very small number of users of Pillar 3 disclosures, including prudential job applicants, competitors and academics. We are not aware of any users that would exert market discipline over firms such as investors, as per the original policy intent.

A bolder approach

The BSA encourages the PRA to be bolder in its proposals than set out in CP4/23. Table 1 below shows an initial summary of areas where more radical thinking could be considered.

Table 1	CP changes	Bolder ideas	Bolder key benefits
Liquidity: LCR	None proposed	OLAR standardisation framework and guidance; based on firms own OLAR calculations	Better alignment of liquidity ratios to building society business model
Liquidity: I90D	None proposed	See ILAAP section	See ILAAP section
Liquidity: PRA110	None proposed	Assess appropriateness of reporting requirement – smaller firms unlikely to have cliff risk or peak liquidity risk exposures	Operating model, resourcing & cost management
Funding: NSFR	NSFR removed; replaced with RDR	N/A – as requirement removed in CP	N/A
Funding: ALMM	4 templates removed – C67/69/70/71	Further templates reporting removed	Resourcing and cost management
Risk management: ILAAP	Templates provided to simplify contents and focus areas	Provision of specific stress scenarios & key assumptions SREP assessment – require every 2/3 years; 1 integrated document	Operating model, governance and resourcing
Risk management: Pillar 2 liquidity	Removed requirement; still assessed by firms via PRA110?	Assess requirement to assess – possible LCR buffer to offset?	Resourcing and governance
Disclosure: Pillar 3	Removal of requirement (if no listed instruments)	Consider disclosure in Annual Report and Accounts if listed instruments	N/A
Guidance: SS20/15	Out of scope	Proportionality assessment of current guidance carried out	To be determined following assessment

Reviews: SREP or equivalent annual reviews	Out of scope? or None proposed?	Assess whether annual review could be extended to every 2/3 years (subject to PRA assessment) – covering key risks in 1 review	Resourcing, business strategy and governance
Funds transfer pricing (FTP)	There are currently no rules that require small societies to have a FTP policy nor is it referenced in SS4/23. However perceived 'best practice' often from IA or consultants means societies are pushed to develop an FTP approach.	N/A	The PRA could confirm that FTPs are not required for simpler firms to avoid 'best practice creep'

Table 2 below summarises the typical liquidity and funding operating model outputs for a Simpler-Regime Firm building society, and how the CP impacts them:

Table 2	**Current state**	**CP changes**	**Future benefits**
Liquidity: LCR	Ongoing requirement: 100% minimum coverage for 30 day stress	None proposed	N/A
Liquidity: I90D	Internal stress assessment for 90 day period	None proposed	N/A
Liquidity: PRA110	Monthly return covering 30 day peak liquidity risk, post 30 day cliff risk & 90 day stresses	None proposed	N/A
Funding: NSFR	Ongoing requirement: 100% minimum coverage for stable funding horizon	NSFR removed; replaced with RDR	Resourcing impact of removal of NSFR calculation and reporting requirement; RDR already managed

Funding: ALMM	Suite of liquidity monitoring templates reported: C66-71	4 templates removed – C67/69/70/71	Resourcing & cost management
Risk management: ILAAP		Templates provided to simplify contents and focus areas	
Risk management: Pillar 2 liquidity	Assessment via PRA110 and annual ILAAP process	Removed requirement, although still assessed by firms via PRA110	Limited – societies will likely still assess for ILAAP purposes e.g. intra-day, initial margin
Disclosure: Pillar 3	Detailed disclosure of Liquidity, Capital and Credit risk aspects	Removal of requirement (if no listed instruments)	Q1 preparation, review and governance
Guidance: SS20/15	Suite of CRM and FRM guidance/parameters for firms, based on risk category assessed in	Out of scope	N/A
Reviews: SREP or equivalent annual reviews	Triannual cycle: Liquidity; Capital; Risk management	Out of scope? or None proposed?	N/A

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