Supervising building societies' treasury and lending activities

Our response to PRA's CP 12/16

4 July 2016

Building Societies Association

Introduction

The BSA welcomes the opportunity to respond to PRA's CP 12/16, revising Supervisory Statement SS 20/15, which is the document corresponding to the former Building Societies' Specialist Sourcebook. For convenience in this response we will refer to the current and proposed texts of SS 20/15 as the "Sourcebook".

Before turning to the substance of our response, we think it is worth restating that the BSA and the PRA share some key objectives, as we both expect and want building societies to maintain a high degree of prudent management, safety and financial soundness, thereby continuing to protect their members' savings. We agree that societies should manage their intrinsic risks effectively, but should also continue to thrive commercially, and serve important social purposes in housing finance. We may disagree with PRA about the right balance between prescription and freedom to achieve those objectives. And we may disagree about some the risk relativities as perceived by the PRA.

We also welcome and appreciate the early engagement BSA members have had with the relevant PRA staff, especially at an important round table with member societies on 12 May. At that occasion, we were able to identify a number of minor inconsistencies and unintended errors in the revised Sourcebook text, which we sent in advance of this response to the PRA for checking and correction. We attach these for completeness as an Annex to this response, but need say no more about them in the body of the response.

Finally, we also welcome the efforts being made by the PRA, as detailed in the PRA's letter of 4 April 2016, to respond to the BSA's October 2015 challenge regarding the competition aspects of the Sourcebook. We strongly encourage the PRA to persevere in this.

The BSA and its members will be very happy to provide any further information and assistance to the PRA in the post-consultation finalisation of the revised Sourcebook.

General points of principle

We explained above the shared interest between PRA and BSA in the safety and financial soundness of building societies. So our contributions in this response should be read as seeking to improve the overall outcomes from the Sourcebook revision exercise, as well as touching on issues of principle that may have wider resonance for the future.

(i) Public policy on housing

Building societies have always served a wider social purpose. As well as providing a safe home for their members' savings, building societies finance housing, helping people to buy or build their homes (hence the name). So building societies' mortgage lending, in all its forms, makes an important contribution to the Government's wider public policy to increase the supply and availability of housing. BSA members, with their long experience, and their local or regional knowledge, are well placed to contribute not only through traditional mortgage lending, but also by lending in non-standard "niches"[1] and in new, innovative ways.

Building societies that specialise in personal rather than automated underwriting are particularly well placed to give the extra time and closer skilled attention that these kinds of lending often require. The BSA strongly supports Government initiatives (following recent legislation[2]) on self- and custom-build, and has taken its own initiative[3] on lending into retirement. In both cases, our members are responding to changing social needs and trends.

There need be no necessary conflict with prudential standards. Building societies know that different types of mortgage lending carry somewhat different risks, which need to be well-managed, through a combination of basic expertise, explicit limits and other controls, and careful monitoring with feedback into lending policy. The Sourcebook emphasises the importance of risk management that is commensurate with the different, or additional, risks in particular types of lending. As a broad principle, that cannot reasonably be gainsaid. The problem may arise in the application, and its perception. The BSA's concern, therefore, is that (no doubt quite unintentionally) the revised Sourcebook risks creating a perceived climate that seems in places hostile to a wider range of niche lending by smaller societies. Exactly what the words on the page say may be of secondary importance to the mood music that is being generated.

We consider this outcome would be regrettable (as well as avoidable). BSA members, especially medium and smaller societies, may be frustrated in making their contribution to these wider public policy objectives, whether this is to encourage self- and custom building; or to improve access to lending into retirement. And Government will be disappointed that willing contributors are being discouraged. So we urge PRA to take the greatest care, both with the tone and language in the final Sourcebook, and with the behavioural aspects of its application by supervisors, not to obstruct or compromise these wider social objectives. The BSA is happy to provide what assistance we can in this endeavour.

[1] "Niches" are more specialised areas of lending favoured by particular societies : as the term is well-understood in the sector, we use it elsewhere in this response

[2] The Self-build and Custom Housebuilding Act 2015

[3] https://www.bsa.org.uk/document-library/information/publications/lending-into-retirement-report.aspx

(ii) Evidence-based views of risk

Self-build

Related to the issue mentioned above is the importance of basing PRA views about the relative riskiness of different forms of lending on good evidence rather than being influenced by anecdote, speculation and even prejudice. We take first the example of **self-build**, where the draft in CP 12/16 identifies a number of individually reasonable risk elements (planning, marketability, site security, etc) that need to be managed. BSA members who offer mortgages for self-build properties will be fully conversant with these, but are also aware that self-build lending includes an important risk mitigant (compared with conventional lending) in that the borrower's commitment to the property is far greater – for two reasons: typically the borrower puts his/ her own cash in first towards the land acquisition, and may carry out some parts of the actual construction work. So the key question is not what the theoretical risks are, but what is the actual delinquency and loss experience? To use modelling language, what are the typical PDs and LGDs for self-build, and how do they compare with conventional lending?

Where a society demonstrates a good track record of loss experience in this field, that should be regarded as contributory evidence that different or additional risks are in fact being managed well. When challenged on this point, PRA staff sought to argue that past performance is not necessarily a good guide to the future. Clearly there will always remain uncertainties and unknowns. Experience after a fairly short period, rather than over one or two complete economic cycles, can mislead – we accept that. But careful review and analysis of past performance over an adequate period remains the foundation of all internal model approaches so PRA's argument goes against the grain.

The BSA is aware, through our close liaison with the National Custom- and Self-Build Association, of the results of recent confidential research into the risk profile of self-build lending going back to 2001, carried out by a leading mortgage insurer specialising in this area of lending. In brief, the summary picture, which the BSA is permitted to share with PRA, is as follows: the claims frequency over this period on self-build was 0.11%, compared with 0.27% experienced by the same insurer on other forms of lending. We have urged, through the NaCSBA, that the fuller research behind these reassuring results, which is proprietary information, could be shared in confidence by the insurer with the PRA to assist its further deliberations.

So, unless the PRA can produce an evidence base to the contrary, it would seem that restricting lending to the custom and self build sector will not reduce overall risk exposure for lenders, but could potentially have the opposite effect if substituted for conventional mortgage loans. We also mention in the Appendix the distinction between custom- and self-build.

Lending into retirement

We are content with the revised Sourcebook wording around **'lending into retirement'** which recognises that lending for a fixed term is different in nature to lifetime mortgage lending. However, by making a comparison between the two the PRA may be suggesting that they are part of the same continuum. We would like to see it made clear that supervisors should not treat lending into retirement, interest-paid and for a fixed term, differently to other conventional mortgage lending. This will be important to allow for growth in lending into retirement as the population ages.

After corrections are made to maximum LTVs (see annex) for interest-paid lifetime mortgages, then the PRA's approach regarding different lifetime mortgage products would appear sensible. No BSA member currently does new interest roll-up lending though some have back-books. The lifetime mortgage products currently on offer – none of which have a no-negative equity guarantee - are purely of the 'interest-paid' variety and those offering them have suitable underwriting controls in place to mitigate the risks discussed. Maximum LTVs are between 35% and 50% and while some may fix the rate for the short-term, none do so indefinitely.

Shared ownership

A further example concerns shared ownership lending, which is not a new area: the shared ownership model has been an established feature of social housing provision for 20 – 30 years. Since shared ownership may appeal to households that cannot initially afford outright purchase, it is perfectly plausible that there may be a greater degree of income stretch, and therefore higher credit risk, than for conventional mortgages. The revised Sourcebook text also goes into some detail of a range of theoretical risks (forfeiture of sharing owner's lease, validity of mortgagee protection clause, etc), but presents no evidence as to how often these theoretical risks actually crystallise in practice.

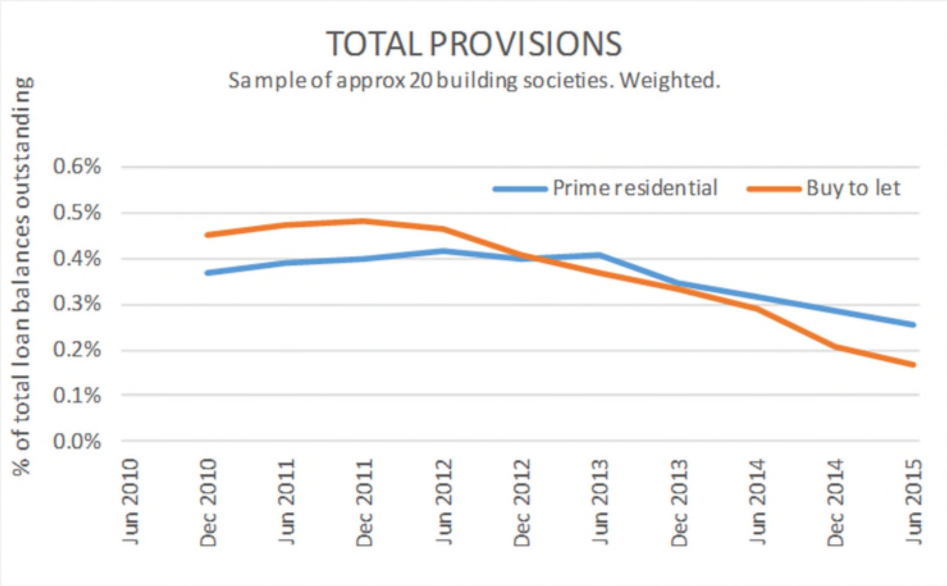
The BSA draws attention to recently available research on the performance of shared ownership housing at the 52 housing associations (accounting for nearly 100,000 shared ownership properties) comprised in the National Housing Group, and cited[4] in "Inside Housing" at the end of June. This research indicates that rent arrears in shared ownership are a problem, but that repossessions of shared ownership properties remain rare – though at a higher rate than for conventional mortgages. Nevertheless, the BSA's understanding is that actual lender losses resulting specifically from either lease forfeiture due to borrower default; or non-payment under an MPC; are also rare. So, in summary, the BSA accepts that shared ownership involves greater risks, but the evidence suggests that these are the expected risks of borrower income stretch and affordability (which can and will be mitigated by the strict affordability assessments now required) rather than the more technical and theoretical risks cited by the PRA. Given the increasing importance of shared ownership in social housing provision, we agree that societies should pay attention to the greater risks, but should do so in an evidence-led manner.

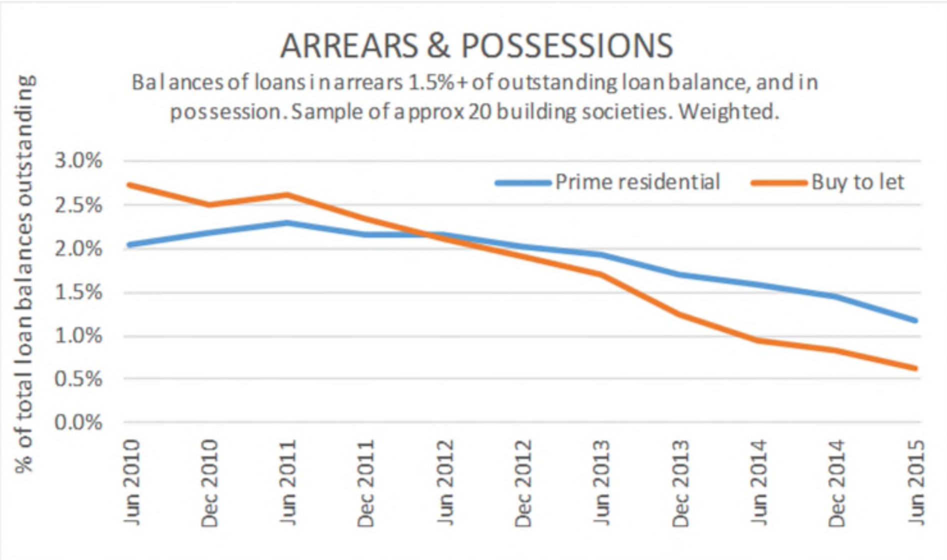
The distinct impression from some of the Sourcebook language is of a false dichotomy between "safe" conventional mortgage lending and "risky" non-traditional niches, when in fact conventional mortgage lending also carries plenty of risk and uncertainty, deriving especially from unpredictable post-completion events such as accident, sickness, unemployment / income reduction and relationship breakdown.

Buy to let

The same question around the evidence base is encountered in the paragraphs on buy to let (BTL). The additional/ different risks cited are individually reasonable, but (as the BSA has consistently argued in other regulatory consultations) recent data from our own members confirms that the loss experience from prime BTL lending is – perhaps counter-intuitively – generally no worse than from conventional lending to owner-occupiers. The relevant data are presented below.

[4] http://www.insidehousing.co.uk/analysis-and-data/data/shared-ownership-2/7015633.article?adfesuccess=1





However, our members are far from complacent about the risks, and recognise that the data referenced above covers a relatively short period – less than a full economic cycle. Indeed, opinions among member societies do vary, with some taking a more conservative line. One such society commented to us that the higher personal leverage (in order to maximise returns) typically encountered among BTL borrowers leads to an increased risk of loss under "normalised" stressed economic conditions of interest rates rising and house prices falling, with PDs and LGDs rising as a result, and therefore of BTL giving rise to worse losses than owner occupier lending.

As the PRA has separately consulted on the matter of underwriting standards for buy to let in its CP 11/16, to which the BSA has submitted a comprehensive and well-argued response[5] ahead of the closing date of 29 June, we do not reproduce here in detail the points we have already made in that response. In summary – (i) we question the rationale for the particular threshold at 4+ properties; and (ii) we underline the risk of BTL regulatory arbitrage as FCA-regulated centralised lenders, that are not deposit takers, and therefore outside the scope of the PRA's proposed policy, will not have to meet these underwriting standards, and consumer BTL demand could therefore be redirected towards those lenders. Finally, we emphase the need for complete consistency between the final outputs from CP 11/16 and the relevant parts

[5] https://www.bsa.org.uk/information/industry-responses/our-response-to-the-pra-s-buy-to-let-underwriting

of CP 12/16 – there are several apparent inconsistencies which need to be ironed out (see Annex item : Paragraphs 3.22 to 3.27 on buy to let). Some of our members have addressed these in detail in their own individual responses.

(iii) Cost benefit analysis

We disagree with the PRA's approach to CBA on the revised Sourcebook, which is moreover inconsistent with the approach taken elsewhere by the PRA.

We contrast paragraph 3.4 of CP 12/16 with paragraphs 3.3 to 3.10 of CP 11/16. In CP 12/16, relating to the Sourcebook, PRA states:

"Since the supervisory statement contains no rules, just an explanation of supervisory expectations, the PRA has concluded that a full cost benefit analysis is not required to be performed."

However, in the parallel CP 11/16 on BTL underwriting standards, which also proposes an SS without rules, PRA states:

"In drafting this CP, the PRA had regard to the Regulatory Principles. In particular, the burdens and restrictions resulting from the expectations contained in the supervisory statement have been assessed and are considered to be proportionate to the benefits, considered in general terms, which are expected to result."

The CBA is then set out from paragraph 3.4 onwards.

In brief, we consider that PRA was **right** in CP 11/16, but **wrong** in substance in CP 12/16.

We reject, first, the PRA's argument that as the revised SS 20/15 contains no explicit rules, CBA is not required : this verges on sophistry. It is quite clear that the SS constitutes quasi-rules, or guidance on rules, however presented as a "Supervisory Statement". Indeed, we suspect the PRA is not entirely sure of its ground either, since it hedges its bets in CP 12/16. Paragraph 3.5 of CP 12/16 claims, almost correctly, that CBA is not required if the impact is of minimal significance – and then asserts a rather different point - that the implementation costs are materially exceeded by the benefits. To arrive at this conclusion, PRA then attempts to claim that the main element of the implementation costs should not be attributed to the updated Sourcebook but rather to societies' reactions. We find this latter argument unconvincing.

We think a more accurate and straightforward CBA for CP 12/16 could have been summarised as follows.

"The updated Sourcebook will result in some increased costs to societies. These will be modest, because the changes to the Sourcebook are relatively few, but they may arise in relation to new expectations on types of non-traditional lending. There may also be some reduction in cost through some of the simplifications proposed in CP 12/16. The benefits, in terms of enhanced resilience, will be substantial, but very difficult to quantify in financial terms. Overall, these benefits readily justify the modest net costs."

CBA along these lines would be respectable. We find the content of paragraphs 3.4 to 3.9 unimpressive, especially by comparison with the contemporaneous, and entirely reasonable, CBA in CP 11/16. We are therefore not fully persuaded that in CP 12/16 PRA has complied with its legal obligations under FSMA.

(iv) Competition arguments

We acknowledged above the willingness of PRA to try to address the competition point. We think this gains added importance and urgency from the imminent commencement on 6 July 2016 of section 20 of the Bank of England and Financial Services Act (Regulatory principles : diversity). Moreover, we note that CP 11/16 shows quite clearly how microprudential action can be taken in an even-handed way across a product sector comprising both building societies and mortgage banks.

The best arguments for extending, in some form or manner, the guidance or expectations in the updated Sourcebook to other categories of banks, are provided by PRA itself. In paragraph 3.8, PRA opines in detail as to what the benefits resulting from the updated Sourcebook will be, and concludes that "the benefits in terms of reducing firm failures, or near failures, could be significant – as demonstrated during the financial crises years from 2007 to 2010". The BSA and building societies would not dream of being so selfish as to expect that such significant benefits should therefore remain confined to building societies – after the extreme cases of the two mortgage banks Northern Rock and Bradford and Bingley – we would be only too pleased to share these benefits with the wider mortgage banking sector, along the pattern of CP 11/16. Indeed, recent and well-publicised poor practices at a prominent challenger bank perhaps underline the need for these expectations to be disseminated and applied more widely.

Flexibility of revised guidance

Our members generally welcome the PRA's dropping of flow limits as a further constraint alongside stock limits. Several members make a point of mentioning this positive move in their own responses.

Apart from the general points of principle above, and the minor errors and inconsistencies recapitulated in the Annex, we have relatively few specific counter-proposals, which we cover in the next section. But our members do have one general and major concern regarding application and behaviours.

Subject to the reservations in this response, the updated Sourcebook text, taken as a whole, is a reasonable vehicle for achieving the objectives PRA has identified in paragraph 3.8 of the CP (improving risk management, alignment with risk appetite, and reducing crystallised risk from lending and treasury activities) provided that its application by supervisors remains consistent with the declared intentions of PRA and the reassurances given to our members on 12 May. Many, perhaps most, societies' experience of the application of the existing Sourcebook has been satisfactory. But for some societies, on some occasions, the tendencies towards inflexibility, and treating the Sourcebook text and the tables with their limits as quasi-rules, have surfaced. We attribute these occurrences variously to lack of understanding, lack of confidence, or excess of zeal on the part of individual supervisors. Going forward, our members have to take on trust from PRA that these behavioural aspects (which are almost as important as the words on the page) will prove satisfactory, in line with its assurances. We agree with PRA at paragraph 1.3 that the pre-specification of its expectations will be helpful to societies. So we also think that the BSA's pre-specification of our members' legitimate expectations, that the supervisory application of the Sourcebook will adhere to the assurances already given, will be helpful to the PRA's management.

Among the issues relating to application we mention briefly the following: legacy positions; intermediate situations between approach categories; and early adoption. Regarding legacy positions, PRA has confirmed that there will be no expectation that a society with existing stock of e.g. a particular kind of niche lending, that is greater than the new or updated indicative limit for that society's approach category, will be expected to dispose of any assets – though clearly new lending will be constrained. Regarding intermediate situations (bulges or extensions) between approaches, we understand that the present sensible practice will continue. The BSA attaches great importance to this for the following reason (which also explains why we think it helps to achieve the PRA's own objectives better). Within non-traditional lending, for example, a smaller, less sophisticated society on the traditional approach may only wish to pursue one single type of such niche lending (e.g. self build) – where it has extensive experience, expertise and a good track record on actual losses. The society may have no intention of lending in other niches for which Appendix 2 provides limits, or need to move to the next higher approach in terms of its lending as a whole. So it is important that the application of the Sourcebook framework accommodates that society as its Board agrees to a higher limit, without incentivising the society to move to the next higher approach merely in order to achieve a higher limit for one specific niche.

Finally, we note that a society may now commence the internal work of deciding that its own Board limits (based on the existing Sourcebook text) should now be changed, with due process, to reflect a different risk appetite etc, with suitable reasons, and then engage with PRA on the basis of that, ahead of the finalisation of the revised Sourcebook text. That is, a degree of early adoption is permissible. However, societies should clearly not expect to short-circuit that process by changing the % limit stated in the society's own policy merely because the revised Sourcebook proposes a more generous limit.

Specific counter-proposals

Indicative limits for niche lending

On self-build, in light of the evidence referred to above, we consider higher indicative limits would be appropriate. There is also a definitional point – as self-build loans involve several drawdowns during the construction phase over a period of two years or so, a society has to decide whether to monitor its current stock, against the applicable limit, on the basis of aggregate amounts of advanced, or on the basis of total commitments. Undrawn commitments are obviously a far more significant feature than with conventional mortgage lending. That being the case, higher limits (and consistency of definition) are needed. The BSA's counter-proposal is that the indicative limits for self-build construction phase should be increased from 5% to 15% for the traditional approach; and from 15% to 25% for the limited approach.

Buy to let: post completion

One member has contributed the following important practical point. The final revised text, when published, should make clear in the context of post completion loan administration (paragraph 3.27 (j)) the need to differentiate the requirements for single property backbook loans from that needed for portfolio landlords. The issue here, as touched on in the consultation paper, is one of proportionality and the cost implications of the annual review contemplated.

Where a lender has a material, active multiple-property backbook loan relationship with a portfolio landlord, it seems to be entirely reasonable that a comprehensive review of the totality of the portfolio (examining, for example, portfolio level LTV, portfolio level ICR and debt coverage, voids and refinance risks) is appropriate. However, the same level of review is arguably not required where the relationship is limited to a single loan to a portfolio landlord who has assembled a large portfolio utilising loan facilities from a wide range of different lenders where it would be more appropriate to use trigger events (such as missed payments) to provoke a more detailed review.

Explicit recognition of mortgage insurance

Given the degree of detail on specific risks attached to various kinds of non-traditional lending, we think PRA has missed an opportunity to recognise the positive benefit of the risk transfer that can be achieved through mortgage insurance. MI can significantly reduce crystallised risk, whether or not it is for the time being recognised for capital purposes.

Timeline on changes of approach

The PRA should commit to an expectation that a submission for a change of approach or an intermediate situation (bulge or extension) should be turned round by PRA within say three months, and that all material communications by PRA regarding such submissions should be, or be confirmed, in writing.

Non-retail (corporate) deposits

The revised Sourcebook definition of NRCDs, as distinct from deposits from individuals, mentions local businesses and professional firms (e.g. solicitors). Strictly, these depositors will often not be *corporate* at all – most solicitors' firms remain traditional partnerships, and many small businesses remain unincorporated. Non retail (*business*) deposits would be more accurate terminology. And some of these sub-categories, e.g. small (below FSCS limit of £75,000) deposits from smaller local businesses tend not to be at all volatile. More importantly, the BSA considers the indicative limits generally too low: a more sensible indication would be: for administered approach, 15% SDL (not 10%) and for matched approach 25% SDL (not 15%).

Wholesale funding

The introduction of maturity limits for wholesale funding for societies on the extended approach appears to be a new departure, at least for societies formerly producing full ILAAs rather than benefiting from the simplified (pre-LCR) liquidity regime. While the desirability of pushing out funding to longer maturities is accepted, there is a practical problem arising from the proposed ladder. A society that had prudently secured a major tranche of longer term funding, say at original maturity of 3 years +, could have difficulty in complying with the 2 year and 1 year limits as this (prudent) term funding rolls down across the time buckets towards final maturity. At the extreme, a society might be driven to attempt to part-prepay just to stay within the limits. We wonder if the proposed maturity ladder limits can be reformulated in a way that avoids this unintended consequence. But if the ladder limits operate as stated, we suggest a modest recalibration: ≤ 12 months, from 10% to 15% SDL; ≤ 2 years , from 15% to 20% SDL; and ≤ 3 years, from 20% to 25% SDL.

PRA should also be aware that the tenor of matched secured funding is naturally reducing. One member has pointed out to us that the average life at which RMBS are now issued implies an average duration for mortgage collateral of only 2 to 2.5 years, compared with 4 to 5 years in the past. At the same time, many societies may be unable to raise wholesale funding beyond 12 months except through RMBS – which the encumbrance limits- see below- seek to discourage. The trade off of some encumbrance for more stable, medium term funding may well be a positive one for all concerned.

Encumbrance

This section (paragraphs 4.77-78) make perfectly sensible points about the effects of **encumbrance** on other funding. The Table in Appendix 5 then restricts **administered** societies to encumbrance only in respect of central bank facilities, while **matched** societies can additionally use market repo only. But **administered** societies must equally hold their LCR requirement in HQLA, and have few options: central bank reserves; gilts <3 years, and T-bills. Both the latter need to be monetised to provide the required cash. Presumably, since administered societies can hold these assets, but cannot do market repo, the PRA expects monetisation to be done either by outright sale (crystallising any market risk) or by using them as collateral for drawings from the central bank. However, there may well be other providers of funds who would more readily lend to such societies on a secured basis than on an unsecured basis.

The effects of encumbrance on the positon of unsecured creditors, including as a result of overcollateralization and haircuts, does not depend on the identity of the secured creditor – so we question the implicit assumption that encumbrance in favour of the central bank is somehow more benign than equivalent encumbrance in favour, say, of one the society's major bank counterparties. The BSA considers that administered societies should be able to provide collateral to major bank lenders, if needed, as well as to the central bank.

Turning to the restriction on **matched** societies, **we also urge PRA to recognise the positive benefits of secured funding structures, which can be a way of diversifying and lengthening the funding available to medium and smaller societies,** including those on the matched approach, provided the prescription limiting their encumbrance to central bank and market repo only is lifted. Market repo, by contrast, tends to be shorter dated, and entails haircuts and mark to market adjustments. And, as with administered societies, matched societies may be able to access prudent medium –term funding from a major bank counterparty, and this should also be permitted. In this context, we welcome the insights in the response being submitted by BSA associate InCol Limited, and we urge the PRA to further discussions on this issue.

Conclusion

The revised Sourcebook as proposed in CP 12/16 is, overall, if sensibly and flexibly applied, a reasonable vehicle to achieve the PRA's objectives on risk management, alignment with risk appetite and reduction of crystallised risk. The BSA considers that the PRA's acceptance of the BSA's counter-proposals, and correcting the minor errors and inconsistencies already identified, will further enhance the Sourcebook's suitability and effectiveness, while striking a better balance between prescription and freedom. The BSA and its members will be very happy to provide any further information and assistance to the PRA in the post-consultation finalisation of the revised Sourcebook.

Annex: minor errors/ inconsistencies

Items or comments not previously notified to the PRA after 12 May are shown *in italics*.

Paragraphs 2.6 and 5.1

Both contain references to Chapter 0.

Paragraphs 3.15 to 3.19 – pricing of risk

PRA to clarify that this does not mean societies should be pricing differently for each customer based on his/ her risk, *notwithstanding the mention in paragraph 3.17 of "information available from credit reference bureaux". As one member has pointed out, individual pricing potentially raises conduct issues too, and it is not general practice in the mortgage market.*

Paragraph 3.21 – non-traditional residential lending

Is the reclassification of credit-impaired loans solely for internal reporting purposes? If so, the inconsistency between internal and external approach seems wrong. PRA to clarify.

Paragraphs 3.22 to 3.27 - buy to let

PRA to confirm that all buy to let will be classified as BTL and the reference to commercial or portfolio landlords refers only to aspects of the underwriting process expected. PRA will ensure BTL requirements consistent with the consultation paper, *Underwriting standards for buy-to-let mortgage contracts*, CP 11/ 16.

To illustrate this point further, CP 12/16 prescribes at paragraph 3.27 a list of factors to be taken into consideration, mostly at the underwriting stage. Some of these items are obvious common sense – in which case we wonder why they were not included in CP 11/16 as they contain nothing specific to building societies. A few of the items go further, for instance indents (c) – personal taxation provisions; (e) – availability of other security ; and (h) - borrower's other BTL exposures ; are, taken together, quite intrusive. On competition grounds, if no others, these prescriptions should either be extended to all BTL lenders subject to PRA regulation, or – if the CBA does not support that – they should be removed from the revised Sourcebook.

Paragraphs 3.38 -39 and Appendix 2 – lifetime

PRA to adjust maximum LTV for interest-paid lifetime – not to be the same as LTV for interest roll-up, as wrongly stated in Appendix 2.

Paragraphs 3.28 to 3.31 - self build

PRA to clarify that guidance on self build refers only to the construction phase – i.e. after completion of the building, self build loans become mainstream.

PRA to acknowledge the greater risk of making stage payments in advance of building work compared to paying out in arrears against work done.

Text on “custom build” to be decoupled from “self build” and its lower risk nature acknowledged. *The BSA’s understanding of the distinctions is given below.*

Self build *projects are where someone directly organises the design and construction of their new home.*

This covers quite a wide range of projects. The most obvious example is a traditional “DIY self build” home, where the self builder selects the design they want and then does much of the actual construction work themselves.

Self build also includes projects where the self builder arranges for an architect/ contractor to build their home for them; and those projects that are delivered by kit home companies (where the self builder still has to find the plot, arrange for the slab to be installed and then has to organise the kit home company to build the property for them).

Many community-led projects are defined as self builds too – as the members of the community often do all the organising and often quite a bit of the construction work. Some people have summarised self build homes as those where people roll their sleeves up and get their hands dirty by organising or doing the physical work themselves.

Custom build *homes tend to be those where you work with a specialist developer to help deliver your own home.*

There are a range of different business models available so this can mean anything from the developer securing or providing a site in the first place, through to managing the construction work and even arranging the finance.

Custom build developers will offer different degrees of customisation, some offer a menu of different options to choose from, allowing you to select for example different roofs, porches etc and will fully complete your home, others may build the property to a watertight stage so that you can then complete yourself to your own requirements.

Given that a developer is effectively managing the project this type of house building is often viewed as less risky than self-build and goes some way to de-risking the process –as it is more likely to be delivered within budgets and timescales.

Paragraph 4.30 and Appendix 3 – internal audit

Paragraph 4.30 states sensible enough that “societies with complex treasuries or lacking internal auditors with treasury expertise should consider co-sourcing or outsourcing treasury audits to an audit firm with the appropriate expertise and experience”, but Appendix 3 states that while matched societies may have non-specialist IA that they supplement with outsourced or co-sourced specialist support in the treasury area, extended societies should have “specialist IT and treasury IA” – the clear implication being that extended societies should have specialist IA in-house and should not outsource or co-source this. We do not believe this was intended, and it should be corrected.

Paragraph 4.60 – wholesale counterparty credit management

This paragraph refers to “more active treasury operations needing a separate wholesale credit risk committee.” The definition of the extended approach (as set out in paragraph 4.146) would seem to imply that an extended society already has a “more active treasury operation”. However, for societies with a limited requirement for wholesale funding and robust controls already in place around the governance of counterparty credit risk (for example daily monitoring by a middle office function, monthly oversight by ALCO), the requirement to establish a separate wholesale funding credit risk committee *seems disproportionate. Therefore, some clarity around what “more active” means would be beneficial.*

Paragraphs 4.70 to 4.72 – non-retail (corporate) deposits

PRA to review the wording to reflect the variety of non-retail corporate funding. The revision will acknowledge the considerable difference in the likely behaviour of client accounts and pension funds compared with small SME accounts.

Paragraphs 4.133 and Appendix 5 – administered approach

Text says no wholesale funding yet appendix provides details of wholesale funding allowable. PRA to amend.

Paragraphs 4.136 to 4.141 and Appendix 3

There are some conflicting numbers on how much is required on administered rates for matched approach >50%, 40% maximum on non-administered and 40% minimum on administered up to one year. PRA to clarify.

Paragraphs 4.138 and 4.33 - HQLA

OLAR does not have to be covered wholly by HQLA – *other assets (including, especially for smaller societies in relation to intraday risk, credit balances held at the principal clearing bank) have a role.* PRA to reword.

Paragraph 4.139 - matched approach

Could the PRA clarify what is "short term" in terms of deposits with banks and or other societies?

Paragraph 4.141 and Appendix 3 - treasury

Matched approach - fixed rate lending/ funding is a maximum of five years, not three. PRA to amend. They also said that they would look at making clearer what the Fixed rate limit was on the matched approach

Paragraph 4.148 - extended approach

PRA to clarify the second part of the last sentence so that it refers to independent second line. PRA also to clarify whether, for consistency, reference should be to a chief risk officer rather than head of risk.

Paragraph 4.153 and Appendix 5 – encumbrance

Extended approach – 20% in the text and 15% in the appendix. PRA to align. Clarification sought that the level excludes Government funding schemes such as FLS.

Also a definitional problem – where an extended society uses central bank facilities to pledge illiquid mortgage collateral and receives gilts or T-bills, which it then monetises by market repo, the second leg would appear to count against the encumbrance limit, even though it is a necessary follow on to the initial use of central bank facilities, which are excluded from the encumbrance limit. This might mean an extended society is constrained to use only those central bank facilities where the Bank provides reserves rather than gilts or T-bills against the society's *collateral. Or does the PRA mean that any encumbrance – including on the subsequent repo of gilts or T-bills – originally derived from use of central bank facilities – is to be excluded?*

Paragraph 4.163 - middle office

Comprehensive approach – "middle office" does not report to the CRO. PRA to amend.

One society commented that, where resource is available, having middle office reporting to the CRO conflicts with perceived best practice in the design of the three lines of defence.

Appendix 3

Under the "risk management structure" row, the PRA should be consistent in terminology – under the extended approach the reference is to second line reporting into the CRO and under the comprehensive approach it refers to risk director.

Appendix 5

Extended approach - maturity structure of wholesale market funding is the same as for traditional and matched. PRA to check and amend. <12 months should be possibly 15%, two years 20% and three years 25%.

Appendices 3 and 5

The indicative limits, depending on the particular approach, should – we presume – apply in a business as usual environment. Under stressed conditions, the top priority is meeting immediate obligations and maintaining available liquidity, so that – for example – use of wholesale funding may shoot up as a society resorts to secured funding, including central bank facilities, as part of its contingency funding plan. We think it would be sensible for the PRA to make clear that the complex limit structure is for BAU circumstances, and may be "trumped" by the exigencies of a stress situation, including actions mandated by a society's CFP or recovery plan- because (lest we forget) survival is more important.

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