A Strong and Simple prudential framework for non-systemic building societies and banks

BSA response to PRA DP 1/21

July 2021

Building Societies Association

Introduction

The BSA is very pleased to respond formally to the PRA's bold, farsighted and ground-breaking initiative towards a more proportionate and effective prudential regime for smaller deposit takers. We have warmly welcomed each of the steps leading up to DP 1/21, and the BSA's governing Council recently affirmed its support for the general approach and direction of travel. We also greatly appreciate the PRA's openness and engagement with the building society sector, and are determined to play a constructive role in the development of the "strong and simple" regime. And we encourage the PRA to remain bold and ambitious as this project progresses. This is a truly historic opportunity for the majority of BSA members.

The BSA response endeavours to present, as far as possible, a coherent, cogent and consistent position, answering the specific questions in the DP. This response broadly follows the DP's sequence. Individual societies' circumstances and future plans vary of course, so there will naturally be a spectrum of views on the contents of the DP. While the response represents the majority consensus, significant divergent views are also noted in passing, and the BSA has encouraged all its member societies to contribute their own individual responses, whether broadly in support of the BSA response, or with different perspectives.

The PRA's initiative is not only very welcome in itself, but also – as an early mover on better regulation post-Brexit– it signals the direction that other authorities, whether Government departments or other regulators, ought to follow. The same thinking that has challenged the EU-based consensus on the single rule book on grounds of proportionality should be applied to challenge other EU-derived nostrums – prime among which is the concept of the "public interest entity" (PIE). We do not think it is necessary or desirable for smaller deposit takers automatically to be classed as PIEs and will be making this point forcefully in responding to BEIS' current consultation. Where PRA has shown the way, let others learn and follow.

Executive Summary

We welcome this initiative, and agree that the PRA's analysis of the complexity problem, resilience, avoiding barriers to growth, and its long term vision for a strong and simple framework, are all essentially correct. The PRA should as proposed start with a regime for the smallest firms, but within an outline plan to cater for larger non systemic firms as well. This simplest regime should focus on standalone domestic UK firms only, up to say £ 5 bn in size, but excluding features such as IRB modelling, trading books, defined high risk activities, and on certain other criteria. There will need to be layers, but not too many.

While a majority of BSA members prefer a more streamlined approach, this could also be an interim solution, with quick wins, but does not preclude developing a more focused approach in the longer term – the latter being attractive in principle to some small societies.

Calibration is however critical - if the new regime goes too far with excess conservatism, the endeavour will fail, as ultra-high resilience is not competitively sustainable.

Many other current demands – ICAAPs, ILAAPs etc - could be greatly simplified, and facilitated by templates. Pillar 3 disclosures should be largely dispensed with, as they are a waste of time for small simple firms.

Regulatory reporting is of prime importance, as the most burdensome area of all. We suggest various ways to cut back the burden- gaining some more quick wins-and at the opposite end, point to the simplicity of credit union returns.

It is time for PRA to consider what if any further role SS 20/15 - the “Sourcebook” - really has, given the strong and simple approach : reverent retirement may be best.

The BSA and member societies stand ready to help PRA further in developing the strong and simple regime, and applaud the initiative.

Context

The building society sector includes societies of all sizes (see the BSA's own statistics[1] on asset size rankings and concentration) from very large to fairly small. At the large end, Nationwide BS is a domestically systemic firm. Several other large societies are regarded as near -systemic and therefore expected to hold bail-in resources (MREL). But the majority by number of societies are medium-sized or small. They would, for instance, qualify already as **"small and non complex banks"** (SNCBs) under the definition (see Article 4 .1(145)) in the EU's CRR2[2]. We expect, therefore, that the majority of societies should be able to benefit, perhaps substantially, from a strong and simple regime, and accordingly the BSA is devoting considerable collective effort to help PRA make a success of this initiative.

Our members' need for proportionality has grown over time. The standard prescription of applying Basel capital standards, designed for large internationally-active banks, to all deposit takers, has proved more and more onerous and counterproductive for medium-sized and smaller societies. So the BSA's advocacy of proportionality has developed accordingly.

The main obstacle hitherto has been the EU's approach of single market uniformity and the single rule book. Although proportionality is supposedly guaranteed by the EU's founding treaty[3], in practice this has largely been trumped by single market ideology (notwithstanding protestations to the contrary). As long ago as 2013, BSA identified this growing problem in our response to the UK Government's Balance of Competences Review[4]. We (alongside other representatives of smaller banks across the EU) also advocated strongly[5] for a more proportionate regime for small deposit-takers in the review of CRR – although that achieved only limited success - viz. the reliefs for small and non complex banks cited above, especially the cutting back of Pillar 3 requirements, and the mandate to reduce supervisory reporting costs for SNCBs.

Following CRR 2, we also took a leading role in EU-wide advocacy for, essentially, the strong and simple principle, by national associations of smaller cooperative banking networks. Our joint paper, ***Proportionality in EU banking regulation : the case for a step-change to accompany the introduction of "Basel 4"*** published[6] in June 2019, foreshadowed in many respects the thinking in DP 1/21 – including the complexity problem and international comparisons.

The other piece of parallel work – particularly relevant under a more streamlined approach – is the EBA's mandate under CRR 2 to reduce supervisory reporting costs for SNCBs by between 10%-20%. That ambition is modest enough, and the EBA has recently provided[7] its first report and recommendations. Since for the time being banks and building societies are still mostly completing the EU-derived COREP returns, the EBA's (again modest) proposals provide a relevant yardstick or baseline against which the PRA can be seen to excel.

So, moving on from DP 1/21, we expect the PRA to go far beyond the rather timid tinkering that characterised the CRR 2 concessions to SNCBs. Now free from the ideological and legal constraints of the single rule book, the UK and the PRA can pursue genuine proportionality and improve overall outcomes. We are particularly pleased that the PRA has moved quickly to seize this opportunity.

---

[1] https://www.bsa.org.uk/statistics/sector-info-performance/sector-information
[2] Regulation (EU) 2019/876
[3] See Article 5, Treaty on European Union
[4] https://www.bsa.org.uk/information/industry-responses/balance-of-competences-review
[5] https://www.bsa.org.uk/information/industry-responses/impact-of-crd-4-on-financing-the-economy
[6] https://www.bsa.org.uk/information/industry-responses/proportionality-in-eu-banking-regulation
[7] Study Of The Cost Of Compliance With Supervisory Reporting Requirements

The BSA's largest, but still non-systemic, members - forming a "marzipan layer" between large systemic banks, and much smaller, simpler firms -typically have a different priority at present. They suffer much less from the complexity problem as they have larger resources (though one of our larger members points out that staying up to date with emerging regulation, piecing it together in a strategic way and attracting/retaining sufficient and appropriate SME resource remains a significant challenge even at their size). . Most have voluntarily adopted internal modelling, which entails a major increase in complexity and investment in systems and knowhow. Their principal concern has been in the area of MREL : through a combination of ill-judged EU prescription, and the possible extension of the leverage ratio, they faced an exceedingly disadvantageous and prejudicial treatment if MREL => 2 x LR. We have addressed this separately in discussions with the Bank and PRA : we are now hopeful (following CP 14/21) for a better outcome, but record the point here for completeness.

Leaving MREL aside, these largest members have a concern that they may be left competitively disadvantaged as the "squeezed middle" – with neither the full massive economies of scale and market power of the systemic banks, nor the benefits that may soon accrue to the smaller and simpler banks. They therefore await with interest the PRA's offering to their category.

DP Chapter 1 – introduction

We agree with and support the principal points made early in this chapter (paragraphs 1.2, 1.4 and 1.5). The key challenge is to overcome the **complexity problem** while maintaining **resilience** and also not creating **barriers to growth**. The BSA has always accepted that the maintenance of high levels both of **individual firm resilience** and of **collective financial stability** is essential. Indeed, the BSA may have been one of the first to articulate the idea of the "simplicity premium" – that a reduction in regulatory complexity could be accompanied by a compensating modest upward calibration of key resilience measures, while still providing an overall net gain for smaller firms. **But calibration is critical – if the extra level of conservatism is too great, it will cause the whole initiative to fail. Not because societies are unhappy in principle to hold more capital, but simple arithmetic demonstrates that ultra-high capital levels make their business unsustainable. To that extent, the BSA's, and societies', welcome for the DP 1/21 project must remain contingent on the final calibration.**

We also appreciate PRA's decision to outline in this DP the principles, possible design choices, and areas for inevitable trade-off, and to seek input and consensus before proceeding to detailed proposals in a future CP. Finally, we agree with PRA that any regime should remain consistent with the **Basel Core Principles for Effective Banking Supervision** which – in contrast to the capital framework – were designed for universal application.

DP Chapter 2 – existing framework

The chapter correctly identifies, based on latest information, the global picture of greater regulatory proportionality for smaller banks - hitherto obscured by the UK's absorption in the EU, whose single rule book turns out to be an outlier in this respect. There is also a very intelligent examination of corresponding prudential frameworks in the US, Canada, Australia and Switzerland that helps identify some of the possible design choices for the UK. These international comparisons are particularly helpful in reassuring other UK stakeholders that **adopting a strong and simple approach is not an untried experiment**, but closer to the global norm, and has been successfully followed in other leading jurisdictions. (Switzerland, for example, has always been regarded as tough on banking regulation, and recently introduced[8] its *Kleinbankenregime*.) The analysis of distress prediction is also interesting and usefully supports the main case.

Q1 : The **complexity problem** is accurately summarised in this chapter. We can support PRA's evidence (Chart 1) with further information collated by the BSA in 2016 : the ratio of compliance staff costs to assets was considerably (nearly ten times) higher for smaller societies than for larger societies. BSA analysis of 2014/15 data found that for the largest societies, compliance staff costs averaged around £45 per million pounds of assets. For small societies, the average was nearer £450 per million pounds of assets. Similar experiences have been observed by our cooperative banking friends in parts of the EU-27 as well. We are happy to share more details of our research with PRA.

We also agree in principle with the PRA's identification of the **barriers to growth** problem, though this problem is much more acute for the fastest growing firms, like new or challenger banks, whose strategy involves rapid growth relative to the whole market. Most building societies by contrast pursue organic growth, enabled by capital from retained earnings, and their relative size may change only slowly. The BSA suggests that a simple way to mitigate the barriers to growth problem as regards building societies might be to set a **dynamic** size ceiling (s) for the strong and simple regime (s) against some measure of total market size, rather than rely merely on an absolute £ figure. The ceiling(s) would naturally grow (with an upwards-only ratchet) over time and prevent firms being captured purely on account of the upward inflationary drift in their absolute size.

DP Chapter 3 – long term vision

Q2 : The BSA supports the long term vision outlined in paragraphs 3.1 and 3.2, including (as mentioned above) adherence across the board to the **Basel Core Principles**. Chart 2 illustrates the extensive scope in theory for the regime(s) covering non-systemic and domestic firms, comprising not only the great majority of building societies, but also a clear majority of all UK deposit-takers (excluding credit unions – but see below).

Q3 : We agree that, as stated in paragraph 3.4, a single new regime is unlikely to cater adequately for the entire range of non-systemic firms. Consequently, we think there will have to be **some limited layering**. At minimum, we envisage a **radically simpler regime for small banks and building societies (probably covering at least those that qualify as SNCB under CRR 2)** and a more advanced regime for the remainder. It has been noted that the typically very smallest deposit-takers – credit unions – already have their own bespoke strong and simple approach. Several large credit unions however now exceed in size a handful of the smallest banks and building societies. **The dovetailing of the existing large credit union regime should therefore also be considered in the round – we suggest how below.** At the same time, we are wary of aiming for too many layers. Not only does this bring back complexity, but we suspect that diminishing returns on the scarce PRA policy and supervisory resource will set in quite quickly. **The greatest gains from the strong and simple initiative will, we expect, be realised among the smallest firms benefiting from the simplest of the new regimes.** The incremental gain from adding several more layers for the in-between firms will be smaller and smaller.

Q4 : For the same reasons, we broadly support the PRA's plan to start with the simpler regime for the smallest firms. It would nevertheless be highly desirable for PRA to be able to outline its general plans for the whole sub-Basel framework at the same time as coming forward with detailed proposals for the smallest firms, bearing in mind that to some extent, design choices for the intermediate firms may be influenced, if not constrained, by decisions

[8] https://www.finma.ch/en/news/2019/11/20191127-mm-kleinbankenregime/

for the smallest. This is a strong message from our larger members, the "marzipan layer" of societies mentioned above. While in no way do they wish to obstruct smaller societies' rapid realisation of their greater benefits from "strong and simple", they are concerned that they themselves could face an extended period of "planning blight". A concrete example illustrates this: a society in the range £5bn to £ 10 bn total assets may be ready to start developing internal modelling capability for mortgage credit risk, with a view to migrating to IRB risk weights in due course. That decision is now complicated by the possibility that the move to IRB might disqualify them from a future layer of "strong and simple". **Some early visibility of PRA's intentions for intermediate firms is therefore highly desirable.**

DP Chapter 4 – the simpler regime

We agree fundamentally with paragraph 4.2 : the simpler regime should be designed for small firms that are not internationally active, where the complexity problem is pronounced, and with activities and business models such that their resilience could be assured under a relatively simple set of prudential rules : actual criteria for determining whether a firm is in scope of the simpler regime should reflect these characteristics. As previously mentioned, the majority of building societies fall comfortably and naturally within scope according to this description. We would also add that the simple regime should be designed primarily (if not exclusively) for the benefit of **standalone domestic UK firms - small building societies and small independent UK banks**. We see little need to cater for either small banks within large (near systemic or systemic) UK groups, or small subsidiaries of foreign banking groups. We return to this below.

Q5 : Given that UK building societies are overwhelmingly domestic, the exact definition of a disqualifying level of international activity is of less concern to the BSA. Following the UK's exit from the EU, no society currently undertakes an explicit cross-border line of business into the EU-27. The main areas of overseas contact for simpler building societies are servicing UK expatriate savings and mortgage customers, and undertaking occasional wholesale market transactions with counterparties outside the UK, or in non- sterling currencies. A few societies also undertake some activities in the British Overseas Territories – Jersey, Guernsey, Isle of Man and Gibraltar ("**domestic UK" should therefore include these territories**) or cater for members living / working on both sides of the Irish border (similarly to be treated as domestic business). As a first step, we would favour (for simplicity) using the existing definitions of cross border activities mentioned in paragraph 4.5, with carve-outs where necessary.

We agree that the simple regime (for the smallest firms) should be based on a straightforward and generous **size measure**, complemented by a few other exclusion criteria related to **complexity**. We are content with the simplicity of a total assets measure, noting that this has already been applied under CRR2 – where the criterion is < € 5 billion. **A good starting point would be a total assets ceiling of £5 billion**. But – as mentioned above – the ceiling should also be dynamic, being allowed to rise naturally (with an upwards-only ratchet) in line with the overall growth of the banking sector. This could be done either by specifying periodic revalorisation of the £5 bn figure, or by tying the ceiling also to a specified small percentage of the total banking sector assets. We are also open to modified size measures such as total assets minus HQLA, or total retail deposits, **provided the overall effect is at least as comprehensive as the SNCB definition in CRR 2.** Some of our members would moreover encourage PRA to be bolder and set the overall ceiling much higher, at say £ 10 billion TA, pointing out the high comparable ceilings in the US.

Q6 : The three exclusion criteria discussed in paragraphs 4.8 to 4.13 all make sense for the simple regime (i.e. for the smallest firms) only – they need not and probably should not apply in the same way to any higher layers – see also the preceding remarks.

The choice of **IRB modelling** involves a voluntary acceptance of new complexity and expense – the initial and ongoing investment in modelling systems is quite considerable – so this suggests (as indicated in paragraph 4.9) that IRB use would be an excluding criterion for the simple regime for the smallest firms, though not necessarily for any intermediate firms. As indicated above, it is probably not desirable artificially to inhibit large intermediate firms from developing (or maintaining) IRB capability if it feels right for them.

A similar argument applies to **trading books** - leaving aside the normal activities of holding and monetising liquid asset instruments, and using derivatives to manage intrinsic balance sheet risk (which almost all deposit-takers need to do, but do not amount to proprietary trading). As suggested in paragraph 4.10, firms with a non-zero, or non-trivial, trading book should be excluded from the simple regime (though again, not necessarily from any intermediate regimes) in order to retain optimum simplicity. We mention in passing that for these intermediate regimes, trading book activity could benefit from a modular plug-in : the market risk, CCR and CVA requirements could be applied in addition to the basic framework.

Paragraphs 4.11 to 4.13 sensibly address the questions of high-risk activities ; the provision of clearing and settlement services ; undertaking critical functions ; and the correlation with resolution strategy. **The BSA broadly agrees with the PRA approach on all of these points**, though detail and definition will need some more work. Most straightforward is the link with **resolution strategy** : we agree that the simple regime should be available only to firms assigned to a modified insolvency strategy. Similarly, providing **clearing and settlement services** to other institutions means being part of the UK's financial markets infrastructure, and in our view does not fit with the strong and simple mandate. The same is true up to a point for **critical functions**, though this is also a matter of scale – as paragraph 4.13 accepts. Where for instance a society provides e.g. some savings administration services, as a subsidiary to its main business, we do not think this should necessarily disqualify that society from the simpler regime if it met all the other criteria. As paragraph 4.13 suggests, this might only be appropriate if the firm in question is a *significant* (to be defined) provider, and has in consequence been assigned a bail-in resolution strategy. So we agree with the implicit view in paragraph 4.13 that where such a firm retains modified insolvency as its resolution strategy, any provision is not significant enough to disqualify it from the simpler regime. Finally, turning to **high-risk activities** : we broadly align with PRA's stance on this, though it is unlikely to affect our members who do not undertake such activities anyway. The simple (or simplest) regime should not have to be complicated to deal with high-risk activities by a small minority of banks. Care is needed, however, with definitions. The BSA does not consider niche areas of the mortgage market – which our members may serve as part of their wider offering –to be "high risk activities". The truly "high risk activities" can be best understood by reference, for instance, to the Basel framework categories of **"specialised lending"** and **"commercial ADC"** for which risk weights well above 100% are to be applied. See sections 7.2 (paragraphs 44 to 48) and 10.3 (paragraphs 74-75) in the BCBS 2017[9] document.

All the above observations relate to the simple (or simplest) regime only – the prescription could be different for intermediate regime (s).

Q7 : the BSA supports two-way **optionality** – that is, firms that initially qualify for the simple regime could choose not to adopt it ; and later on, firms that are initially within the simple regime could choose to move to an intermediate regime or the full Basel regime without having to wait to be disqualified against one of the simple regime criteria first. We think this will cater for fast growing banks that may not expect to qualify long term for the simple

[9] Basel III: Finalising post-crisis reforms (Dec 2017)

regime. But we suggest the optionality is accompanied by our earlier suggestion that the size criterion should have an upwards-only dynamic component so that its real effect as a measure of significance / impact is not eroded over time, with otherwise qualifying firms being dragged out of “strong and simple” by inflationary drift. We have an open mind as to the **mechanism** : the waiver route makes sense, and on balance we think firms should opt in to strong and simple rather than vice versa. We also discuss below the possibility of separate optionality at modular level e.g. capital or liquidity.

Q8 : **Groups , foreign subsidiaries and herding**

The BSA’s view, answering DP Q8, is that the strong and simple regime should be designed for, and focus on, the **smallest standalone domestic UK firms only**. This is of course without prejudice to whether other firms – either parts of large UK banking groups or UK subsidiaries of foreign banking groups – should be eligible for any intermediate regime. As identified in paragraphs 4.16 to 4.20, subsidiaries of large groups do not experience the complexity problem, as they have the resources of the large UK or foreign group to draw on. At the same time, they are likely anyway to be precluded from substantive benefit as they will (and should) remain subject to consolidated supervision at group level and at least on key Pillar 1 requirements such as capital and liquidity will be obliged to calculate and comply with full Basel rules on a consolidated basis. If the foreign group is EU-based, or has a regional presence in the EU, it will have to apply full Basel / CRR requirements either at group consolidated level or subconsolidated at the level of the EU intermediate holding entity. So we see no need, and little positive justification, for the **simpler** regime to seek to cater for such firms – though we appreciate the PRA considering the matter.

Any possible increase in the risk of **“systemic as a herd”** should be considered, but is likely to be greatly outweighed by other more important factors. Building societies already have some “herd” character as a result of the statutory mandates in the Building Societies Act requiring intentional focus on the low risk model of residential mortgages funded by retail savings. This herd quality exists regardless of the prudential regime, nor do we think it will be much affected by a move from full Basel to a simple regime. Decisions or trends in UK banking supervision tend to push towards lower-risk, and inevitably more herd-like, models as the net resilience gain is believed to be substantially positive. At the large bank end, this is fundamental to ring-fencing, which explicitly trades herding around low-risk activities against potential diversification benefits. For building societies, this is certainly the effect – if not the intention – of both the Building Societies Act and the Sourcebook approach. We comment in detail below on whether there is still a need or a place for the Sourcebook in a new simple regime. There are, in any case, other macroprudential tools that can address herding risks in particular asset classes.

Streamlined vs focused

This is probably the most important area of debate for building societies. Before outlining where we think societies’ preferences lie, we start by setting out two important factors : the influence of **“sunk costs”** ; and the **by-product benefits** of some elements of complexity.

The overall cost burden arising from the complexity of current prudential regulation and regulatory reporting has two components, which we can illustrate by reference to the COREP returns which were quite unnecessarily imposed by the EU on all societies under CRR. The FSA/PRA itself estimated in CP 5/13 that the initial **embedding** costs for COREP for all UK CRR firms would be £ 700 mn , with annual **running** costs of £ 900 mn odd. Those initial costs, and several past years’ running costs, have now been spent and cannot be recovered – the only saving going forward would be the net difference in future running costs between COREP and a simpler alternative, less any initial costs for embedding that alternative. Since any change involves systems work and can be costly, a short term view is to put up with something imperfect, thereby obtaining in one sense further value from the sunk costs already incurred. The long term view might be different : if the alternative is compelling enough, the additional cost and disturbance of change is a small price to pay for a stream of substantial benefits. It can also be argued that any truly **sunk costs** should be immaterial to this choice.

By-product benefits are a more subtle issue. One of the leading prudential theories from Basel 2 onwards was that the added complexity of features such as ICAAPs, or IRB modelling, would also drive improvements in risk management with wider benefits than appeared merely in the narrow calculation of capital. This idea is not without merit. Some societies would agree that the experience of having to do e.g. ICAAPs has generally improved their overall risk management capability, and they would understandably be **reluctant to go backwards**. For instance, performing more and more sophisticated mortgage book analysis is reckoned to be generally a good thing. The question, however, is whether there are better, simpler and more efficient ways to maintain appropriate capital without sacrificing risk management experience.

Paragraph 4.25 well describes the concepts of **streamlined** and **focused**, making clear that they are theoretical constructs at either end of a spectrum, not necessarily put forward in themselves as a binary choice : the final regime could well be somewhere in between. Table 2 illustrates some of the main advantages and disadvantages**. A further point is whether a streamlined approach remains subject to further change merely because the full Basel framework (from which it derives) itself changes. Or not ?**

An early contribution from the BSA was to raise the possibility of a two-stage process : an interim, more streamlined framework, yielding quick wins from carving out swathes of unnecessary CRR regulation and reporting, but leading ultimately to a more focused regime, allowing time to get it right, including the all important calibration. This could prove attractive to many societies, and we are very keen to explore it further.

Paragraph 4.27 gives an assurance which is extremely important for BSA members, and which the BSA therefore welcomes and applauds. It is so significant that we reproduce it here for emphasis :

"Wherever the outcome lies on the spectrum of options, the PRA will ensure calibrations do not go beyond what is necessary to maintain resilience of small firms."

We completely agree. We have consistently supported the principle of a reasonable, modest **"simplicity premium"**, but we are also conscious that it is all too easy to go "over the top" in calibrating a new regime, and it is anyway not an exact science. We will hold PRA to account on this assurance as the regime is developed. Nevertheless we accept the other point in that paragraph – a focused regime with fewer, simpler requirements may need to be more conservatively calibrated than a streamlined regime with more detailed requirements. **But if this goes "over the top" the whole endeavour will fail.**

Figure 5 is a useful schematic of the inter-relationship between focused and streamlined requirements, and **importantly brings in the existing element of the credit unions regime**, which as the paragraph explains is already a highly focused regime. The BSA has experience of this regime through our six large credit union members, and has commented on their behalf on previous changes for credit unions. By comparison with the current regime for small building societies, the **large** CUs regime is radically focused, and very simple, quite conservatively calibrated, but arguably effective. There may be no immediate read across, but bearing in mind that large CUs covered by that regime are now significantly larger than the smallest banks and building societies, we suggest that in the short term those smallest firms could even be able to adopt a slightly modified version of the large credit union capital regime. We include an illustration of this below.

Definition of capital

Q9 : We agree broadly with the observations in paragraphs 4.32 to 4.35. Building societies, especially smaller ones, have the advantage that their capital structure is fairly simple : the vast majority of their total tier 1 capital is reserves, and in two recent instances a medium-sized and a small society have each successfully issued CCDS, a mutual CET 1 instrument, to raise expansion capital. This opens a pathway to other smaller societies to issue CCDS to smaller institutional and professional investors. No small society has issued, or is likely to issue, AT1 and the FCA has banned its sale to retail investors anyway. Nor do societies need or issue growth shares. Tier 2 does have an ongoing role in supporting gone-concern loss absorbency.

Minimum requirements : focused

Q10 : a suitably calibrated **simpler risk weighted** system, as described in paragraph 4.37 would be attractive. To illustrate the practical scope for simplification, it is instructive to refer also to the marginal capital requirement for large credit unions – 10% on a leverage basis. The BSA has always opposed use (as a principal Pillar 1 requirement) of the oversimplified and risk-denying leverage ratio, on several grounds (see our previous published[10] responses) , but it would be relatively simple to construct a few buckets that would adequately cater for the vast majority of simple firms' business. So, for instance, if : -

- claims on the Bank of England (reserves accounts etc) and claims on the UK Government (including guarantees) were weighted at 0% ;
- all residential mortgages up to say 95% LTV were weighted at 50% (as in Basel 1 !); and
- all other claims are weighted at 100%;

small societies could probably meet a Pillar 1 capital ratio of 8%, plus buffer of say 2%, without much difficulty. **Incidentally, such an approach (which in fact quite closely resembles Basel 1) would also be the next natural development for the capital regime for large credit unions.**

Minimum requirements – streamlined

We broadly support the first suggestion in paragraph 4.39 – to use the existing standardised Basel approaches for credit and operational risk. Given that part of the point of a streamlined approach is to start from where small firms already are, this would seem sensible. The more complicated question for credit risk is whether this should be existing Basel 3, the revised version under impending Basel 4, or a choice. Our members may see different pros and cons as between Basel 3 and 4 versions : and much will depend on whether the UK finally implements the fixing of LTV at origination (with its easily-demonstrated perverse results). For the present, we recommend firms should have the choice either to use existing Basel 3 rules, or adopt Basel 4 rules, for credit risk. This is, interestingly, in line with an initiative from the German banking industry, supported by the EACB, for smaller EU banks to retain the simpler Basel 3 credit risk buckets, avoiding the massive upheaval of re-bucketing demanded under Basel 4, against a simplicity premium of 7%

We advocated above restricting the simple approach to firms that do not undertake trading activity, in which case Pillar 1 components for market risk, CCR and CVA can be dispensed with.

Pillar 2A – streamlined

We make one preliminary observation arguing, at least as far as ***mortgages*** are concerned, caution on the suggestion in paragraph 4.41 that Pillar 1 requirements be calibrated even more conservatively to reduce the need for Pillar 2A. For this we draw on PRA's own previous analysis showing the (current) Pillar 1 RWs to be excessively conservative – and in that context it was a matter of regret to PRA that it was still required to pile Pillar 2A on top. This point is so important that we quote extensively from PRA's own CP 3/17[11], emphasis added :

---

[10]https://www.bsa.org.uk/information/industry-responses/leverage-ratio-review-interim-report
[11] CP3/17 Refining the PRA's Pillar 2A capital framework February 2017 page 5, paragraph 1.6.

"The PRA's Pillar 2A credit risk methodology is based on a comparison of firms' SA risk weights to risk weights derived from internal-rating based (IRB) models (the 'IRB benchmark'). The IRB benchmark suggests that for certain asset classes (eg credit cards) the SA for credit risk may underestimate the risk, in which case supervisors may want to apply a Pillar 2A capital add-on. ***For others, such as residential mortgages with a low loan-to-value (LTV) ratio, the level of capital required under the SA is significantly higher than the Pillar 1 capital charge implied from average IRB risk weights.***

The PRA has expressed some concerns about the potentially conservative nature of the SA compared to IRB risk weights, especially for asset classes that are considered lower risk."

So we urge PRA to fully take on board its own previous insights.

As regards high-risk lending, we suggest it may be preferable – as mentioned above – to exclude high-risk activities (such as specialised lending and commercial ADC) from the simplest regime in order not to skew the entire Pillar 2A structure to accommodate those higher risks. We agree that concentration risk should be simplified as suggested– the HH index is an unnecessary complication. And we see no obvious alternative to the present treatment of either pension obligation risk, or IRRBB – though in the latter case, the suggested simplifications – fewer scenarios, principal cash flows only – would be welcome.

Leverage ratio

Neither the BSA nor its members advocate, or practise, excessive leverage – that is usually a product of banks' financial engineering. As explained above, BSA supports sensible and effective capital requirements in part because our members are continuously exposed to the wider costs of bank failure through the FSCS. We were ready to accept a differentiated LR under CRR2. But we consider that a universal and inflexible explicitly risk-insensitive measure should not be the primary requirement for a sector that specialises in a low-risk asset class. We perceive that the supposed attraction of the leverage ratio (LR) has arisen as a direct result of the massively increased complexity first of Basel 2, and then of Basel 3, and banks' gaming of the rules. That is not to say that the LR should not be a useful supplementary tool for supervision – as is now contemplated in CP 14/21 – we have no problem with that, if it is done sensibly and flexibly.

The BSA has therefore consistently argued against the use of the leverage ratio as a principal Pillar 1 requirement, or parallel framework, and the demonstrably perverse results such as on deposits at central banks (which has already necessitated modification). There is now no need for the LR to be extended as a Pillar 1 requirement to a wider range of firms : this would have been automatic under CRR2, but that outcome has been averted, as now recognised under PRA's CP 14/21 – which broad outcome we support . Paragraph 4.45 mentions that the LR is the primary capital requirement for credit unions, though since for the great majority of credit unions their principal asset – personal unsecured loans – would be risk weighted at 100% anyway, the practical difference as against a risk weighting system is very limited. We argued above that the natural development for the credit union regime – for largest CUs at any rate – would be to introduce an element of risk weighting at least for mortgages and central bank / Government claims. So it would now be a retrograde step (and inconsistent with CP 14/21's approach) to build in the pure LR as the principal (Pillar 1 – equivalent) requirement to any simple regime.

Buffers – focused and streamlined

While we agree with much of the analysis in paragraphs 4.46 to 4.50, we sound again **a note of caution against inadvertent, cumulative excess conservatism in calibration** – particularly in a streamlined approach: the risk is that with the best of intentions PRA calibrates each element of the total capital demand (Pillar 1, Pillar 2A, buffers) conservatively, but in isolation from the other elements, and the overall demand becomes excessive. It can be difficult to see the wood for the trees. To remedy this, we suggest PRA at the next stage undertakes some back-testing of proposed approaches against, say, end 2020 figures for a selection of building societies and banks, to see if the overall results "feel" right.

A further comment in relation to paragraph 4.47 comes from the experience with credit unions : in the most recent changes[12] the PRA moved away from a buffer structure (marginal requirement of 8% + 2% buffer) to a higher Pillar 1 figure of 10% : essentially, Pillar 1 grew to absorb the buffer. We are not convinced this is the right approach at all. If the total capital demand under a focused approach is to be increased, we think a modest part of that should be formulated as a standard buffer – to allow for corrective action without triggering a formal breach.

Under the streamlined approach we would prefer a single firm –specific buffer to a potentially higher CCoB calibrated to take account of potentially high risk businesses.

ICAAP simplification

This is an area for potential quick wins. If the underlying capital framework is simplified, the question needs to be asked (especially under a focused approach): **what real value does the ICAAP add ? And would the resources it consumes be better used on directly mitigating other risks ?**

The full ICAAP clearly makes sense for large internationally active banks, as part of fine-tuning risk sensitivity, but we doubt its value for smaller simpler firms once the capital rules are made simpler but slightly more conservative. Where a simpler ICAAP is still required, we think the **template suggestion is admirable**, and draws on an excellent initiative from PRA's predecessor FSA at the time of the introduction of Pillar 2 in the mid 2000s. A simple, clear, robust and effective ICAAP template for a stylised firm – **"The Isle of Dogs Building Society"** – was prepared and communicated to societies at a series of events. The result was that every society was enabled to produce a first-time ICAAP of reasonable quality, meeting the supervisor's expectations, without inordinate resource duplication and re-inventing the wheel. We suggest that template be recovered from the archive and updated, perhaps as the **"Moorgate Building Society"** ! The BSA would be ready and willing to assist in this process.

Liquidity and funding

Building societies are naturally prudent and have no difficulty at all with high liquidity requirements, as witness their typically high LCRs. The problem of complexity comes with some of the detail in CRR – the worst being the over-complicated Additional Liquidity Monitoring Metrics for retail deposits, which the EU forced on the UK under CRR when the previous Type A/Type B methodology would have been perfectly adequate. It is noteworthy that the EBA seems now, in its latest recommendations, to be giving up on detailed reporting of ALMMs : the report[13] states *"The reporting on additional liquidity monitoring metrics was identified as particularly costly and challenging by a high number of respondents"* .

While a focused requirement such as { ***liquid assets % banking liabilities*** } could work, we tend to favour a more streamlined approach here, based at least on the LCR. The full NSFR is excessive and even in the EU a simplified version has now been introduced for SNCBs. We can see no case for the full NSFR to be continued, but a sensible interim compromise might be to keep the simplified NSFR for the time being.

At the risk of adding some complication, we also put forward a highly practical suggestion from among our members. Capital and liquidity are the two basic quantitative foundations of resilience, but the impact of complexity, and the trade-off against more conservative calibration, are not the same for each. On the one hand, most societies naturally, and

[12] Credit unions: Review of the capital regime – CP 28/19 and PS 6/20

[13] EBA -Study of the cost of compliance with supervisory reporting requirements June 2021

traditionally, operate with prudently high liquidity as now measured by the LCR and might be ready to accept a higher Pillar 1 minimum within a radically simpler liquidity regime – while on capital, given the constraints on organic capital growth, such a trade-off could be harmful. A society might therefore be best suited to a more focused liquidity regime, but a more streamlined capital regime. Or, conceivably, among banks, vice versa. Could not optionality be extended in this dimension too ?

We agree that **Pillar 2 liquidity** could be simplified, given the limited domestic operations of the smallest firms in-scope of the simple regime. A good example is **intra-day liquidity** : for large, internationally-active banks that may be making / receiving payments and settling securities transactions round the clock in multiple currencies across several time zones, intra-day risk is a major item. But for small domestic building societies or banks, with little or no foreign currency activity, and limited transactions on wholesale securities or derivatives markets, it is a much simpler issue – typically dealt with by societies maintaining substantial balances at their normal clearing bank so they remain in credit throughout the day – problem solved. The BSA argued exactly this point in our responses[14] to PRA's consultations on Pillar 2 liquidity, so it is gratifying to see the point accepted in paragraph 4.56.

As regards the ILAAP, we think this adds little value for small firms, particularly items such as funds transfer pricing and currency management; the original idea of the **ILSA** – focusing on basic matters of systems and controls, would be a simpler but much more effective in addressing the actual risks faced by smallest firms. As with the ICAAP (see above) our members strongly favour the idea of a **template**, again for the "Moorgate Building Society".

Recovery, resolution and solvent wind-down

We strongly support the suggestions in paragraph 4.62 : on the basis that the simple regime only covers firms with modified insolvency strategy, we think simplified obligations (as already available under BRRD) are a first step, but the second proposal – for additional focused guidance on PRA's expectations for recovery planning - would make the remaining process more efficient. We contribute another anecdote to demonstrate this : when PRA's predecessor FSA introduced RRP requirements, the regulator cooperated with the BSA to produce a workable template for first-time submissions. A pioneering and praiseworthy society carried out the early spadework, sharing its outline RRP with the BSA, which anonymised it and passed it to FSA for regulatory review. After review and amendment it was provided to all BSA members, and was also made available with permission to smaller banks. The result was that all such firms were able to produce a first-round recovery plan of acceptable quality, broadly meeting regulatory expectations, without taking up the immense aggregate resource, with duplication and wheel re-invention, that would otherwise have ensued. The BSA would be ready to assist in any similar endeavours in future.

The widening of the accepted scope for **solvent wind-down** (SWD) also aligns closely with what the BSA has argued for. In our response to a related consultation[15] we pointed out that **SWD, if practical, is a much superior method of market exit** – for all stakeholders – than any resolution option. We gave five reasons for this : optimum realisation values; avoidance of confidence crises; conservation of FSCS resources; no insolvency costs; no risk of criminal sanctions on directors etc. See pages 4 and 5 of our referenced response for fuller analysis.

What is necessary, inter alia, is for the **Bank / PRA to normalise and de-stigmatise SWD** at least for firms within the simpler regime. Given that all depositors are substantially protected by the FSCS, once SWD is seen as an accepted route, the risk of panics and confidence crises precipitating insolvency is greatly reduced. But this does require active handling by the Bank /

[14] Pillar 2 Liquidity : BSA responses in 2016 and 2017

[15] BSA response to CP 9/20 : Non-systemic UK banks : the PRA's approach to new and growing banks.

PRA : laissez-faire is not good enough, and the benefits in terms of avoiding value destruction justify the effort.

Governance, remuneration, risk management

We agree that good governance is especially important for smaller firms – indeed, that is one reason why the **boards and senior management of smallest firms should be set free from unproductive regulatory complexity** so as to be able to concentrate more on making sound, better reasoned and challenged, risk-controlled, strategic decisions.

We support any sensible moves to streamline the SMCR approvals process, which is felt to be a serious impediment to effective staffing and management. A regime designed to weed out abuses at large banks discovered during the last financial crisis risks ballooning into an uncontrolled bureaucracy hindering smaller firms the most.

Disclosure

It has long been evident that the whole Pillar 3 exercise has largely been a waste of time for smaller firms as almost nobody reads the full output (apart from, occasionally, competitors). For example, one society had just one download of its Pillar 3 document from its website for every thousand of its members across the whole of 2019. Even some of our larger members doubt the value of Pillar 3 – one commented that it sees very low levels of internet traffic to its disclosures, yet they take significant time, effort and expense to produce. This is moreover true not only in the UK but in other European states – in Germany, for instance, our colleagues in the cooperative banking federation also measured the minimal traffic to their members' Pillar 3 webpages. Even the EU has in effect now admitted that full Pillar 3 for SNCBs is a waste of resource, as the Pillar 3 requirements for SNCBs have been massively cut back by CRR2. PRA needs if anything to go even further.

We appreciate that PRA would like to hear not only from producers of Pillar 3 disclosures – building societies and banks themselves – but also from (supposed) genuine users. We suspect that for simple regime banks, like SNCBs, this is practically an empty set (apart from competitors or maybe rating agencies). The PRA may be waiting some time…….

Q21: Would a more 'focused' or a more 'streamlined' design approach best deliver the objectives of the simpler regime? A majority among societies tends to favour a streamlined approach at least in the shorter term, due to sunk costs and possible quick wins – but the longer-term option of a more focused regime is also favoured by some, especially the smallest societies. There are also two practical reasons – separate from the arguments of principle as between focused vs. streamlined. Several societies worry that a focused regime might – ipso facto – take substantially longer to deliver than slicing off complexities from existing regimes by way of streamlining : the latter therefore may bring quicker wins even if sub-optimal in the much longer term. Societies are also concerned about the price tag – the simplicity premium – that is, extent of more conservative calibration that goes with simplification. Again, the better-known quantity of a streamlined regime seems reassuring by comparison. Our suggestion of a two-stage process may help with this.

Q22: Are there other areas of the prudential framework, including options for simplification that should be considered when developing the simpler regime? Societies are particularly keen to address the question of the Sourcebook and its future – see below – as well as the important issue of **regulatory reporting**.

Q23: Were they introduced, would the policy options taken together have a significant impact on the complexity of prudential regulation for smaller banks and building societies? Yes, definitely. Smaller building societies welcome this possibility not just for themselves, but because they can then devote more of their resource to serving their members and supporting the UK's household sector.

Regulatory reporting

(We commented at length on the burden of regulatory reporting in an informal paper presented to the PRA in November 2020. Some of the arguments are repeated here.)

This is such an important issue for our members, given that regulatory reporting is a large part of the total burden of regulatory complexity, that it deserves a separate section of our response. We agree with PRA's stance in paragraph 4.77: **the data requirements should follow the policy**, so they cannot be considered in any detail first; and reporting has high implementation and ongoing costs but also significant change costs with long lead times. Consequently, at this stage, we mainly respond in terms of principles and learning from past experience.

The extent of ongoing costs is considerable, with even small societies having several members of staff dedicated to completing regulatory returns, as distinct to producing financial and other management information. Some of the information prepared for these returns is not used in the business. The complexity of reporting gives rise to "key person" risks as a lot of expertise and tacit knowledge accumulates in certain individuals. Therefore small firms must invest in training to develop capacity and resilience to reduce this risk. They also invest considerably in developing and maintaining systems to complete returns.

But once the initial implementation costs are sunk, subsequent changes to regulatory returns require considerable extra resource to be spent to implement the change. Therefore, even if a simplification of a return reduces ongoing costs, the payback period may be very long such that there is not much appetite for **piecemea**l simplifications.

Unclear guidance also creates costs for the regulators : there can be less certainty around the understanding of the aggregated returns, as firms may have interpreted the guidance in different ways, resulting in more queries and a greater burden in reviewing the data. Reducing the excess burden from regulatory reporting therefore depends on the interaction between these costs relative to the benefit the regulators (and firms themselves) receive from the information.

We respectfully beg to differ on PRA's general claim in paragraph 4.78 that it *"embeds simplicity and proportionality into reporting requirements"* and could cite numerous examples to the contrary (for instance, large parts of PRA 110) – even accepting the validity of some of the examples cited in support. However, we realise that the most egregious instance of unnecessary reporting – the entire COREP and FINREP framework – where the UK was compelled to replace perfectly adequate regulatory returns for the sake of EU uniformity, was not directly the fault of the PRA. PRA itself estimated[16] the total cost to building societies alone as nearly £ 300 million but no single benefit for our members has ever been demonstrated.

A bad outcome at this stage would be to repeat the uniformity mistake of COREP in relation to the data initiatives the Bank is undertaking, mentioned in paragraph 4.79. Even worse would be to repeat the error of taking returns, for example, elements of FINREP, not required for smaller firms under the CRR, goldplating them and introducing them for all firms. By contrast, we think it would be instructive to consider the PRA regulatory returns submitted by the largest credit unions: the quarterly CQ, and the annual CY. These contain in a nutshell all the key information that the PRA requires for those firms: the main return in practice is the CQ which runs to only three pages. They are not suitable as they stand for banks or building societies, but they can serve as a yardstick for simplification and proportionality for the

---

[16] PRA's estimate based on median total compliance cost from firm survey, see Table 15.1 on page 57 of PRA CP 5/13 : Strengthening capital standards : implementing CRD IV August 2013

smallest firms. Such simplicity could reduce the reliance on external firms to help with the implementation of regulatory returns.

A further suggestion is that **there could be some quick wins here**. Suppose PRA could quickly identify parts of certain returns that add no or little value for the supervision of the smallest firms (e.g. large parts of the troublesome PRA 110 such as the memorandum items). Our 2020 paper identified other returns that could either be switched off completely or reduced for many building societies. These included eight BoE statistical returns. We pointed out that small building societies, even in aggregate, are unlikely to make a significant difference to the monetary aggregates. For example, the 34 smallest building societies, all with assets under £3bn, have in aggregate a 1% share of UK mortgage balances. We also identified other returns where the information was either duplicated elsewhere and/ or the information collected was not meaningful due to very low levels of transactions. Could these not be switched off quickly for expected in-scope firms? We think this deserves further exploration and are happy to provide again the list of returns that could be potentially switched off. The strongest voices are, it has to be said, raised against the PRA 110.

A key area for improvement lies in guidance. Clearer guidance, in a single place, with common definitions where possible, could benefit firms and regulators as it would lead to greater consistency across reporters. Unclear guidance raises implementation costs as firms must invest greater resources in developing their own interpretations, and it raises ongoing costs due to a greater number of queries and workarounds to adjust for subsequent changes in interpretation. We appreciate that PRA felt constrained in providing authoritative interpretations or guidance on COREP returns, as this was an exclusive EU “competence” – fortunately, no longer. But we give one concrete example of the problem that arose as a result : because the COREP items were so unclear, auditors then demanded separate “interpretation documents” justifying every single line item – a colossal waste of time, money and cause of unnecessary aggravation. In our opinion, any return that requires this overlay cannot be fit for purpose in the first place. It was never necessary with the previous building society returns (MFS 1, QFS 1 etc) with their clear and thoughtful guidance notes.

When the regulator has an expectation of what should be reported in which box, it should state this up front. When there is a transition to a new form from a legacy form, the regulator should show how the outgoing return maps onto the new one. To help firms to plan the development of reporting systems, a published timetable for minor review and reform of returns, definitions and guidance, would be helpful.

We also put forward a suggestion that learns from existing practice in another field. Even with simplification, it will not be the case that all parts of a return are relevant to every simpler firm – and the wider the scope of the simpler regime, the more this will be so. We think it would be worth exploring an approach similar to that used by HMRC for dynamic reporting, whereby some initial questions determine the level of detail subsequently required, and the firm is not presented with parts of the return that are irrelevant. This would help to limit implementation costs as smaller firms would not have to investigate and comprehend the guidance for large numbers of cells that are subsequently zero. Another suggestion from our members is that, perhaps using some form of AI, there could be a greater pre-population of returns, enhancing clarity and speeding completion.

In conclusion, the sector supports the Bank’s vision for it to get the data it needs at the lowest possible cost to the industry. Ultimately the strong and simple regime could be a good test in applying a proportionate approach through clearly defined data standards, modernised reporting instructions and integrated reporting, as the Bank is seeking to achieve more broadly.

Evolution and transitioning, barriers to growth

Q25 We strongly support the ideas in paragraphs 4.80 to 4.82 for a constrained cycle for regulatory changes / updates, outside genuine emergencies.

Q26 – Q28 On transitioning, we have already suggested above that ceilings / thresholds could be dynamic, and normalised to a sector measure, with upwards-only ratcheting, so that – in particular – firms are not dragged out of the simpler regime either by inflation, or because they keep pace with the general growth of the banking sector. We also suggest making the size criterion somewhat elastic – say, based on some **rolling average** rather than a single point of time – to avoid flip flopping. Plus PRA should be able temporarily to waive ceilings / thresholds in either direction to facilitate transitions. We agree with PRA's suggestion of suitable flexibility on transitional arrangements rather than having to have many layers.

Sourcebook

The handling of the Sourcebook – formally SS 20/15 as updated, but universally referred to within the sector by its former title as the Building Societies Specialist **Sourcebook** - is another major issue for societies : we address this in one place in this section. First, the Sourcebook needs to be seen in its **historical context** – a somewhat frightened but entirely understandable reaction to weaknesses, and a few near-failures averted by merger, in the sector during the financial crisis. In that context it was a reasonable endeavour, indeed initially accepted by the BSA in 2010. Most of it is generally helpful, if occasionally verging on the patronising. Nevertheless, moving on to a strong and simple regime, with the prospect of slightly more conservative Pillar 1, raises the question whether the Sourcebook should be regarded as having now fulfilled its original mission? Should it now be formally stood down, in an honoured and respectful way ? Is it not now ready to become one of the Chelsea Pensioners of supervision ? The BSA looks forward to debating this with the PRA.

If something like the present Sourcebook is to remain, PRA needs to address the following. The one area which causes particular problems out of all proportion to its true risk significance is the panoply of restrictions on fixed rate lending – this takes on totemic significance for the PRA. We suggest this could be desensitised inter alia as part of the strong and simple process. In the past we had suggested that the risks that the fixed rate prescriptions in the Sourcebook were designed to cover could be alternatively addressed by a modest Pillar 2 add-on instead. Depending on the calibration of the simple regime, even this may not be necessary. And we underline the point we have made repeatedly in correspondence with PRA: that this fixation continues to fight the last war. At a time when (finally) there is the prospect of medium term increases in interest rates, if not a more normal yield curve, initial fixed rates, especially for 3 to 5 years, actually better protect borrowers during the initial period of greatest payment stress. So there is a trade-off between basis risk and credit risk over that period. Moreover, it is difficult to see obstacles to fixed rate lending that do not create immediate conduct problems in this environment. There has to be a better way.

The other consistent criticism around the Sourcebook is that there are no equivalent constraints on smaller banks. While the Sourcebook is building society-specific, it would be perfectly feasible for an equivalent to have been developed and applied to major categories of challenger banks, for example. That might have averted the weaknesses that then required the 2018/19 fast-growing firms remedial exercise[17], which needed to be applied only to banks.

[17] Review and findings: Fast growing firms

Indeed, a source of harmless amusement to our own members was to attempt to correlate the weaknesses observed at the fast growing banks with the measures in the Sourcebook which, had they been applied, might have averted those weaknesses.

PRA has often claimed that, through individual supervision, such banks are in fact subject to similar constraints, but without any explicit Sourcebook text. Frankly, this claim has always been met with polite disbelief, nor does it appear consistent with the facts, including the behaviours that necessitated the fast-growing firms exercise. Rather, the BSA's general assumption is that in this case, societies' general propensity to comply has been their undoing – banks would probably have put up a more aggressive defence and PRA and its predecessor were not prepared to pick a fight on that issue.

What matters now is not the historical antecedents (though they must be understood) but the best way forward. We see three broad alternative and logically valid approaches :

(i) Keep the Sourcebook (revised) and apply one or more parallel Sourcebooks to banks that qualify for the strong and simple approach.
(ii) Discard the Sourcebook for building societies, so putting societies on the same footing as banks.
(iii) Keep the Sourcebook for building societies only and translate this into a significant explicit discount (relative to banks) on the final calibration of the strong and simple regime.

Approach (i) would be best for financial stability, clearly. Approach (ii) is, we think, on balance the main preference among our members, though we would be content with (i). Approach (iii) is a fair alternative if PRA cannot manage either (i) or (ii). The rationale for (iii) we think follows unavoidably from the PRA's own analysis in this DP.

We start from the understanding that the Sourcebook does constitute a corpus of prudential requirements, although it is superficially phrased as guidance, and that the PRA regards it as effective in reducing prudential risk. Chapter 4 discussed quite sensibly – in the context of focused vs streamlined – the trade-off between discarding wider prudential requirements and the compensating increase in conservatism of the core requirements (see Table 2 on page 27 of the DP and the surrounding text). Therefore, if societies remain subject to a form of the Sourcebook and small banks do not, it is the latter that need **more** of the added conservatism in Pillar 1 core requirements. QED societies should be entitled to a sizeable discount relative to banks. What is no longer acceptable is to keep the Sourcebook for societies only, with no compensating discount, as at present. The BSA looks forward to debating this with the PRA.

Future plans

We agree that there should be further papers addressing e.g. those larger non-systemic firms that will not qualify for strong and simple – noting in particular the concerns of our largest non-systemic societies - the "marzipan layer" -outlined above. Coordination with Basel 4 is important. What we least want is for strong and simple candidate firms to have to implement Basel 4 and then ditch most of what they have done as they go strong and simple. On the other hand, some of the design choices (streamlined vs focused, and nature of capital regime) have more or less interdependency with Basel generally, and some strong and simple firms could benefit considerably if their Pillar 1 capital is based on a simplified form of Basel 4 instead.

Another comparison exercise that the PRA will need to undertake at the next stage is to review any strong and simple regime against the latest regime for new banks. It would be illogical if new (and ipso facto unproven) banks were subject to significantly more relaxed requirements, once they begin to move out of the start-up phase than established building societies (or other banks).

Conclusion

The BSA and indeed relevant staff at societies themselves, remain very much at the PRA's disposal after the close of the formal consultation period if we, and they, can help in any way with this historic and farsighted initiative which we have warmly welcomed.

By Jeremy Palmer, Andrew Gall and Andrea Jeffries

York House
23 Kingsway
London WC2B 6UJ

020 7520 5900
@BSABuildingSocs
www.bsa.org.uk

www.bsa.org.uk

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

We fulfil two key roles. We provide our members with information to help them run their businesses. We also represent their interests to audiences including the Financial Conduct Authority, Prudential Regulation Authority and other regulators, the Government and Parliament, the Bank of England, the media and other opinion formers, and the general public.

Our members have total assets of over £435 billion, and account for 23% of the UK mortgage market and 17% of the UK savings market.