Written evidence submitted by the Building Societies Association (BSA)

Executive summary

The BSA has warmly supported the PRA's Strong and Simple initiative from the start, and we hope the majority of our members will benefit. We agree with the PRA's underlying analysis, especially of the "complexity problem", the broad outlines covered in last year's Discussion Paper, and the great majority of the proposed scope criteria in the latest Consultation Paper. In one specific area – the application of the "domestic UK" criterion to UK expatriates' mortgages lent on UK properties, we propose a modification that would better reflect the location of the underlying risk. Otherwise we remain fully supportive of this endeavour, and look forward to the proposals for the detailed content of the framework.

Introduction

The BSA represents all 43 building societies, the majority of whom hope to benefit from the PRA's Strong and Simple framework, as well as seven larger credit unions (which already have a much simpler regime).

Building societies serve almost 26 million consumers across the UK and have total assets of over £481 billion. Together with their subsidiaries, they are helping over 3.6 million families and individuals to buy their own home with mortgages totalling over £357 billion, representing 23% of the total mortgage balances outstanding in the UK. They are also helping over 23 million people build their financial resilience, holding over £333 billion of retail savings, this accounts for 18% of all cash savings in the UK. With all of their headquarters outside London, building societies employ more than 51,500 full and part-time staff. In addition to digital services they operate through almost 1,350 branches, holding a rising share of financial services branches in local communities.

Proportionality

The BSA has argued (since at least 2016) for greater proportionality in the prudential regulation of smaller domestic deposit takers, as a response to the "complexity problem" mainly arising from the EU's application to all "credit institutions" of the Basel standards designed for large internationally active banks. We previously advocated this in the EU's review of the Capital Requirements Regulation (CRR), but with very limited results - some minor reliefs in CRR2 for the new category of "small and non-complex banks" (SNCBs). We argued the case in a joint paper with several national associations of smaller cooperative banks in the EU, making clear that a simpler approach did not by any means have to lead to lower standards or weaker resilience. And we warmly welcomed the first indications from the Bank /PRA that, following Brexit, a more proportionate regime for the UK was a real possibility. This came in a speech by Sam Woods, the PRA's CEO, at the Mansion House in October 2019 in the course of which he outlined the complexity problem as follows:

"Another thing we've been looking at afresh is the complexity of our prudential rules. The scale of the global financial crisis resulted in part from the huge complexity of the financial system, and the many gaps in the rules that sought to regulate it. Fixing these gaps required more regulatory constraints and more regulatory discretion – a necessary increase in 'essential' regulatory complexity. But when should we start worrying about 'too much' complexity?

This is important for at least two reasons: first, excessive complexity may well be counter-productive in terms of our safety and soundness objective; and second, complexity may be anti-competitive if it is harder for small firms to bear the cost of mastering it. Designing a framework to trade off costs and benefits of complexity is an emerging research question."

The BSA has done some previous work on the complexity question by looking at the relative compliance burden between large and small societies. One indicative finding was that the ratio of compliance staff costs to assets is considerably higher for smaller societies than for larger societies. For the largest societies, compliance costs averaged around £45 per million pounds of assets. For small societies, the average is nearer £450 per million pounds of assets – ten times as much. The PRA provided more recent evidence of the same problem in DP 1/21: see Chart 1 and text on page 8.

General views on "strong and simple" and the PRA's consultation

The BSA is on the record in strongly supporting the PRA's vision for a Strong and Simple ("S&S") framework outlined in its discussion paper DP 1/21 last year. We agreed with the PRA's analysis of the subject, including of the complexity problem. Our views are set out formally in our published response to DP 1/21. We have accepted that such a major change as the development of the strong and simple framework will take time and it is better for PRA to take the time to get it right, as far as possible, at first attempt rather than rush the process and have to make changes later. But we remark in passing that this is far from a novel, untried experiment. Many, perhaps most, major prudential jurisdictions outside the EU already have simpler, more proportionate regimes for smaller domestic banks. The most recent and relevant example was the introduction and piloting of a small banks regime in Switzerland in 2019, which appears to have been successful.

The PRA's current consultation paper CP5/22 does not contain the main policy content of the new S&S framework, which will be consulted on next year. Rather it addresses primarily the scope and boundaries of the lowest / simplest tier of the proposed framework. We think this is probably the right sequence though it can be challenging to comment fully on scope without visibility of that main policy content. The BSA is finalising and will shortly submit its formal response to CP 5/22 which will also be broadly positive and supportive.

Classification

We agree generally with the classification proposed in CP 5/22, going on from the outlines indicated in DP 1/21. We support the limitation of S&S to predominantly UK domestic firms below £15 bn in size. We had requested an initial size ceiling of at least £5 bn (slightly larger than the ceiling for SNCBs in CRR2) but with periodic revaluation as needed. PRA's more generous ceiling of £15 bn will allow some more of our members to benefit from S&S and also builds in headroom for growth and inflation, and we therefore support it. In the longer term there may also be scope for a further tier of the regime to accommodate non-systemic domestic UK deposit-takers, with simple business models, but larger than £15 bn.

We agreed with the three principal exclusion criteria outlined in DP 1/21 and reaffirmed in CP 5/22: formal use of IRB models for capital requirements; actual trading book of substance; or provision of clearing or settlement services.

More exclusions / inclusions

The BSA does not argue for any further activities to be excluded: broadly speaking, CP 5/22 draws the boundaries in the right place. But there are specialised areas where we will be requesting PRA to modify the detail of one or two definitions: these do not affect the big picture or the substance of the policy but are important to a number of our member societies.

Include mortgages to UK expatriates

One of these specialisms, within the overall UK mortgage business, is to provide loans to UK expatriates, secured on their UK properties, while they are e.g. working abroad. As a result of the precise definition proposed in CP 5/22, based on a particular line item in a data return that is already completed, this category of business ends up being (we believe inadvertently) treated as foreign rather than UK business. The reason is that this particular data return is completed on the basis of the location of the immediate obligor (in this case, the expatriate borrower) rather than of the ultimate risk (which is clearly in the UK).

We will be addressing this matter in much greater detail in our formal response to the PRA, and we will suggest work-arounds (possibly using the FSMA procedure for rule modifications provided in section 138A) that will cater better for this area of business without affecting the generality of the UK domestic/ foreign distinction proposed in CP 5/22.

Channel Islands, Isle of Man, Gibraltar

Some of our building society members operate in a small way either for savings and/or mortgage business, in one or other of these British overseas territories, which are regarded largely as extensions of the UK. Again we would propose that the application of the UK criterion for S&S could take the same approach.

Financial stability / safety and soundness

In our response to DP 1/21, we made clear that maintaining a high level of individual firm resilience (i.e. safety and soundness), and of collective financial stability, is essential. It is very important that S&S is not characterised as in any way reducing or compromising the safety and soundness of individual firms. Rather, the S&S framework will be designed to deliver equivalent or better individual resilience, but at lower cost and effort, by addressing the complexity problem – see above. The substantial costs and effort previously consumed by compliance with the increasingly complicated full Basel framework can be better used both in fully meeting simpler requirements and in managing and risk-controlling the firm's business better. We see this result as a win- win for both societies and the prudential supervisor (and we believe also for wider society, as it helps sustain a diversity of smaller regional firms).

The BSA may have been the first to articulate the concept of the "simplicity premium" - that is, If a substantial simplification in the prudential regime can be achieved, a small increase in resilience standards may be reasonable and acceptable, and still deliver net benefits to the firms. Nevertheless calibration is critical - if a strong and simple regime were to be excessively conservative, it will not

work for the target group of societies and smaller banks - if the extra cost of (say) very high capital or leverage ratios makes their business uneconomic.

Sufficient simplification?

This question cannot be answered properly yet as the PRA has not gone into detail about the main policy content of the strong and simple framework - this is to be consulted on later in 2022 or 2023. But it is clear that PRA has understood the problem, so we are modestly confident that PRA will come up with suitable proposals, and the BSA is geared up for full, detailed and constructive engagement with PRA. The main policy choice is whether the S&S framework should be more “streamlined”, that is, largely a cut-down version of current requirements, or more “focused”, that is a radically different set of simple requirements. Indications from our membership, and also from the PRA’s feedback statement, suggest a degree of preference for a more streamlined approach. The BSA has floated the idea of starting down the streamlined route but leaving open the door to ultimately developing a more focused regime.

Within the overall prudential regime, some of the simplifications of greatest value (in terms of resource saving) will come from the hoped–for reduction in regulatory reporting that should follow the simplification of prudential policy. Regulatory reporting is an especially burdensome aspect of the complexity problem, and this has been recognised even in the EU where some reporting burdens are being eased for SNCBs. So we look for an even more ambitious reduction in reporting burden from the PRA, recognising that the policy content has to be settled first. The detail of what has to be complied with will largely drive the detail of what it will be necessary to report.

One reason why we attach so much importance to reducing reporting burdens for smaller firms is that, at present, much of the fine detail required in some of these returns appears to add little value though it is costly to produce. Our members make little or no use of it for their own business purposes, nor do we believe much of it is actually used to any great extent by the PRA. A much smaller set of reporting requirements, where every item mattered and so justified the effort, would be the ideal – as would a move away from some of the ad hoc reporting firms frequently have to generate for regulators on request.

Basel 3.1

We strongly support and welcome CP 5/22’s reassurance that sequential changes can be avoided, by letting firms prospectively within the S&S framework remain on current requirements, avoiding the need to fully implement Basel 3.1, but instead move direct to the final S&S framework once available. This makes a lot of practical sense and is something we strongly advocated in our response to DP 1/21.

Internal ratings

We agree that for the simplest firms, i.e. the main category now defined by the CP 5/22 proposals, formal use of IRB models e.g. for regulatory capital purposes, should be an exclusion criterion. Those

firms that develop and rely on IRB models are voluntarily embracing new complexity and expense, and this approach is arguably unsuited to small deposit takers anyway. But while formal use of IRB models is a natural exclusion criterion, this need not inhibit development of other modelling capabilities that do not yet involve formal approval for regulatory use.

Competition

Yes, our view is that a more proportionate approach as embodied in the S&S initiative will help redress the anti-competitive effect of the complexity problem within the current Basel based regulatory framework. That is, the burden of complexity and the compliance effort and cost needed to operationalize complex requirements bears down far more heavily on the limited resources of smaller firms, thereby providing a structural advantage to large incumbent banks. (See above, under Proportionality.) This may then be even more pronounced where those large banks also benefit from the capital incentives attaching to the further complexity of using internal rating models. We agree with the brief summary on competition at paragraph 3.35 of CP 3/22 and the more detailed consideration within the text of DP 1/21.

A specific point on competition relates to the future application of the PRA's specialist sourcebook for building societies, currently published as Supervisory Statement 20/15. Within the future scope of the simpler regime, we have called on PRA to address whether continuation of this material, for societies only, is fair – and suggest some options for going forward.

A relevant contrast?

In supporting the PRA's Strong and Simple approach, we have contrasted it with another piece of existing regulation where proportionality is demonstrably absent: the categorisation of all building societies as "public interest entities" for the purposes of statutory audit. This too derives from interaction with former EU regulations. We have recently argued in response to a BEIS consultation that the application of PIE status to smaller societies added little benefit but came with considerable costs and downside. The same thinking behind Strong and Simple would have been valuable here. We now look forward to some possible easing of these burdens following the latest indications from BEIS.

Matters for the Committee's attention

The BSA would particularly welcome the Committee's in–principle support for our stance on the treatment of UK expatriate mortgages as domestic UK rather than foreign business.

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