Building Societies Association – Written Evidence (SCG0050)

Thank you for your invitation to give evidence to the Committee before Christmas and for the genuine interest in engagement from both you and the other Committee members.

As I promised in the session, I am writing to provide the additional information you requested in the session and in the clerk's follow-up.

In response to Lord Vaux's question on 'cliff edges' caused by regulation (p., 8 Q. 256) Mr Fieth noted the PRA's 20% valuation reduction on self-built houses for the purposes of risk-weighting the firm's exposure (p., 11 Q. 256), which the Chair requested he expand upon.

To put it into context, the amount of self and custom build in the UK is equivalent to the number of new homes built by one of the top 5 housebuilders.[1] Currently 27 lenders support self and custom build and they are all building societies.

In the Basel framework, there is a national discretion to allow member jurisdictions to align the capital required for self-build mortgages to that of ordinary owner-occupied mortgages. This allows Basel Committee members to tailor the approach to their local market, while still being in full compliance with the standards.

The PRA initially proposed not to use this discretion and to instead apply a 75% risk weight, despite the losses on this class of lending being negligible. In the final rules, although they aligned the risk-weight with owner-occupied mortgages at 20% (up to 55% LTV and 75% thereafter), they also introduced an additional 20% haircut on the valuation. As valuations for self-build properties already include additional levels of conservatism, this 20% haircut is effectively double counting and appears to be arbitrary. We have asked the PRA to explain their position and simply been told the rules are final and cannot be changed. We have also made these points in our published written response to a related 'Strong and Simple' on the requirements for non-systemic firms.[2]

What aggregate impact does this rule have on the capital holding requirements for your members, and what downstream effects does this have for consumers?

The downstream effect of the haircut is that the loan-to-value ratio (LTV) of the mortgage will be higher than it should be. From a customer perspective this will almost certainly increase the interest rate charged,

[1] https://assets.publishing.service.gov.uk/media/6128c585e90e07053ec5e447/Bacon_Review.pdf

[2] See item 3 in table on page 12 of BSA Response to CP7/24

from a lender’s perspective it means that a higher average risk weight will apply to the loan, leading to a material increase in the capital required. As there is a 20% risk weight applicable (RWA) for the loan up to 55% LTV and 75% on the portion over 55% the 20% haircut will result in a much larger portion of the loan being risk-weighted at 75% rather than 20%. This is likely to be a material increase in capital for any loan without a higher LTV.

Here is an example of how this would affect a residential self-build mortgage loan of £85,000 secured against a part-built self-build property valued at £100,000:

	RWA at 20%/35%	**RWA at 75%**	**Total RWA**	**Increase in RWA**
Current requirement	28,000	3,750	31,750	-
Basel 3.1	11,000	22,500	33,500	5.5%
Basel 3.1 with 20% haircut	8,800	30,750	39,550	24.5%

It is difficult to calculate any aggregate impact of this rule because it depends not only on the specific LTV mix of portfolios across lenders, which will likely change as a result, but also on whether lenders choose to stay committed to the sector or adjust their portfolios to favour other types of lending. As with all costs on mortgage products, this higher capital requirement ultimately results in higher prices being passed on to consumers, which may in turn deter potential self-builders.

We note the PRA’s reasoning for the reduction given at 2.213 of PS9/24. What was the BSA’s reaction to this position and what representations has it made to the PRA on this issue?

The BSA agrees with the points noted in the PRA’s PS9/24 paragraph 2.213 that there are several types of valuation and risk-based methodologies that societies use to ensure that valuations are sufficiently conservative to allow for these factors. However, we disagree with the conclusion that an additional haircut of 20% is required. We have asked the PRA to explain their position and simply been told the rules are final and cannot be changed.

How does this rule negatively impact the UK’s growth and competitiveness? What approach do other jurisdictions take on this issue?

Increasing the costs of self and custom build mortgages in this way is ultimately likely to limit the number of homes built using these methods and stunt the potential growth in this market and its wider supply chains.

The approach in the EU is to utilise the national discretion in the Basel framework and apply the preferential risk-weight without any haircut to the valuation. This applies to properties with no more than four residential dwellings and where the property is the primary residence of the obligor.

The contribution of building societies to wider economic growth

Given the Committee's focus on economic growth, and Lord Eatwell's comment that the sector does not seem to contribute very much to growth, I also wanted to take this opportunity to outline how building societies contribute to wider economic growth.

- **Growth through improving the functioning of the housing market**

  People take out a mortgage in order to buy or move home, rather than to have a mortgage itself. This intermediate role helps economic growth by enabling people to move for jobs, improving labour mobility, and it leads to a more efficient use of the housing stock as people are better able to upsize and downsize as required.

  There are also wider economic benefits from sector support for the housing market. Research shows that for every resale housing transaction that takes place, the economy benefits by around £9,559 on average through associated costs. Scaling that figure up means that for every 100,000 housing transactions, there is a net impact of around £1 billion.[3]

  In the six months to September 2024 the sector provided 72% of the growth in the mortgage market, and accounts for 24% of all outstanding mortgages.[4]

- **Growth through building homes**

  Building societies play a crucial role in financing investment in new housing, vital if the Government is to reach its target to build 1.5 million new homes. In 2023, building societies lent 26,500 mortgages on new-build properties, 16% of all their loans for house purchase that year. Societies also directly support the financing of new homes through self and custom-build mortgages as well as through collaborations with SME builders and housing associations.

- **Growth through our members**

[3] https://content.knightfrank.com/research/2121/documents/en/knight-frankhbf-economic-benefits-of- housing-market-activity-2020-7616.pdf

[4] https://www.bsa.org.uk/media-centre/press-releases/building-societies-drive-three-quarters-of-the- growth-in-mortgage-market

The building society ownership model results in societies focusing on long term growth and returning economic value to members. For example, Nationwide members' financial benefit increased to £950m (H1 2023/24: £885m), from pricing and incentives that were better than the market average. Nationwide also distributed £385m through their Fairer Share Payments to 3.85m eligible members in June 2024. Across the sector over £2.5bn profits was reinvested into members and communities (based on 2024 retained profits).

- **Growth through SMEs**

  Building societies are also able to support other types of lending through their subsidiaries, such as the recent acquisitions by Nationwide of Virgin Money and Coventry of the Co-operative Bank. A number of building societies also offer a sustainable and complementary alternative to banking hubs by providing access to banking services through kiosks sited within building society branches.

- **Growth through savings**

  Building societies and credit unions support people to save and increase their financial resilience, providing increased benefits for productivity. Research[5] we commissioned from the Bristol University Personal Finance Research Centre and sponsored by Yorkshire Building Society looked at the relationship between savings and wellbeing and found that having a regular savings habit, no matter how small the amount saved, improves life satisfaction. Other research shows improved wellbeing boosts people's productivity at work. In in 2023 savers received £2.1 billion more in interest on their total savings with building societies compared to what they would have received based on the average offered by the large banks.

I hope that this further information is helpful, but please let me know if you have any further questions which we can help with.

10 January 2025

[5] https://www.bsa.org.uk/media-centre/press-releases/saving-just-a-small-amount-can-help-people-escape-the-cycle-of-poor-financial-and-mental-wellbeing