BSA Response to CP7/24: Strong & Simple capital regime for SDDTs

December 2024

Building Societies Association

Summary

The Building Societies Association (BSA) represents all 42 UK building societies, as well as 7 credit unions. Building societies have total assets of almost £525 billion and together with their subsidiaries, hold residential mortgages of over £395 billion, 24% of the total outstanding in the UK. They also hold £399 billion of retail deposits, accounting for 19% of all such deposits in the UK. Building societies account for 40% of all cash ISA balances. They employ around 52,300 full and part-time staff and operate through approximately 1,300 branches, a 30% share of branches across the UK.

The BSA has been a strong supporter of the PRA's Strong and Simple agenda from the outset, and our members that are eligible to be a Small Domestic Deposit-Taker (SDDT) will generally want to adopt the regime. We do not believe that simplification is a weakening of the regime, in fact we believe that the opposite can be true. Simpler rules that are clear to understand and easier to implement can in fact be stronger than complex rules. The proposals in CP7/24 show a clear intent by the PRA to design a more proportionate regime for smaller deposit-takers that are not 'internationally active' and therefore do not need to implement the full Basel framework. We support the PRA aligning to international standards for those firms for which they are designed and therefore note that the proposals will not impact the UK's ability to fully align with the Basel framework for larger banks. We also welcome that the PRA intends to consider whether any of the proposals in CP7/24 could apply to mid-tier firms that are not internationally active. The BSA is not commenting on potential simplifications for Large and Simple firms in this document but stands ready to engage with the PRA on this separately.

The BSA broadly supports the proposals in CP7/24 as well as noting that in order to achieve true proportionality, all stakeholders across the industry need to work together to make this happen. We believe the risk of gold-plating the requirements is high with pressure coming from a range of stakeholders (as noted further below) to revert to increasing levels of detail under the guise of being 'best practice' regardless of whether it is relevant or adds value. The BSA stands ready to support the PRA in achieving proportionality of implementation as well as proportionality in the policy requirements.

We note the wide range of areas within the proposals where the PRA could choose to require additional information or set capital add-ons. Such flexibility and subjectivity in the requirements can lead to an inappropriate calibration when capital requirements are set which may drift over time and be out of line with the original intention, modelled by the PRA in its CBA. It also makes it difficult for firms to make the decision as to whether to adopt SDDT if they are unaware of the likely calibration. The BSA has conducted its own analysis to demonstrate the potential variability of capital requirements which could undermine the stated intent that capital should be more predictable and reduce the need for firms to hold a management buffer of capital. We believe the opposite could be true with firms needing to hold higher management buffers to cover the subjectivity and, in some places, material variability in the requirements.

We note that the PRA is not proposing to adjust the requirements under the ICAA Part of the PRA Rulebook to assess and maintain capital to cover all risks. Again, this could lead to 'regulatory creep' whereby any one of a range of stakeholders could lead a firm to gold-plate the requirements, to demonstrate compliance with the overarching rules. Such stakeholders include specialists within firms themselves, independent non-executive board members, outsourced internal auditors, external advisors and individual PRA supervisors. We propose that the PRA considers the incentives that drive each of these stakeholders and whether there are ways to ensure proportionate implementation, such as through outreach. For the PRA's staff and internal processes, we propose that internal PRA assurance teams (2nd and 3rd line) are given the explicit mandate to review whether the PRA's actions are proportionate as well

as the quality of supervisory decisions. We don't believe true proportionality can be achieved in the absence of the correct incentives being in place.

One important component that is not covered by CP7/24 is SS20/15 The Building Societies Sourcebook. The BSA believes that now is an appropriate time to conduct a fundamental review of the sourcebook as part of the Strong and Simple agenda and, either:

- apply it to all SDDT deposit-takers i.e. banks and building societies, or
- remove the sourcebook altogether

At the very least, this review should remove the now inappropriate and badly calibrated limits in the appendices, and allow firms to set their own limits, given that other rules can be equally or more effective drivers of sound risk management, such as the Senior Managers and Certification Regime (SMCR).

Finally, the BSA is concerned that the proposed approach to regulatory reporting will require SDDTs to implement a suite of brand new regulatory returns ahead of the broader Banking Data Review project that sits under the Transforming Data Collection (TDC) umbrella project. The proposals essentially require firms to 'dig up the road twice' for regulatory reporting. We believe that the CBA costs included in the document significantly underestimate the costs of such an approach, and we do not support the proposals in this area.

Pillar 1

The BSA supports the overall approach to largely mirror the pillar 1 risk-weights in the Basel 3.1 package, albeit with a small number of exceptions. This building block approach reduces cliff edge effects as firms can build on the extra components if they need to transition out of SDDT and into Basel 3.1 rather than fundamentally change their capital calculations. We also support that the PRA has removed the requirements to hold capital against counterparty credit risk and CVA, and aligned the calculation of market risk to credit risk. We note that capital held for these risks aren't material in any case for a firm that qualifies for SDDT, so the removal should not increase risk in any material way. One area where we would welcome clarification is for securitisations, where the PRA is proposing to continue to apply capital requirements for Counterparty Credit Risk to SDDTs that hold a securitisation position that results from one of the derivative positions in Annex II of the CRR.

The BSA is also strongly supportive of removing the counterparty due diligence requirements. This doesn't mean that the risk is not assessed, but rather that firms can rely on external rating agencies given that rating agencies are more adequately resourced to perform this role and operate under the supervision of the FCA. We do not believe it is proportionate nor practical to require small firms to duplicate the work of rating agencies.

For mortgages, the BSA was pleased to see that the PRA has clarified that suitably robust statistical methods or an independent valuer are permissible, including the use of AVMs or indices, where it is prudent to do so. BSA members expect to continue to implement valuations in a risk-based way in line with current market norms.

While we support the overall approach of mirroring Basel 3.1, the BSA opposes a small number of areas which we are also including in an issues log at the end of this response.

- The PRA has introduced a 20% haircut to property valuations for self-build mortgages in its final rules in PS9/24. This was not part of the consultation in CP16/22 and is not grounded in evidence. Valuations for self-build properties under construction already include various layers of conservatism to allow for the greater variability of such properties. This means that the additional 20% haircut is double-counting. It is also at odds with the recommendation letter by the Chancellor to the Prudential Regulation Committee to support the transition to net zero.[1] We would also like to remind the PRA that the data previously submitted by the BSA to the PRA in response to CP16/22 clearly demonstrated that loss rates for self-build mortgages have been at or close to zero throughout the economic cycle.

- Section 2.39 of the CP7/24 refers to the expectation that central counterparties are used for clearing derivative contracts. For many small firms it is neither feasible nor cost effective to set up central clearing for derivatives and under the Small Financial Counterparties (SFC) exemption within European Market Infrastructure Regulation (EMIR), qualifying societies are not required to centrally clear derivatives.
- The proposed rules introduce a 1.5x multiplier for foreign currency lending. This will capture ex-pat mortgages where the property is in the UK and the loan is in sterling but the borrower is working abroad and earning foreign currency. It will also significantly impact the Northern Ireland market where many people live and work either side of the land border. These borrowers are typically higher earners and the losses on these types of loan are low. The additional earnings cover the risk of fx movements so the 1.5x multiplier is not necessary. We propose that the PRA considers an exemption in circumstances where the borrower's earnings are sufficient to cover any fx movements.

Pillar 2a

The BSA welcomes the efforts by the PRA to simplify the calculation of pillar 2a across a number of risk types. While the intention is welcome, in places the proposals introduce a large degree of flexibility for the PRA to apply supervisory judgement, and hence increasing ambiguity and potentially reducing transparency, and hindering growth. This creates uncertainty and makes planning more challenging and can result in a firm needing to hold a higher management buffer to accommodate potential future increases in capital requirements should they occur. We do not believe it was the PRA's intention to increase management buffers as it has stated the opposite in paragraphs 9.35-9.44 of the CBA section of CP7/24.

We propose that there needs to be a balance between achieving simplicity by utilising supervisory judgement while giving firms a degree of certainty on the level of capital requirements they can expect over time, so as not to hinder competitiveness and growth. As such we believe that where new areas of supervisory judgement are introduced these should be accompanied by some high-level principles that the PRA will follow. The principles should indicate how the PRA will apply judgements without being over-engineered which would re-introduce complexity. We propose in our detailed comments below some examples of the types of principles that could apply for each relevant aspect.

[1] See letter of 14 November

Credit risk

The BSA welcomes the PRA's proposals to remove the scenario analysis for pillar 2a credit risk. As described in the consultation, this is a significant amount of work and rarely results in a capital add-on for building societies. As such this work is not proportionate to the risks.

However, we note that analysis maybe required for higher risk lending and the PRA gives the example of sub-prime lending. We would ask the PRA to be clearer in what it means by higher risk lending. This is an area where the PRA could be clearer by setting out some principles on when a firm is expected to conduct more detailed analysis and when it is not considered necessary.

The BSA believes that Pillar 2a analysis should only be required if i) the lending is genuinely more risky i.e. has higher loss rates <u>and</u> ii) the pillar 1 capital treatment is highly likely to be insufficient through the economic cycle. We urge the PRA not to require additional analysis for certain 'niche' types of lending just because they are not mainstream but not higher risk such as having more manual underwriting. It would be helpful for the PRA to be clearer on this point to avoid creating incentives for firms to conduct the analysis anyway, just to be on the safe side (or outsourced internal auditors to feel it is appropriate to advise that it is 'best practice').

We also note that the PRA is not planning to change the ICAA rules in the PRA Rulebook. Again, this could mean that other stakeholders advise firms that it is best practice to conduct analysis to prove that pillar 1 is sufficient for all risk types even though the PRA has said that this isn't necessary. We propose that the PRA confirms that firms can meet the ICAA rules through their other risk management activities such as regular reporting to Credit Committee rather than by reproducing unnecessary analysis in the ICAAP.

Finally, as currently drafted, the consultation and draft supervisory statement in appendix 6 could be read to imply that if an SDDT firm meets the requirements to conduct a pillar 2a assessment for credit risk then they must do this for the whole credit portfolio rather than just for the lending that is higher risk. This could be made clearer in the final wording of the policy.

Credit concentration risk

The BSA supports the proposals to remove the use of the HHI-index, and that the add-ons are not applied to residential mortgages. Credit concentration risk has evolved significantly since the concept was first introduced with the implementation of Basel II. So, while the BSA supports the proposed approach, we also note that changes in working patterns since COVID and hence the lesser impact of the closure of a single local employer means that concentration risk is not as pronounced as perhaps it was in the past. However, intuitively there remain risks associated to concentrations in lending portfolios and hence we support the proposals as set out.

Operational risk

The PRA's proposed approach to operational risk is one of the most concerning areas for the BSA and its members. We have a number of concerns with the proposed approach:

- The calibration of the three operational risk buckets is opaque.
- The spread between the three buckets is material[2] and results in a significant rise in capital requirements as firms move between buckets with unintended consequences on business-as-usual activities.

[2] The move from bucket 1 to bucket 2 more than doubles the amount of capital held for operational risk. A move from bucket 1 to bucket 3 more than quadruples operational risk capital

- There is significant uncertainty for firms if they cannot anticipate which operational risk bucket will be the relevant one for them for planning purposes. This could result in additional management buffers to cover the potential increase in capital requirements.
- If a higher bucket is allocated then the firm may be stuck in that bucket for a period of four years if that is the time to their next SREP even though issues may have been resolved much sooner ('bucket drag'). This therefore conflicts with the PRA's secondary competition, competitiveness and growth objectives.
- There is no change in the requirement for firms to conduct operational risk scenario analysis as per the current regime, so there is no simplification for firms, who may end up with a higher capital charge due to the bucketing approach. Also, 1 in 1000 can be a somewhat obscure concept (or spurious accuracy) given scenarios contain many subjective assumptions, so the calibration is largely theoretical.

The BSA proposes that the PRA considers ways to provide more certainty to firms on which operational risk bucket will be the relevant one for them. If a firm is well managed with mature controls and limited operational risk loss events, then we believe they should have confidence that they would default to bucket 1. The PRA should also set out conditions which would allow for any operational risk add-on (or increase in bucket) under pillar 2a to be removed if the firm's Board and its PRA supervisor are satisfied that they are met, ahead of waiting for the next SREP. The BSA is particularly concerned that the jump between buckets is too high and may not be a true representation of any additional operational risk.

The BSA proposes that the PRA sets out some high-level principles which it will follow when determining which operational risk bucket to allocate a firm to, thus reducing the uncertainty.

- The allocation should be based on <u>net</u> not <u>gross</u> risks. For example, if a firm embarks on an IT transformation then this should not automatically place a firm into a higher risk bucket. Rather the PRA should take a holistic view on the quality of governance, and the risk management framework including operational risk controls in addition to any changes in gross risk.
- The allocation should be based on actual operational risk in the firm and <u>not</u> be used as a punishment for the quality of scenario analysis in the ICAAP. If the PRA considers the scenario analysis is sub-standard but the firm has strong operational risk management and controls then feedback should be provided first before a capital add-on (or increase in bucket) is considered.
- The PRA should consider the consistency of the conservatism within firms' own scenario analysis i.e. a firm that runs a very conservative catastrophic combined scenario with large losses as an outcome should not by default be subject to a higher operational risk bucket than a firm that has run milder scenarios.
- The PRA should take into account actual operational risk losses experienced by firms, while also considering if operational risk controls have been improved following any material losses in a way that such losses are less likely to occur in the future.
- The PRA should consider if the firm previously qualified for the refined approach which is only available to firms with mature embedded risk management. If this is the case, then they should default to bucket one.
- Firms should have a clear and proportionate transition period if they are told they are being moved to a higher bucket, so as to minimise firms having to hold excess capital unnecessarily.
- When moving a firm to a higher bucket, the PRA should set clear actions that once completed should result in the firm moving back to a lower bucket ahead of the next SREP.

The BSA has gathered data[3] from 20 out of 36 SDDT-eligible societies. Around half of these societies also provided operational risk loss data. For those societies, they experienced, in total, operational risk losses of £811k on average per year over the last 10-years on an extrapolated basis. This compares to current pillar 1 + pillar 2a operational risk capital requirement of over £57m for the same group of societies, which could increase to over £60m if all these societies are allocated to operational risk bucket 1. The capital requirement increases to over £122m if the same societies were all allocated to operational risk bucket 2. We are strongly of the view that it is disproportionate to hold the amount of capital required under bucket 1, let alone bucket 2, when compared to average total losses of £811k per year.

The BSA also proposes that if the PRA wishes to retain the bucketing approach for pillar 2a for operational risk then it should consider having 4 buckets rather than 3, with lower add-ons for each bucket including zero for the lowest bucket, to increase risk-sensitivity while retaining the simplicity. This would be more reflective of the simple business model of building societies and have more regard for the level of losses incurred versus the capital requirement.

Alternatively, the PRA could consider no buckets i.e. retaining the current approach where pillar 2a capital add-ons are tailored to firms' scenario analysis. This latter consideration should not increase the workload for the PRA as it is proposing for firms to continue to conduct scenario analysis which the PRA will need to review as part of the SREP in any case.

The BSA encourages the PRA to publish further information on its approach to Pillar 2a operational risk at the earliest opportunity. As mentioned above it is very difficult for a firm to decide whether it should opt into the SDDT or implement Basel 3.1 in the absence of much greater clarity on this key component.

IRRBB and pension obligation risk

We note that the PRA intends to retain the current approaches to IRRBB and pension risk. We encourage the PRA to be as transparent as possible in this area. These add-ons can be quite significant and will therefore be impacted by the proposed removal of the refined approach, which for many societies will increase TCR. As such, and in line with the PRA's secondary competition objective we believe it is important that the PRA is more nuanced in its approach to setting capital add-ons that may not be reviewed again until the next SREP which could be a period of four years. For example, any pension risk add-on should also include a clear list of actions that would result in the reduction or removal of the add-on, for example if the scheme is de-risked and the Board has confirmed to the PRA that this is the case. For IRRBB, if the PRA has accepted the firm's methodology for IRRBB capital add-ons then the society should be able to update these at its annual assessment of Pillar 2a and confirm this to the PRA rather than wait four years.

A related point is that given pillar 2a is set as a percentage of pillar 1, most capital add-ons set at a point in time will scale with growth of the firm even if those risks are not related to credit risk and balance sheet size. As such this exacerbates the above problem with capital add-ons being stuck with a firm for up to four years when no longer relevant.

The refined approach

The BSA is responding to the separate consultation CP9/24. In summary the BSA is concerned that the removal of the refined approach could lead to significant increases in Total Capital Requirements (TCR) for building societies who currently benefit from the approach. This is relevant for non-SDDT firms not on IRB as well as SDDT firms and the impacts can be material.

[3] Societies provided data to the BSA, based on their interpretation of the proposed new requirements, on a best endeavours basis

The BSA data analysis demonstrates that, on average, there will be an increase in TCR for building societies, due to the removal of the refined approach, and this can be material.[4] The PRA's own analysis as set out in chart 3 of CP7/24 also shows an average increase in TCR. The split between the minimum requirements in TCR, and the buffer which can be utilised, is an important legal distinction and we would question why the PRA intends to shift the balance between the capital minima and the buffers?

The refined approach was originally introduced to remove the large differential between capital requirements for firms on the standardised approach and those which use internal models (IRB), in particular for residential mortgages. The Bank of England's own analysis[5] shows that the current standardised approach risk weights are many multiples higher (around 5.5 times) than IRB. The Bank then forecasts that this differential could reduce to 1.5-2.5 times higher. While the reduction is welcome, this does not go far enough. The BSA strongly believes that 1.5-2.5 times higher capital for similarly low-risk mortgage exposures is excessive and anti-competitive. The differential for buy-to-let is even higher. The IRB floor is already penal to monoline mortgage lenders as set out in the BSA's response to CP16/22. Taken together, the removal of the refined approach and the retention of the IRB floor for IRB societies mean that large diversified mortgage lenders[6] have a competitive advantage in the mortgage market compared to mutual building societies.

As such, the proposals could run counter to the PRA's secondary competition objective and also the FSMA requirement for the PRA to have regards to mutuals. The refined approach is particularly relevant for building societies given their low-risk mortgage portfolios and the proposal to remove the refined approach is therefore more detrimental to building societies than other business models.

The BSA proposes that the PRA considers ways to simplify the refined approach rather than remove it altogether. The mathematical offsetting between different pillar 2a risk categories isn't complex in itself. However, in order to perform this offsetting there would need to be a mechanism to demonstrate the over-capitalisation of pillar 1 credit risk. We believe that the IRB benchmark tables are useful data for the industry not just for the purpose of pillar 2a calculations but more generally for risk management purposes. The publication of regular benchmarking tables is also aligned to the FSMA principle that the regulators should generally publish information where it is useful and does not breach confidentiality.[7]

The BSA would also note that the IRB floor is phased in by way of transitional arrangements over a 3 year period to 2029. This allows IRB firms to build up any additional capital to meet the new requirements over a period of time. By comparison, the PRA is proposing that the refined approach is removed overnight on 1st Jan 2027. This is inequitable given the purpose of the refined approach is to narrow the gap between standardised approach and IRB. So, while the BSA position is to retain a simplified version of the refined approach, as a second best option its removal should at least be subject to a transitional arrangement to align with the transitional arrangements for the introduction of the IRB floor.

[4] For further details, see the BSA's response to CP9/24
[5] See CP9/24 paragraph 2.17
[6] Those with a range of IRB models that mean that the IRB floor is less likely to be binding
[7] See FSMA Section 3B Regulatory principles "the desirability in appropriate cases of each regulator publishing information relating to persons on whom requirements are imposed by or under this Act, or requiring such persons to publish information, as a means of contributing to the advancement by each regulator of its objectives"

Capital buffers

The existing capital buffer framework is more complex in the UK than in any other jurisdiction in the world. The interactions between the PRA buffer and the Basel buffers are unduly complex and do not necessarily add to firm's resilience in any meaningful way. The BSA therefore recognises the PRA's attempt to simplify this complex area of the framework. We support the removal of the countercyclical buffer which is complex to calculate with firms needing to track the countercyclical buffers in other countries (e.g. for ex-pat mortgages), albeit that building societies are almost exclusively domestically-based.

Single Capital Buffer (SCB)

The BSA supports the goal of having a single capital buffer. However, the SCB is single only in name, as it is made up of three components, much like the existing PRA buffer. It is also linked to stress testing outcomes. While we understand the theory of tying the buffer calculation to stress testing it also makes the process quite complex compared to, for example, a flat buffer.

We note that in the CBA chart 3 in CP7/24 the PRA uses a buffer of 4.11% which is a weighted average of firms' buffers under SDDT proposals. We understand that 3.5% is the minimum but seek further guidance on what level of buffer a low-risk business model like a building society might expect to receive. Without sight of example non-cyclical scenarios or an indication around the level of buffer, it is currently impossible for a firm to project what level of buffer might apply. Specifically, the risk-weight migration during a stress scenario will be different under the new regime compared to the current regime and this is something that needs to be tested. This is important for business planning purposes, particularly for a mutually-owned building society that cannot easily raise external capital.

The PRA has stated that it will publish two non-cyclical stress scenarios annually to guide firms on the severity of the stress test that they should apply. This severity will vary through the cycle in order to ensure that firms that have a SREP at different points in the cycle aren't penalised with a higher buffer. The level of the buffer should remain broadly constant regardless of when the SREP is performed.

While we generally agree with the approach of linking the buffer to the outcomes of stress testing, publishing two new scenarios annually is excessive and creates timing issues. In reality, while the current ACS varies each year, there are common features, such as the fall in house prices which are generally quite similar. As such, the BSA proposes that the PRA should consider ways to give guidance to firms on the expected severity of the scenarios without over-engineering annual published scenarios. For example, the PRA could publish the most severe scenario that might apply at the top of the economic cycle, then annually it could confirm where in the cycle firms should consider they are relative to that stress and adjust accordingly. This would reduce the work for the PRA as well as for firms in trying to second-guess frequently changing scenarios and may also allow for more automation.

The BSA challenges the calibration of the 3.5% minimum buffer. The new pillar 1 calculation is designed to be more risk-sensitive and the lower LTV cut off at 55% LTV, and more so the introduction of the 'whole-loan approach' for certain types of residential real estate exposures, may mean that pillar 1 requirements increase more rapidly in a market downturn than currently.[8] This could mean that a smaller percentage buffer under the new regime

[8] Pillar 1 for mortgages is designed to be less cyclical by using original valuation to calculate the LTV during rising house prices. However, there is a requirement to revalue during a market downturn. This means that the calculation of the buffer based on a falling house price scenario may result in a more volatile pillar 1.

equates to higher levels of nominal capital during a market downturn when compared to the current regime. Either way, the dynamics of how risk weights change through a stress will be different under the new regime, so re-basing current buffers is potentially too crude an approach. As such, a lower minimum of 2.5% might be more appropriate than 3.5% and the PRA should factor this change in pillar 1 into its analysis by also explaining the buffer calibration. The reduction to 2.5% would mitigate the impact of Pillar 1 volatility in a market downturn. This volatility is also another reason why the PRA should retain a simplified version of the refined approach as already discussed as the level of TCR will also feed into the buffer calculation.

The BSA encourages the PRA to publish examples of its likely non-cyclical scenarios at its earliest opportunity, or at least as part of the policy statement. As mentioned above it is very difficult for a firm to decide whether it should opt into the SDDT or implement Basel 3.1 in the absence of this key component that will drive the calibration of the buffer. While the BSA has conducted analysis for other components of the proposals, it isn't possible to analyse the buffer without sight of the example stress scenarios.

Risk management & governance scalar

The PRA is proposing to include a risk management and governance scalar as one component of the SCB. This is another area of judgement, subjectivity and hence uncertainty for firms, and where we would welcome the PRA providing some high-level principles on when it might apply. The BSA believes that this should be used only in rare circumstances and not for firms that generally have a positive approach towards risk management and compliance with PRA requirements. It might, for example, be used for a firm that is on the PRA's watchlist or in breach of one of the PRA's fundamental rules, and would likely be used in conjunction with other supervisory tools, such as heightened supervision. It should never be used, if for example, the PRA has doubts around the adequacy of capital but does not have sufficient resources to conduct further work with a firm, as a way of being conservative to cover the PRA's uncertainty. This would be the opposite of proportionate, not based on actual risk and anti-competitive. As such, the BSA supports the policy of having the option to apply a scalar, on the basis that it is generally only used for outlier firms not as the norm.

We note in the draft supervisory statement that the application of the 40% scalar is calculated as up to 40% CET1 TCR but then applied to the SCB. This feels unnecessarily complicated and we therefore propose it is a more simple percentage uplift of SCB, if used at all.

Use of the SCB

We welcome that the PRA has clarified that the SCB can be utilised and does not mean a breach of minimum requirements. This is an important clarification to ensure that buffers are useable as per their design. We also welcome the removal of the maximum distribution amounts (MDA) thresholds that exist in the Basel framework as these are rigid and automatic and do not allow for supervisory judgement on the specific circumstances that the firm is in. This is an area where the BSA welcomes the PRA having more flexibility and applying its judgement. However, to give firms clearer guidance, the PRA could state that it is more likely to be flexible during an economic downturn when the CCyB is released for larger firms. In those circumstances the supervisory consequences of operating within the SCB should be lower than at other points in the cycle. Such an approach would drive a degree of consistency between the buffers and their usage for Basel 3.1 firms and SDDTs and reduce the likelihood that SDDT's modify business plans to avoid utilising the buffer.

ICAAP

The ICAAP is an extremely resource intensive process including multiple layers of governance and oversight. The process is a valuable way to understand in detail a society's capital adequacy in normal times and through an economic downturn. However, what is less valuable is updating the ICAAP annually. The cost of updating an ICAAP compared with the new insights that it provides are disproportionate for a building society with a simple and stable business model of accepting deposits and issuing mortgage loans to its members. The business model is constrained by statute, and growth rates are constrained by the general inability to raise capital other than through retained earnings.

The BSA has previously raised the issue of duplication across regulatory documents so that each document is a stand-alone package. This means that many hundreds of pages are duplicative across the ICAAP, ILAAP, the recovery plan and the new solvent exit analysis, which are in turn duplication from the business plan, the risk management framework and other policy documents. The BSA therefore welcomes the comments in CP7/24 that firms are permitted to include cross-references between documents to avoid duplication and reduce the volume of drafting to be more manageable for societies and their boards. For every hour that a board member is spending reviewing regulatory documents, that is less time that they are reviewing strategy and broader risk management.

Timing and scheduling

The BSA supports the PRA's proposals to reduce the frequency of the full ICAAP document to once every two years as set out in table 5 in CP7/24. We would question, however, why pillar 2a calculations need to continue to be conducted annually, particularly if the PRA will only conduct a SREP once in every four years? We propose that there should be greater alignment between the TCR and any requirement to conduct pillar 2a calculations. For example, if the PRA has approved the TCR as part of a SREP and the firm is updating its calculations of pillar 2a using the same methodology and assumptions that the PRA has approved then the firm should have the ability to self-certify via its Board that the pillar 2a add-ons can be adjusted.

The BSA supports the proposals for reserve stress testing scenarios to be performed every two years. However, this requirement is not actually reduced as reverse stress testing is required to be performed annually for recovery planning, as noted by the PRA. Consequently, the BSA proposes that the requirements for recovery planning should also be reduced to once every two years. This is in the spirit of the SDDT regime, without materially reducing the resilience of firms.

The BSA also supports the proposals to reduce the frequency of the full ILAAP to once every two years in line with our response to CP4/23. We would also ask for there be a mechanism for SDDTs to reduce the frequency of ICAAP and ILAAP as soon as the PRA's rules are finalised and ahead of 2027.

The proposed requirements, taken with the BSA's further proposals above, should significantly reduce the regulatory burden for building societies. This would have additional benefits to safety and soundness if resources are diverted into risk management, as well as increasing capacity to build and conserve capital while firms continue to support customers. The proposals would also further advance the PRA's secondary competition objective.

ICAAP template

The BSA welcomes the publication of an optional ICAAP structure in Annex 1 of the draft Supervisory Statement in Appendix 6 of CP7/24. We invite the PRA to go further in being clearer that it is acceptable for an SDDT to combine elements of ICAAP, ILAAP, the recovery plan and solvent exit analysis. The PRA hasn't said that this is not permitted. If the PRA were to positively state that it is acceptable then this would mitigate the risk of stakeholders taking the view that it is best practice to retain standalone, duplicative and lengthy documents.

Capital deductions

The BSA agrees that the current system of capital deductions is complex as set out by the PRA in CP7/24. We support the proposed simplifications. We note that this is an area that does not have a material impact on SDDT-eligible building societies hence our response.

One point we would question is the ongoing relevance of a 1250% risk weight. This can result in higher capital requirements than applying a capital deduction. As such, a capital deduction would be preferable rather than a 1250% risk weight.

Regulatory reporting

The proposals in CP7/24 coupled with the credit risk reporting for Basel 3.1 represent a material change project for many building societies. This comes at a time when the Transforming Data Collection (TDC) project is also looking at wholesale changes to regulatory reporting to streamline and improve the approach.

In line with the philosophy of Strong and Simple, we welcome the PRA's proposals to de-scope 38 regulatory returns under SDDT. These are returns that are not generally material for building societies, but the act of completing the returns, even if they are largely irrelevant, takes time and governance. As such, the de-scoping of less relevant returns is always welcome and to be applauded. In addition, we propose that the PRA considers de-scoping the leverage ratio return LV001 given most of the data is already available in other own funds returns. We also request that the PRA reviews the frequency of regulatory reporting returns, particularly where the numbers don't change materially each quarter they could be reduced to bi-annually.

By comparison, the transition to a new credit risk standardised approach means that entirely new returns are required, with new fields that don't currently exist. This is a significant change and hence IT implementation project. We do not believe that the figures in the published CBA adequately capture the costs of migrating to a new suite of regulatory returns for credit risk, and would ask the PRA to disclose more of the analysis and assumptions feeding into the CBA and how these compare to the recent cost survey conducted by the TDC project.

We understand the need for the PRA to receive information in a format that it can assure itself that firms are complying with the regulatory requirements that apply at the relevant point in time. However, we note that under the TDC project, the new regulatory returns will be reviewed again shortly after they are implemented, and potentially before they are implemented for an SDDT. This amounts to an unwelcome and costly 'digging up the road twice' for regulatory reporting.

The BSA would prefer for the TDC to progress with some of the more fundamental decisions and changes that are required *before* firms are required to implement whole new regulatory returns that follow the same format and philosophy as the existing approach to regulatory reporting. For example, one possible approach to be considered by TDC is for firms to report loan level data to the PRA. We believe this is a question that should be addressed first and foremost, before firms spend time and effort implementing revised old-style regulatory returns for SDDT from 1 January 2027. Between now and 2027, the PRA could consider how loan-level data might be a better solution to the regulatory reporting conundrum, and progress with a proof of concept loan level data pilot in a format aligned to existing loan level returns but adapted to Basel 3.1 requirements for credit risk. The BSA stands ready to the support the PRA with this work through the TDC.

In summary, the BSA does not support the proposals for SDDT firms to implement new regulatory returns aligned to Basel 3.1 as published in PS9/24 on 1st January 2027, for the reasons set out above.

Implementation

As mentioned in the summary above, we believe that proportionality is achieved via the PRA's implementation and supervision as much as by the policy itself. This is particularly true when it comes to areas of supervisory judgement where it is important that individually and collectively supervisors aren't incentivised to be excessively conservative i.e. gold-plate. We propose that PRA internal panels and supervisory oversight functions (1st, 2nd and 3rd line) should be given a specific mandate to consider the risk of over-capitalisation (in line with its secondary competition and competitiveness/growth objectives) as well as the risk of under-capitalisation (its primary safety and soundness objective). As such we propose that the PRA's internal processes should formally assess proportionality of implementation and consistency of outcomes (relative to risk) across SDDT firms.

We also propose, as is best practice, that the PRA should conduct and publish a post-implementation review of the new SDDT regime at an appropriate time after it is implemented.

Issues log

For ease of reference, we have tabulated a list of issues that the BSA would like to raise.

	Area	Issue	BSA Position (support/oppose)	BSA Proposal
1	Overarching	Areas of supervisory judgement	BSA supports that the PRA will need to make judgements	BSA proposes that the PRA sets out high level principles to guide firms on how it will make supervisory judgements
2	Overarching	Risk of gold-plating	BSA notes the risks of gold-plating by the PRA and other stakeholders	i. PRA to set up internal processes to avoid PRA goldplating (1st, 2nd and 3rd line) ii. PRA to conduct post-implementation review of SDDT implementation

				iii. PRA to conduct outreach with other stakeholders
	Overarching	SS20/15 BSocs Sourcebook	Fundamental review of the sourcebook	Update the sourcebook to remove limits in appendices and make more principles-based. Apply to all SDDTs or none.
3	Pillar 1	20% haircut	BSA opposes proposals. Valuations already include layers of conservatism to account for uncertainty of value of unfinished property and hence 20% haircut is double-counting.	BSA proposes that no haircut is necessary. Data previously submitted to the PRA in response to CP16/22 demonstrated loss rates on self-build mortgages are at, or close to, zero.
	Pillar 1	1.5x multiplier for foreign currency lending, including ex-pat mortgages	BSA opposes the 1.5x multiplier for loans where the borrower's income is in a foreign currency but the property is in the UK.	BSA proposes that if the borrower has a significantly higher income then the multiplier on the risk weight should not be necessary to cover fx movements.
	Pillar 1	CCR for securitisations	Request additional clarification	Request additional clarification
	Pillar 1	Removal of Due Diligence requirements	BSA supports	
	Pillar 1	Use of suitably robust statistical methods for valuation, including the use of AVMs and indices	BSA supports	
	ICAAP	Central clearing of derivatives	BSA opposes any requirement for all firms to centrally clear derivatives	BSA proposes that firms can conduct bilateral or centrally cleared derivatives in line with the draft SS appendix 6, page 16, and EMIR

	Pillar 2a	Higher risk lending	BSA asks for more clarity on what is deemed higher risk	BSA proposes that Pillar 2a analysis should only be required if i) the lending is genuinely more risky i.e. has higher loss rates and ii) the pillar 1 capital treatment is likely to be insufficient.
	Pillar 2a	Higher risk lending	BSA opposes conducting pillar 2a analysis across the entire portfolio	Where some higher risk lending exists then the analysis need only relate to those exposures not the entire loan portfolio.
	Pillar 2a	Credit concentration risk	BSA supports	
	Pillar 2a	Operational risk	BSA seeks greater clarity on the three operational risk buckets	BSA proposes principles as set out whereby a well-run firm with limited history of operational risk losses would default to bucket 1. Any operational risk add-on should include clear actions that once completed would result in the removal of the add-on outside of the regular SREP cycle. BSA proposes alternative approaches to P2a Op Risk.
	Pillar 2a	IRRBB and pension risk	BSA supports retaining existing approach	BSA proposes that capital add-ons should include clear actions that once completed would result in the removal of the add-on outside of the regular SREP cycle.
	Pillar 2a	Refined approach	BSA opposes removal of the refined approach	BSA proposes that the refined approach is retained but simplified.
	Buffers	Removal of countercyclical buffer	BSA supports	
	Buffers	New annual non-cyclical scenarios	BSA believes that two annual scenarios is excessive	BSA proposes that scenarios are kept simple.
	Buffers	3.5% min SCB	BSA opposes	BSA challenges the calibration of the minimum and proposes that 2.5% is the minimum.

	Buffers	Use of the buffer	BSA supports that the buffer is usable and the removal of the MDA	
	Risk management & governance scalar	40% scalar	BSA seeks clarification that a scalar is rarely used and only for outlier firms	BSA proposes this is used only rarely and the PRA provides high level principles on its application. BSA proposes that if used it is a % of SCB not TCR for simplicity.
	ICAAP, ILAAP, Recovery Plans	timing	BSA supports the full ICAAP and ILAAP being produced every two years, and this should also apply to recovery plans	BSA proposes greater alignment between TCR and pillar 2a calculations such that updates can be approved by the Board if in line with methodology approved by the PRA at the SREP. Recovery plans should be aligned to timing for reverse stress testing at once every two years. The PRA should provide a mechanism for SDDT firms to only update these documents every two years from the same time the PRA rules are finalised.
	ICAAP	Combination and removal of duplication	BSA supports streamlining of all regulatory documents	BSA proposes the PRA goes further in encouraging the combination of documents and the removal of duplication.
	Capital deductions	Simplification of capital deductions	BSA supports	BSA proposes that 1250% risk weight is removed and replaced with capital deduction.
	Regulatory reporting	Proposed new regulatory templates	BSA opposes the proposed templates	PRA to consider how existing loan level data, such as submitted for TFSME could be adapted for Basel 3.1/SDDT. BSA proposes LV001 is descoped.

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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 almost £525 billion, and account for 24% of the UK mortgage market and 19% of the UK savings market.