BSA Response to CP9/24 – Streamlining Pillar 2a and communications

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 & 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. However, the BSA opposes the PRA's proposals to remove the refined methodology as set out in CP9/24 and also referenced in CP7/24. **We believe that the PRA should simplify the refined methodology rather than remove it entirely.**

CP9/24 raises a fundamental question about the appropriate calibration of SDDT and the standardised approach under Basel 3.1 vs the internal ratings-based (IRB) approach. The difference in capital requirements has direct impacts on competition between standardised approach and IRB firms. It also impacts mutuals more heavily than banks due to the predominance of low-risk residential mortgages on building societies' balance sheets which are constrained by statue by way of the nature limits in the Building Societies Act. In addition, the IRB floor has a greater impact on monoline mortgage lenders, such as building societies when compared to banks as set out in the BSA's response to CP16/22. This means that the IRB floor is less likely to bite for a diversified IRB bank, giving it a competitive advantage over mutual building societies in the mortgage market. The BSA is not convinced that there is sufficient empirical evidence to support this significant difference in capital requirements between banks and building societies on the grounds of the PRA's primary safety and soundness objective, and this is at odds with the Government's commitment to double the size of the mutuals and cooperatives sector.

Points of detail on the removal of the refined methodology

The PRA has stated in CP9/24 that the original intent of the refined methodology was to address the conservative nature of the standardised approach risk-weights when compared with the IRB approach, particularly for low-LTV mortgages.[1] While the Basel 3.1 standardised approach risk weights are more risk sensitive in some regards, the move to original valuation is less risk sensitive with capital requirements being based on a property valuation that could be up to five years out of date. In terms of narrowing the gap between the standardised approach and IRB, this has largely been achieved by increasing capital requirements for IRB firms through a combination of the IRB floor and hybrid model adjustments. For IRB building societies this equates to a near doubling of capital requirements when compared to the

[1] See paragraph 2.2 of CP9/24

current requirements. While the PRA considers that the proposals would narrow the gap between standardised approach and IRB, the BSA considers that the removal of the refined approach could lead to a significant increase in nominal capital requirements compared with current Total Capital Requirements (TCR) for its members. The split between TCR and buffers is an important consideration as TCR is a minimum that must not be breached whereas buffers can be utilised during a stress.

Paragraph 1.10 in CP9/24 states that “It is the PRA’s view that the proposed changes would not have a significantly different impact on mutual societies compared to other authorised firms.” We do not agree with this statement and hold the opposite view. The refined methodology is particularly relevant for mutual building societies that are most heavily impacted by the difference between the standardised approach risk weights for residential mortgages and the risk weights that can be achieved under the IRB approach. It is also important to note that building societies cannot choose to diversify into other assets due to the nature limits in the Building Societies Act. The impact is particularly material for non-SDDT societies that are not on IRB and very material for those that are subject to MREL given that the impact is effectively doubled.

Calibration

Paragraph 2.17 of CP9/24 states that the Bank of England’s own analysis shows that the implementation of Basel 3.1 and hybrid model adjustments could narrow the gap between IRB and standardised approach capital requirements for owner-occupied mortgages <50% LTV from around 5.5 times higher to between 1.5 and 2.5 times higher depending on firms’ responses to IRB policy changes. The BSA acknowledges that there should be incentives for developing IRB models resulting in lower risk weights, to reflect the greater risk sensitivity that comes through modelling. However, the balance of those incentives remains excessive if risk weights for non-IRB societies are a magnitude of 1.5-2.5 times higher than those applicable to IRB firms. As mentioned above, this raises the fundamental question of the appropriate differential of capital requirements and how this aligns to the PRA’s secondary competition objective and its FSMA requirement to have regards to its impact on mutuals. Similar large differences exist for higher LTV lending – an area which is very relevant for first time buyers, a government priority. The gap for buy-to-let lending could reduce from 4.5 times higher to 2 to 3 times higher. The BSA questions the empirical evidence to support retaining such large differences in the amount of capital held by standardised approach firms compared to IRB firms. We propose that the PRA reviews loss rates observed on these portfolios at standardised approach and IRB firms through an economic cycle to ascertain if the significant variance in risk weights is actually justified.

Paragraph 2.19 in CP9/24 goes on to state that the benefit of the refined approach would be reduced to no more than 12th of the current size of the adjustment. The BSA is not able to replicate this figure.

The BSA has conducted its own analysis based on submissions by 20 of 36 SDDT-eligible building society members.

BSA Data analysis[2]

The BSA invited SDDT-eligible societies to complete a data submission exercise in autumn 2024. They provided pillar 1, pillar 2a and buffer calculations on the existing approach and according to the new proposals in CP7/24 and Basel 3.1 where relevant for pillar 1. The BSA then simulated a range of outcomes including testing the likely impact of the removal of the

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

refined approach. To calculate the impact of the removal of the refined approach, the BSA calculated the nominal impact on current TCR of removing the refined approach offset and adjusting for the reduction in pillar 1 under SDDT. We did not make any adjustments to reflect changes in pillar 2a methodologies as these are not yet known.

Our analysis showed that the removal of the refined approach could lead to a significant increase in nominal capital requirement compared with current TCR, and the increase is greater for larger societies at c15%. Of the 20 societies that participated in the BSA data exercise, the variance in weighted impact broadly correlated to balance sheet size. There was a slight decline of c1% on average for societies with balance sheets of <£1bn. For societies with a balance sheet of £1bn - £3bn the weighted increase was c10% and it was c15% for societies with a balance sheet >£3bn. The overall weighted increase in nominal capital requirement based on current TCR across the 20 societies was 9.8%.

Table 1: Removal of the refined approach (taking account of changes to pillar 1 under SDDT)

Balance sheet size	All societies (20 as at 6 Dec)	>£3bn	£1bn - £3bn	<£1bn
Weighted average increase/(decrease) in nominal capital requirement as % of current TCR	9.80%	14.75%	9.64%	(1.28%)

PRA Cost Benefit Analysis (CBA)

The PRA's CBA describes the benefits of retiring the refined approach as reducing the burden on firms. We do not concur that this is burdensome relative to the benefits of retaining the refined approach. Most of the work under the current pillar 2a approach is the extensive scenario analysis for credit and operational risk. The netting of unders and overs under pillar 2a is significantly less burdensome.

The PRA states that the new Basel 3.1 risk weights address the safety and soundness issues that the refined approach sought to mitigate. The BSA agrees with this in part but not entirely. The BSA agrees that the new risk weights for residential mortgages are more risk sensitive in certain aspects. However, we believe that in other aspects the new Basel 3.1 risk weights are less risk sensitive, such as the use of original valuations to determine the loan-to-value ratio. We understand the policy intent of using original valuations is to remove cyclicality from property prices in a rising market. However, this is not an accurate reflection of the risk when it is based on out-of-date valuations (up to 5 years old) which do not reflect market movements. This means that firms will need to store two valuations on their systems in order to calculate regulatory capital requirements and separately to manage credit risk. As such, the BSA does not agree with the statements in paragraph 2.33 of the CBA that the proposed risk weights are "more structured, granular and risk-sensitive, especially for real estate exposures."

BSA proposals and implementation

The BSA proposes that the PRA considers ways in which 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 any potential 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. IRB firms represent the majority of the market and so the IRB benchmark tables are helpful and representative information to publish. 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.[3]

The PRA is proposing to retire the refined methodology in a big bang approach on 1 Jan 2027 for SDDTs switching from the interim capital regime (ICR). We note that this does not align to the approach for Basel 3.1 IRB firms that benefit from a three year implementation period for the introduction of the IRB floor. 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.

Proposals to streamline capital communications

The BSA supports the proposals in CP9/24 to streamline capital communications. This is currently a complex process and we therefore welcome the review. We are also very supportive of the PRA reviewing rules as they move across from the onshored primary legislation into the PRA Rulebook. It makes sense to review rules as they come across, taking the opportunity to introduce more proportionality, remove areas of ambiguity, and improve readability and the general coherence of the overall framework. The BSA accepts that it will take many years to fully streamline the framework and therefore it makes sense to adopt a 'tidy up as you go along' approach which we welcome.

[3] 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"

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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 building society members have total assets of almost £525 billion, and account for 24% of the UK mortgage market and 19% of the UK cash savings market. Within this, societies account for 40% of all cash ISA balances.