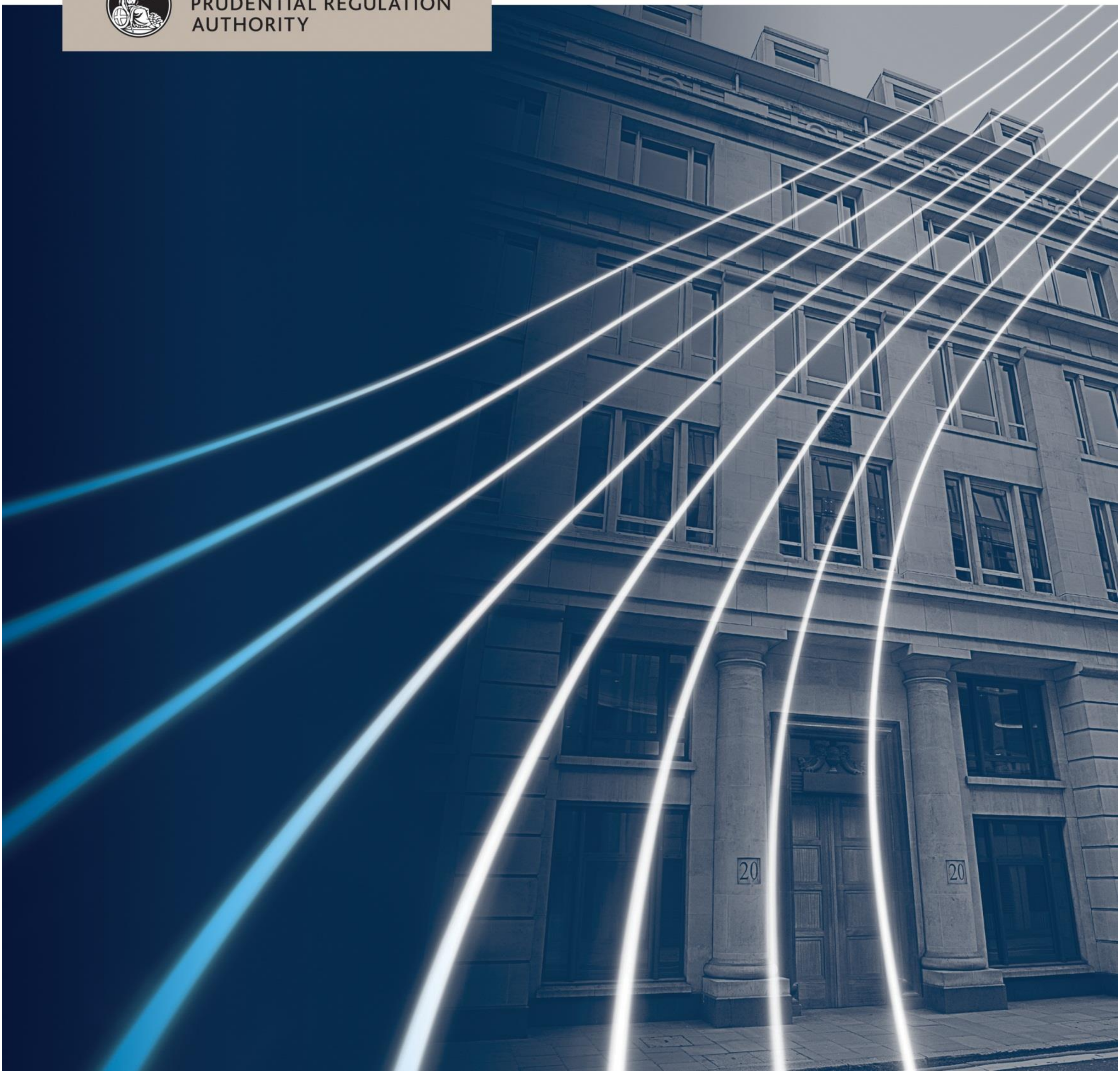
Policy Statement | PS34/16

Supervising building societies' treasury and lending activities

December 2016

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



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This policy statement (PS) provides feedback on responses received to Consultation Paper (CP)12/16 'Supervising building societies' treasury and lending activities' and the final supervisory statement.

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1 Overview

1.1 This Prudential Regulation Authority (PRA) policy statement (PS) provides feedback on responses to Consultation Paper (CP)12/16, 'Supervising building societies' treasury and lending activities' ('the CP')[1] and the final Supervisory Statement (SS)20/15 (see Appendix).

1.2 This PS is relevant to building societies, and should be read in conjunction with the PRA Rulebook for CRR firms and the PRA's approach to banking supervision.[2]

2 Feedback to responses

2.1 The PRA received 22 responses to the proposals in the CP, including from 17 individual building societies. The PRA has set out below the main issues raised by respondents, following the same structure as the SS. In addition to the changes identified below, the PRA has also made several clarifications and corrections to the SS text to address points raised by respondents and following its own review.

Scope and cost benefit analysis

2.2 Some respondents argued that the banking sector, and challenger banks in particular, should also be within scope of the SS, as otherwise building societies may be put at a competitive disadvantage.

2.3 The PRA set out its rationale for the scope of the SS in paragraph 3.13 of the CP and does not consider that the responses received make a convincing case for the scope of this SS to be widened, not least because the SS refers to specific restrictions on building societies' activities, set out in primary legislation (the Building Societies Act 1986) that does not apply to other firms. However the SS does not apply additional restrictions, and societies will still be able to carry out all the types of business that they have the experience, skills and resources to undertake within the capabilities of their risk governance frameworks.

2.4 Other respondents queried the PRA's rationale for not conducting a full cost benefit analysis. The PRA stands by the explanation in Chapter 3 of the CP: that there is no statutory requirement to carry out a full cost benefit analysis since the supervisory statement sets out supervisory expectations rather than rules.

Building society sector business model characteristics and guidance limits

2.5 A number of respondents highlighted the contribution of the building society sector in servicing more specialised segments/niches of the UK mortgage market, where they have built experience to mitigate the risks, and therefore argued against "prescriptive" guidance limits, in the appendices to the SS, that would prevent concentration of effort on a small number of niche products. Some societies highlighted their particular expertise in certain lending fields as a reason why the indicative limits were not appropriate for them.

2.6 The PRA acknowledges the role of the sector in tackling more complex mortgage cases, but believes this reinforces the need to ensure that the risk appetite of a society is matched by its risk expertise and risk management capacity relevant to its chosen niche(s) – which is a key objective of the SS. Hence the SS sets out the PRA's expectations and indicative, rather than "prescriptive", limits. A Society is open to operate outside the stated expectations where it can

1 April 2016: www.bankofengland.co.uk/pra/Pages/publications/cp/2016/cp1216.aspx.
2 March 2016: www.bankofengland.co.uk/publications/Pages/other/pra/supervisoryapproach.aspx.

demonstrate to its own board and its supervisor that an appropriate risk management and controls framework has been established.

2.7 The PRA has taken the opportunity to review again its indicative limits, and Appendix 2 of the SS has been amended to make clear that the sub-categories of self-build, lending into/in retirement, shared ownership and shared equity are included within the overall prime owner occupier indicative limit.

Lending

2.8 Respondents requested greater clarity over the alignment of the CP with policy on underwriting standards for buy-to-let mortgage contracts.[1] The final policy has now been published,[2] and the updated SS20/15 is fully aligned. The table of indicative limits in Appendix 2 of SS20/15 has been amended to show, separately, lending to borrowers with four or more buy-to-let (BTL) properties. Given the changes in current and future personal taxation relating to BTL activity, interest cover expectations in the table have been clarified as being post-income tax (adjusted for allowances).

2.9 The section on self-build (paragraphs 3.26-3.31) has been amended to acknowledge the differences in risk profile across the range of self-build types, from self-construction to 'custom-build', and to highlight the risk management advantages of allowing drawdowns against completed work rather than in advance. Some respondents felt the self-build indicative limit for societies on the 'traditional' approach was too low: having reviewed the potential risks and taking account of the mitigation available through careful management and monitoring of drawdowns, the PRA has decided to increase the indicative limit to 7.5% of the loan book (applying to loans and loan commitments for properties in the build phase).

2.10 Following a number of comments, the section on lifetime mortgages (paragraphs 3.35-3.47) has been redrafted to segment the types of lending, based on different characteristics. The opportunity has been taken to distinguish between interest roll-up mortgages, lending in retirement (ie to borrowers who have already retired and will service the loan from their pension income), and lending into retirement (ie to borrowers who are currently in employment, but may have or will have retired before the loan reaches term).

2.11 Some respondents felt that the loan to value (LTV) indicative limit for interest only lending in retirement on the 'limited' approach was too low: the suggested 25% LTV limit was a drafting error and it has been changed in Appendix 2 to 70% LTV.

Treasury

2.12 Following a number of comments, the wording in paragraph 4.33 of the draft SS (that inadvertently appeared to indicate that a society's liquid assets holdings to meet the overall liquidity adequacy rule (OLAR) should be comprised wholly of High Quality Liquid Assets (HQLA)[3]) has been amended to make it clear that HQLA terminology relates just to the regulatory measure of liquidity (the liquidity coverage requirement).

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1 PRA Consultation Paper 11/16 'Underwriting standards for buy-to-let mortgage contracts' March 2016: www.bankofengland.co.uk/pra/Pages/publications/cp/2016/cp1116.aspx.

2 PRA Policy Statement 28/16 'Underwriting standards for buy-to-let mortgage contracts' September 2016: www.bankofengland.co.uk/pra/Pages/publications/ps/2016/ps2816.aspx and Supervisory Statement 13/16 'Underwriting standards for buy-to-let mortgage contracts' September 2016: www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss1316.aspx.

3 As defined for LCR purposes.

2.13 The section on wholesale funding risks in paragraphs 4.76-4.78 has been modified and expanded to add clarity, as requested by respondents.

2.14 The expectation that funding tenors should increase in line with the level of overall reliance on wholesale markets has been amended to focus on the need for societies to model in some detail the combined impact of refinancing risks across different types of funding, rather than the previous focus on wholesale funding in isolation. Societies are still expected to monitor material wholesale funding concentrations – defined as maturity flows exceeding 5% Shares, Deposits and Liabilities in any rolling quarter, and/or exceeding 10% in any rolling 12 month period. As requested in feedback, the opportunity has also been taken to acknowledge the different funding risk profiles and impact of 'pass-through' structures (such as residential mortgage-backed securities) that are self-amortising.

2.15 In response to requests for more explanation of the PRA's expectations for price modelling, a new annex has been included (Appendix 6) that lists the key theoretical components of a fully-fledged pricing system. In line with the PRA's general approach to proportionality, it is not expected that all societies should be expected to model and calculate every theoretical component, and the level of sophistication will therefore vary according to the treasury 'approach' adopted – as set out in a table in Appendix 6. The stated expectations in the SS on funds transfer pricing (FTP) have been amended to indicate that actual internal transfers based on FTP calculations are not necessary – the aim is to ensure that societies fully understand their costs and income, and factor these into their external pricing decisions.

2.16 The drafting error in the section describing the 'comprehensive' approach has been corrected in paragraph 4.177 to distinguish between middle office and second line risk management. To clarify expectations for risk management under the 'comprehensive' approach, a more detailed explanation of the features of a typical treasury structure has been included in the text.

Implementation

2.17 Respondents sought reassurance that any existing flexibility for a society to operate outside current guidance, following discussion with the PRA, should be carried forward without the need for further consideration. This will be the case, and full implementation details are included in Chapter 7 of SS20/15 (see Appendix). Details on the process for handling any application for a change of treasury or lending approach, or extension, arising from the update of the supervisory statement are also covered. The guidance in the SS takes effect from 1 January 2017.

Appendix

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1 Supervisory Statement 20/15 'Supervising building societies' treasury and lending activities' UPDATE available at, www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss2015update.aspx.