BANK OF ENGLAND

Speech

The state of the building society sector and the PRA's approach to governance

Speech given by

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It's a great pleasure to be at the BSA annual conference again, and in Harrogate again. I note that Harrogate is confirmed as "the happiest place in England!", so I feel a certain sense of expectation by inviting the prudential regulator to speak at the happiest place. My plan this morning is to cover two areas in my remarks: first, an overview of our impressions of the state of the building societies as a whole; and, second, some comments on the PRA's approach to the governance of firms, to coincide with the publication today of consultation of our supervisory statement on board responsibilities.

So, since we are in the happiest place in England, let me start in what I hope you will regard as an appropriate spirit, namely that even though the environment remains one of continuing low interest rates – and, as I always do at this point, let me stress that I am making no judgement on monetary policy whatsoever – the aggregate net interest margin for the building societies has picked up, arrears rates on loans remain low and net new lending has been strong over the last two years. Looking at the sector beyond Nationwide – and I do this not to ignore Nationwide but because its size means that it has a large impact on averages – the average Core Tier One Capital ratio at the end of last year was over 17%, and the average leverage ratio was around 6%. The overall quality of capital is in our view in a good place and you have taken the implementation of Basel 3/EU CRD4 in your stride.

In the four quarters to the end of last year, the societies (again not including Nationwide) contributed 22% of net new mortgage lending in the UK, which compares with a 9% share of the stock of lending. Arrears on first charge mortgages continue on a downward trend that we have seen for at least the last five years, and the building society arrears rate on average is lower than the average for all mortgage loans.

All societies are meeting their liquidity requirements and quite a few of you choose to hold higher liquid asset buffers than our requirements, which is perfectly acceptable as a choice. Access to Bank of England liquidity facilities, which is an important form of insurance, has increased in terms of the number of societies having reserve accounts and preparing for the use of lending facilities should that be needed at some point in the future.

Unsurprisingly, therefore, the overall position on ratings for those societies that have them has improved. So, it's true, Harrogate really is the happiest place in England. Of course, I am now going to go on to talk about risks, but before I do let me say that this sort of performance doesn't happen by accident. But it does show that there is a role for mutuals and one that can succeed. Of course, a lot of hard work goes into achieving these results. On our side, I can also say that Martin Stewart and his colleagues put a lot of hard work into our role, which is founded on sensible forward-looking judgement consistent with our objectives in statute.

So, what can go wrong – the risks? The first area that I would highlight is the potential for margin pressure. Most forecasters see continued growth in the mortgage market as the most likely development, but at a lesser pace than in recent years, which is consistent with actions taken by the Bank of England last summer to limit the growth of borrowing by highly indebted households. Competition in the mortgage market is growing, and for instance rates on two year fixed rate mortgages are at a record low. On the liability side, wholesale funding costs are low, and on much of the evidence they are below retail funding costs on average, and that tends to benefit lenders with greater access to wholesale funding. Therefore, notwithstanding the news on interest margins over the last two years, we are watching this story carefully to see what happens next.

The second risk unfortunately follows from the first, namely that increasing pressure on interest margins can tempt lenders to seek higher returns on assets through riskier loans, and to concentrate more on short-term funding thereby increasing the mismatch. We saw this before the financial crisis broke in 2007 as lenders ventured into higher LTV, sub-prime and commercial property lending without having adequate risk management in place. We also saw this in the late 1980s and early 1990s. This diversification was generally not successful, and in some cases fatal. Since the height of the crisis societies have generally reduced their commercial property loans, and non-prime has declined too. The main area of growth has been buy-to-let lending, which is true not just for societies but for lenders in general. Now, I don't want to demonise buy-to-let lending. We are watching carefully, and for the societies we see no evidence today that BTL loans are of poorer quality than prime owner-occupier, and we see a fair amount of stability over time in maximum LTV and minimum rental cover. But, we are watching carefully, and of course applying stress testing across all loans.

Looked at more broadly, we are not seeing an upward surge in high LTV lending of the sort that was so damaging in the past, but there is an upward direction to the – admittedly small – share of lending at high LTV and high loan-to-income (ie the two together). We are, again, watching this carefully, and it is why in 2010 we implemented the Building Societies Sourcebook to encourage appropriate risk management of lending and funding. The latter will be supported in future when we implement the net stable funding ratio which is the international standard to discourage reliance on short-term funding.

We are also increasingly focussed on operational risks and the prudential implications of conduct risk, as I know are societies. I want to pick out one area of operational risk which is important, namely IT systems risk. One aspect of this is the cost and complexity of updating legacy IT systems in the face of growing demands on those systems from innovation in products. Cyber risk is also very high on our list of priorities. I recognise that not all societies have an internet presence, though I do know, of course, that you all use the internet. We will be seeking to ensure that cyber risk is properly tackled by societies as appropriate. In saying this, I am not seeking to pick out societies from other firms that we supervise, but we do think that these risks are in important respects common to all firms.

Societies have generally been less affected than the large banks by conduct mis-selling costs, though not fully immune. We are watching again very carefully, and I can assure you that as prudential regulator we want to see sensible outcomes that balance the objectives of all parties and ensure that we maintain a stable financial system that can support the activity of today's customers. Nobody wants to see a world where ex-post enforcement weakens the capacity to support economic activity, and that means we must return as soon as possible to a world where the emphasis is on strong risk management, governance and forward-looking supervision.

This review of risks covers much of our work programme for the year. Two other points I would note. First, we are reviewing the Sourcebook which since the beginning of April has been called a Supervisory Statement. The Sourcebook was first introduced in 2010 as a response to the crisis. We will consult on changes later this year and have already had two very useful pre-consultation meetings with the BSA and a number of societies. Let me assure you that this review is not the beginning of a major agenda to change how we supervise societies. Rather, a lot has happened since 2010, and we think a stocktake is in order. Second, recovery and resolution is an important focus of activity following the enactment of the EU Directive (the BRRD). Our objective is to ensure that orderly resolution is possible should it be needed, and thus to support our general approach that we are not a regulator that adopts a policy of no failures. We work closely with the resolution function of the Bank of England to develop and put into effect workable resolution plans.

I said that I would also comment on the PRA's approach to the governance of firms, so let me now turn to that. I will start with an observation based on experience of the crisis, namely that is uncommon and rare to find a problem in the capital or funding or business model of a firm which cannot be traced back to a failure of governance. I don't think this is a radical statement by any means. But it does mean that fixing capital, liquidity, and other areas of risk do not on their own deal with all of the problem. Put another way, it would be unwise to do all of these things and ignore governance. Good governance is critical to delivering a sound and well-run business. At the instigation of the Parliamentary Commission on Banking Standards, we are this year implementing the new Senior Managers Regime. The key principle of that regime is to establish clearly appropriate responsibility for the governance of firms. Put like that, it is not meant to be radical or life-changing, despite whatever you may hear and read. We do want to avoid what the PCBS described as the Murder on the Orient Express outcome when firms get into trouble, which is akin to the "everyone and no-one" is responsible but everyone is connected to the event. Clarity of responsibility is I hope unobjectionable. But this is not clarity in the sense of facilitating witch hunts. Rather, I see clarity as an appropriate allocation of responsibility, as important to creating the right incentives for behaviour and leadership, and of course in areas like remuneration.

In the Senior Managers Regime, responsibility at the highest level covers both executives and non-executives. But, of course, they are different and always will be. There is much commentary, that the response to the crisis has muddied the responsibilities of executives and non-executives, with the burden on the latter increasing. I think there is no doubt that a greater formality is emerging around roles and responsibilities, and I'm afraid the burden of work for non-executives has risen, we can't hide from that. An effective board is at the heart of good governance, ensuring that the appropriate policies are in place in respect of safety and soundness and good conduct. We at the PRA have a strong interest in supporting good governance and the work of board members to deliver it. An effective board is one which understands the business, establishes a clear strategy, articulates a clear risk appetite to support that strategy, oversees an effective risk control framework, and collectively has the skills, the experience and the confidence to hold executive management rigorously to account for delivering that strategy and managing within that risk appetite.

In view of the important role of boards, and the work on governance under way, today we have published for consultation a Supervisory Statement on the responsibilities of boards. We recognise that this is a hugely important issue, and so we thought it was sensible to set out our thinking for comment as a precursor to a statement of our expectations. The statement clarifies our expectations of boards and indicates some of the elements of good governance to which we expect to pay particular attention in assessing how well firms are run. It draws on our regulatory experience and the lessons of past firm failures – including building society ones - and will help boards to understand how we reach our judgments on governance. The statement is not intended to be a comprehensive statement of good practice. Boards have other sources for that, such as the Corporate Governance Code produced by the Financial Reporting Council or the Basel Corporate Governance Principles for banks.

The statement underscores the collective responsibilities shared by board members. As such it complements the individual accountabilities which we are introducing through the Senior Managers and Senior Insurance Managers Regimes. Under these regimes all senior managers, including certain non-executive directors, will be held to a clear standard of behaviour. But the primary role of all NEDs is independent oversight and challenge of the Executive and the PRA recognises that the actual responsibilities of NEDs within the scope of the regimes differ from those of executive Senior Managers and they should be clarified and limited accordingly.

Key messages from the statement are:

- it is a responsibility of boards to establish strategy, set the risk appetite and monitor risk across the business and hold management to account;
- the risk appetite must be clearly owned by the Board, integral to the strategy and actively used to monitor and control risks and inform key business decisions;
- boards should articulate and maintain a culture of risk awareness and ethical behaviour;
- boards should include individuals with a mix of skills and experience that are up-to-date and cover the major business areas in order to make informed decisions and provide effective oversight of the risks;
- but this does not mean expertise in every aspect of a broad and complex financial business – the point is to have the diversity of experience and capacity to provide effective challenge across the full range of business;
- boards should act in a co-operative and collegiate manner whereby the non-executives support and encourage executive management and vice versa;

- but this should not inhibit the non-executive directors from challenging executive management and holding them effectively to account;
- non-executive directors should ensure they have the time and resources and access to the business they need to fulfil their duties;
- executive management have a responsibility to ensure the Board can exercise its role and should exercise their judgement in bringing key issues to the Board’s attention at an early stage; and
- the principle of good governance, including independence of the Chairman, should also apply to material subsidiaries. Boards of regulated subsidiaries need to be able to take decisions where required to meet their own legal and governance responsibilities or in the interests of the safety and soundness of the subsidiary. But, that does not mean they should operate outside the general governance and objectives of the group to which they belong. Independence in this context is carefully defined and limited.

As you will all be aware, we have undertaken significant engagement with the boards of banks and building societies on governance. Through our supervisory work, we are seeing improvement but in our view there is more to do. Board effectiveness will therefore remain a key priority. To conclude, governance matters a lot, I can’t understate that. Effective boards are central to the success of firms and the financial sector, and central to the delivery of our objectives. Thank you.