The Challenges and Opportunities Ahead for the Mutual Sector – speech by David Bailey

Given at The Building Societies Association Conference

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Speech

Introduction

Good morning everyone and I'd like to thank Robin, Mark, Rob and their colleagues at the Building Societies Association for inviting me to speak today.

I'm delighted to be able to join the BSA conference in person for the first time and meet members face to face. It's an added bonus that we are meeting in Liverpool where there is a building sense of excitement and anticipation, not just about this conference but also about the Eurovision song contest next week.

In recognition of Eurovision, I did think about peppering my speech with references to famous songs from over the years, but my team told me to "Refrain[1]" as they said 'David, you'll have trouble "Making your mind up[2]"' so I reluctantly agreed to take a "Better the Devil you know[3]" approach and stuck with a more traditional format instead.

This year's Eurovision theme is "united by music". Whilst the audience today is possibly dressed 'slightly' differently to next week's, it does bring together a wide range of building societies and credit unions who are united by their mutual ownership model and the provision of financial services to a diverse set of members and customers right across the UK.

At the PRA we recognise the vital role mutuals play in the UK financial sector. Collectively, BSA members manage over £500bn of assets, nearly 15% of assets managed by the UK deposit takers we supervise at the PRA. Also, all 50 BSA members have headquarters outside London enabling a connection with local communities, some members of whom might not have other ways of accessing mainstream financial services. This is further fostered through a network of almost 1350 branches serving more than 26 million members. In line with this, we see our role in supervising BSA members as central to our mission at the Bank of England to 'promote the good of the people of the United Kingdom by maintaining monetary and financial stability'.

My remarks today will focus on two areas. Firstly, a key challenge for the mutual sector to tackle over the coming year, managing a fast-evolving outlook for credit risk whilst supporting your members in the current economic climate. I will be setting out the PRA's expectations and a flavour of what we are doing in this space. Secondly, the opportunity we are taking to evolve our regulatory regime to ensure it continues to deliver resilience in

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[1] Refrain, Lys Assia, 1956, Switzerland, winner.
[2] Making your mind up, Bucks Fizz, 1981, UK, winner.
[3] Better the devil, Sonia, 1993, UK

the sector, remains proportionate and supports growth, including in light of the Financial Services and Markets Bill which is currently making its way through Parliament.

Economic outlook and credit conditions

Let me turn to the first of those areas, the current outlook for households and businesses, and what that means for your lending portfolios.

Here the backdrop is clear. Over the past few years, the UK economy has faced a series of events which our Governor, Andrew Bailey, summarised in recent remarks[4], including the Covid pandemic and the interruptions to economic activity that caused; and the rise in energy prices caused by Russia's invasion of Ukraine. Andrew also outlined the challenging economic conditions we now face including through inflation, which at 10.1%[5] remains well above the 2% target and continues to outstrip wage growth, and a growth rate which the latest Monetary Policy Committee report[6] estimates is around 1% per annum compared to a typical rate of nearly 2.75% in the decade leading up to the 2008 financial crisis.

In response to inflation, the MPC has raised interest rates 11 times to 4.25%. Whilst inflation is expected to fall sharply by the end of this year and growth to pick up, the impact on the finances of the households and businesses that you serve has been significant.

We have seen this through indicators showing consumer confidence at its lowest levels since the 1970s[7], households increasingly focusing on value and cost savings in their spending habits, decreased demand for mortgage borrowing in the first quarter of this year[8], and subdued demand for credit from corporates who remain under pressure from the impact of higher interest rates[9]. Furthermore, the stress on household finances is likely to increase as around 4 million mortgage borrowers[10] see their monthly mortgage payments increase, including as borrowers roll off the current fixed term of their mortgages over 2023.

What does this mean for mutuals' credit portfolios?

What I have outlined so far are potential early indicators of pressures to come. The credit data that PRA regulated firms report to us have not yet shown a significant increase in levels of arrears or defaults. These have typically remained at or below pre-Covid levels and only in Q1 2023 have started to show an uptick in areas like 'new to arrears'. This

[4] **Supply matters – speech by Andrew Bailey | Bank of England**
[5] As at 19 April 2022
[6] **Monetary Policy Report - February 2023 | Bank of England**
[7] **UK consumer confidence index 2023 | Statista**
[8] **Credit Conditions Survey - 2023 Q1 | Bank of England**
[9] **Financial Policy Summary and Record - March 2023 | Bank of England**
[10] **Financial Stability Report - December 2022 | Bank of England**

uptick is not yet at a level that indicates a material amount of credit risk is crystallising, but rather I take it as a clear warning that firms need to take action now to be prepared both to support their customers and preserve their resilience should the stress that we are observing result in a marked deterioration in their credit portfolios.

That is exactly why we put credit risk at the top of our list of Supervisory Priorities[11] for UK deposit takers in our annual letter to CEOs in January.

What do we expect mutuals to do?

As I noted at the start, your services are instrumental in supporting UK households and businesses. It's in all our interests that this is maintained, both to the members who rely on your services and also to support the resilience of the broader economy. But it is also vitally important that the risks of doing so are managed prudently.

Whilst the mutual sector generally has a good track record of doing this, it is important that firms continue to enhance the way they manage risk. Aligned with this, we've seen the most proactive firms taking steps that include:

- **Using early warning indicator frameworks** that highlight emerging risks in portfolios at an earlier stage than more traditional, backward-looking credit metrics.
- Reviewing **credit risk management frameworks** to ensure they remain appropriate, with robust governance and controls around credit and affordability assessments.
- **Reviewing lending criteria** to ensure they remain prudent and sustainable.
- Assessing **concentration risks in their portfolio**. This is especially important for firm-specific concentrations, for example in the type or location of their customer base.
- Regularly analysing whether the **levels of credit loss provisions are sufficient** and ensuring these are recognised in a timely manner.
- **Early outreach to customers** whose finances are most vulnerable in the current circumstances whilst bearing in mind relevant FCA guidance[12].
- Ensuring that **customer support and collections arrangements are appropriately scaled** so they can expand rapidly if need be.

This is, of course, not an exhaustive or comprehensive list but simply highlights some of the good practices we are seeing amongst the firms we supervise. However, the message is clear: **the outlook is highly uncertain; and we expect firms to be proactive in enhancing the way you manage the risks in your credit portfolios** – rather than simply

[11] UK Deposit Takers Supervision: 2023 priorities (bankofengland.co.uk)
[12] FG23/2: Guidance for firms supporting existing mortgage borrowers impacted by rising living costs | FCA

relying on historic approaches. Doing so will enable you to continue to support your members in a sustainable way.

As your supervisor, we have been increasing our own focus on credit risks. You will probably have seen this in your firm's engagement with our supervisory teams; through the questions we are asking, the data we are collecting and the reviews we are conducting both with individual firms and thematically. And, of course, our Annual Cyclical Scenario stress test will enable us to assess the resilience of the largest UK deposit takers. The results of this will be published in July. We expect all other firms to use the PRA published scenario as a benchmark in their own stress testing processes.

In short, we expect firms to have a very clear focus on managing the evolving credit risks within their portfolios and we will supplement that with our own ongoing attention in this area.

Finally on this topic, whilst my comments have focused on the short- to medium-term implications of the current outlook, it is important firms focus on the horizon as well. I therefore encourage you to consider how current conditions may impact demand for your services over the longer term and what this may mean for your business model and strategy. This is an area that we will increasingly be asking you about as your supervisor.

The PRA's Supervisory & Regulatory Agenda

Let me move on to the second area I promised to touch on – the opportunity we are taking to evolve our supervisory and regulatory regimes to ensure they remain fit for purpose and proportionate. Doing so will help maintain a resilient mutual sector in the UK, which can support its members with sustainable growth and innovation. It will also allow us to manage our resources efficiently whilst focusing on the biggest risks.

A starting point is to note that the core of our supervisory approach will remain unchanged; it will continue to be underpinned by three key principles:

- Firstly, it is **judgement based** – with supervisors making judgements about the risks that a firm poses to our objectives based on evidence, analysis and direct interaction with firms. The actions we expect firms to take will be based on those judgements;
- Secondly, it is **forward looking** – assessing firms not just against the current risk environment but, as I have just outlined, on how existing risks may evolve and new risks emerge; and
- Thirdly, it is **focused on the key risks** – and that is where we'll primarily dedicate our focus and attention.

Across those three principles we will continue to apply proportionality. This means the supervisory focus on your firm will reflect your size and complexity.

Although the key elements of our supervisory approach remain, we have made some enhancements, which we communicated to you in our January Priorities letter[13]. These include revising the way we categorise the 'potential impact' of firms and refining our schedule of ongoing core assurance work. We are communicating what this means to individual firms over the next year, through the supervisory communications we send.

We also have some significant change taking place on the regulatory front.

The Financial Services and Markets Bill, which is currently making its way through Parliament will – if passed into law – introduce a new secondary competitiveness and growth objective for the PRA. This would sit below our primary objective, to promote the safety and soundness of firms, and alongside our existing secondary objective to facilitate effective competition in the market for services provided by PRA-authorised firms. The new objective would require the PRA to act in a way which, in advancing our primary objective, and subject to aligning with relevant international standards, facilitates the international competitiveness of the UK economy and its growth in the medium to long term.

In a recent speech[14] my colleague, Vicky Saporta, set out how we plan to take forward that new objective, through an approach based on 'responsible openness'. In short this means we will provide a predictable and stable regulatory environment that is grounded in international standards (for example those set out by the Basel Committee), and we will collaborate closely with overseas regulators to maintain their trust in what we do, as well as that of investors and firms.

But importantly and against that backdrop of responsible openness, there is still space to tailor rules to UK circumstances when it is appropriate and when we can do so in ways that maintain trust across markets and with fellow regulators.

And that last point about supporting the specific needs of the UK economy is of particular relevance to our discussions here. I see it as precisely where the mutual sector comes in, through providing high quality financial products and services to households and businesses right across the UK, including some who might not have access through any other routes.

Two priority areas:

That evolving regulatory approach is underpinning our approach to two pieces of policy I know are of keen interest to BSA building society members – **Basel 3.1** and our **Strong and Simple regime** for smaller firms.

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[13] UK Deposit Takers Supervision: 2023 priorities (bankofengland.co.uk)
[14] The regulatory foundations of international competitiveness and growth − speech by Vicky Saporta | Bank of England

Basel 3.1

In keeping with what I have set out, the PRA's proposed approach to the **Basel 3.1 standards**[15] maintains high levels of resilience and is aligned with international standards that we helped shape. The standards constitute a comprehensive package of measures that make significant changes to the way firms calculate risk-weighted assets for the purposes of calculating risk-based capital ratios. The proposed changes will make firms' capital ratios more consistent and comparable.

But we also need to make sure that the new rules work effectively, and in line with our objectives, both for banks and building societies. That is why we stressed in our recent Basel 3.1 CP that it was very much an open consultation and that we welcomed evidence-based analysis and feedback to help shape our final rules.

Input from both the BSA and its members is core to that, and we are grateful for the feedback you have collectively and individually given. We are particularly focused on your feedback in areas where our proposals will impact those products and services that are central to the mutual business model, like both owner occupied and buy to let mortgages.

The consultation closed in late March. We are considering all the feedback received which will inform our final policies and approach to implementation, which we will look to communicate in due course.

Strong and Simple

Alongside that process and aligned with my earlier comments about tailoring rules to UK circumstances where appropriate, we are investing in our Strong and Simple project. Through this we will create a simplified prudential framework for domestically focused non-systemic banks and building societies that is, when compared to the standards that apply today, more proportionate, easier to understand and less costly to implement.

But importantly that simplified framework also has to be strong, by which I mean maintaining overall resilience which is equivalent to what we have today. Events in the global banking sector in recent months have clearly demonstrated why the 'simple' needs to be accompanied by the 'strong'.

As the target population of firms for the first layer of the framework is smaller domestic firms providing savings and lending products in the UK, many building societies are likely to be eligible to take advantage of the simplifications.

Our Basel 3.1 consultation paper set out some proposed revisions to the scope of the first layer, including to address feedback on the definition of domestic exposures. On 27

[15] **Implementing Basel 3.1 in the UK – speech by Phil Evans | Bank of England**

February[16] we published our ‘Phase 1’ Consultation Paper, setting out a number of simplified liquidity, disclosure and reporting measures that address good suggestions respondents raised in relation to our previous discussion paper[17]. In addition, we intend to consider possible further changes to regulatory reporting requirements as part of implementing the Bank’s plan for transforming data collection.

The Phase 1 consultation closes on 30 May and, in the spirit of my previous comments, we welcome responses on all aspects of it. I would encourage societies to respond individually as well as via the BSA. I’d also recommend the Strong & Simple briefing session we are running later in the conference, which will provide further explanation of the proposals.

Following this, we are planning a ‘Phase 2’ consultation on the simpler regime capital framework in H1 2024. Our planning assumption is that the Basel 3.1 Pillar 1 approach to credit risk would be a good starting point for designing the simpler regime risk-based capital framework. Hence, I strongly encourage your engagement with all of the policy developments I have outlined in my remarks today. And I also recognise that you will want to see all our proposals before you can assess the overall impact on your business – which is why we are working hard to get them published in a timely manner. We are also considering what a layer of the framework for ‘mid-tier’ firms might look like, and are currently undertaking some engagement with relevant firms to understand where they see scope for simplification of the prudential regime.

Other Priorities

Before I close, I did want to note our ongoing focus on Diversity & Inclusion in the sector. This is an important area which helps enhance governance, decision-making and risk management in firms, as well as the services you provide your members. We plan a consultation paper later this year, building upon the joint 2021 PRA/FCA discussion paper[18], setting out proposals to introduce a new regulatory framework on diversity, equity and inclusion in the financial sector. I strongly encourage you to engage with those proposals once they are published.

In Conclusion

Let me briefly sum up.

I’ve stressed today the important role that mutuals play in providing your services to a diverse range of households and business right across the UK. It’s vital those services are

[16] **CP4/23 - The Strong and Simple Framework: Liquidity and Disclosure requirements for Simpler-regime Firms | Bank of England**
[17] **FS1/21 – ‘Responses to DP1/21 ‘A strong and simple prudential framework for non-systemic banks and building societies’ | Bank of England**
[18] **DP2/21 – Diversity and inclusion in the financial sector – working together to drive change | Bank of England**

underpinned by resilient firms. The outlook for credit risk remains uncertain and we therefore expect firms to be forward-looking in how you manage the risks this presents. We are doing the same. I also set out the ways in which we are evolving our supervisory and regulatory regimes to ensure that they can support growth and innovation within a sustainable and resilient mutual sector. I encourage you to engage actively with those changes to help us make them work well.

Finally, I was asked before I came up to Liverpool whether I was looking forward to the Q&A section which will follow my remarks. The answer of course is a resounding ‘yes’ as I enjoy the open and frank engagement I have with BSA members. But I also know that some of your questions can be really quite challenging. So, my response, in recognition of events here next week was to quote Gina G by saying, ‘Ooh, Aah…just a little bit’[19] (sorry I just couldn’t resist that one).

I would like to thank Phil Evans, Alison Scott, Vicky Saporta, Monica Shant, Rogier Wieffer, Nick Lock, Vrunda Chunilal, Isabel Jennings and Anjli Shah, for their assistance in preparing these remarks.

Thank you.

[19] Ooh Aah Just A Little Bit, Gina G, 1996, UK