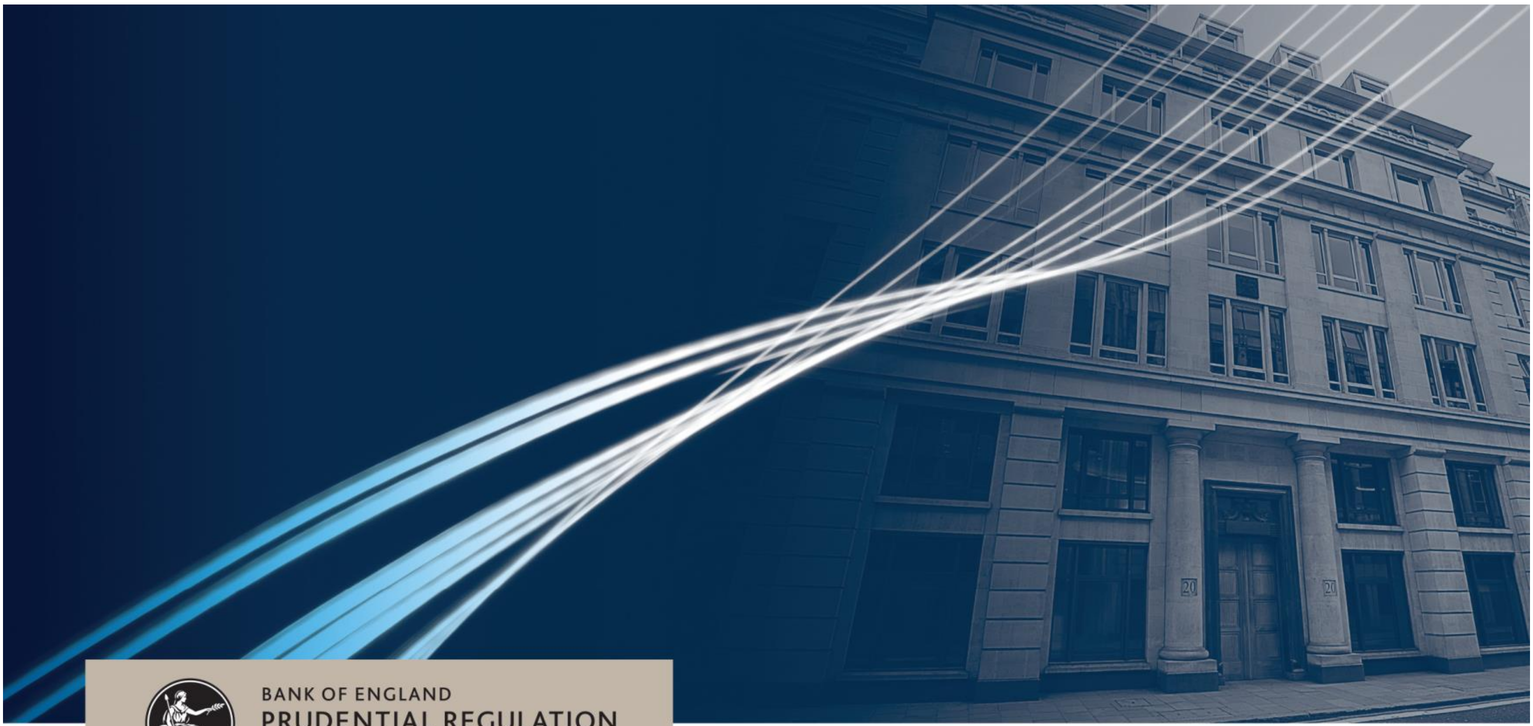

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP12/16

Supervising building societies' treasury and lending activities

April 2016

Prudential Regulation Authority
20 Moorgate
London EC2R 6DA

Prudential Regulation Authority, registered office: 8 Lothbury, London EC2R 7HH.
Registered in England and Wales No: 07854923

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Consultation Paper | CP12/16

Supervising building societies' treasury and lending activities

April 2016

The Bank of England and the Prudential Regulation Authority (PRA) reserve the right to publish any information which it may receive as part of this consultation.

Information provided in response to this consultation, including personal information, may be subject to publication or release to other parties or to disclosure, in accordance with access to information regimes under the Freedom of Information Act 2000 or the Data Protection Act 1998 or otherwise as required by law or in discharge of our statutory functions.

Please indicate if you regard all, or some of, the information you provide as confidential. If the Bank of England or the PRA receives a request for disclosure of this information, the Bank of England or the PRA will take your indication(s) into account, but cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system on emails will not, of itself, be regarded as binding on the Bank of England and the PRA.

Responses are requested by Monday 4 July 2016.

Please address any comments or enquiries to:
Ellen Caswell
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

Email: CP12_16@bankofengland.co.uk

Contents

1 Overview

1.1 This consultation paper (CP) sets out proposed changes to Supervisory Statement 20/15[1] on the approach and expectations of the Prudential Regulation Authority (PRA) in its supervision of building societies' treasury and lending activities.

1.2 The CP and draft supervisory statement are relevant to building societies, and should be read in conjunction with the PRA Rulebook and the PRA's approach to banking supervision.[2] The proposed new version of the supervisory statement is included as an Appendix to this CP.

Purpose of the supervisory statement

1.3 The purpose of the supervisory statement is to set out the PRA's expectations in its supervision of building societies' lending and treasury activities. The statement sets out PRA expectations in respect of societies' compliance with the requirements of the Building Societies Act 1986 ('the 1986 Act') and the PRA Rulebook, and is aimed at all building societies.

1.4 The PRA believes that the pre-specification of its expectations will be helpful to societies, by indicating the key issues that should be considered by a society and explaining where the PRA is likely to focus its attention in its discussions with societies on lending and treasury plans.

1.5 This supervisory statement aims to build on the principle that the risk appetite of a society should be properly aligned to its risk capacity. This principle applies equally to all financial institutions supervised by the PRA.

1.6 However, the statutory restrictions on building societies in the 1986 Act, and their mutual ownership structure, have resulted in a relatively concentrated business model that necessitates specific guidance. In addition, and in particular, constraints on societies' access to external capital mean that safe management and control of business risks is a high priority in order to ensure conservation of capital resources. Moreover, the earnings on reserves of retained profit are a key contributor to the mutual business model, allowing 'dividends' to members to be incorporated into product prices rather than paid to external shareholders; preservation of the endowment return on such reserves is therefore a key management priority for societies.

1.7 The statement describes the key lending and treasury risks to which societies are exposed, and sets out a framework illustrating different potential models ('approaches') for managing and controlling these risks. It is designed to provide clarity on supervisory expectations for the risk management characteristics and organisation that should be in place commensurate with the level and types of risk taken by each society. The PRA expects each society to adopt the approaches (lending and treasury) that are most appropriate to its own business model and risk management capabilities, recognising that the small scale of some societies may preclude having a separate risk management function – and therefore limit the types of activities that they can undertake safely.

1 'Supervising building societies' treasury and lending activities', April 2015; www.bankofengland.co.uk/pra/Pages/publications/ss/2015/ss2015.aspx.

2 March 2016, available at www.bankofengland.co.uk/publications/Pages/other/pra/supervisoryapproach.aspx.

1.8 The PRA expects societies to be forward looking and for their boards to consider all the risks to which they are exposed. While the statement highlights key risks in the area of lending and treasury activities, it is not intended to provide exhaustive coverage of all topics that boards should be aware of and monitor.

1.9 The lending and treasury approaches set out in this statement are not intended to be 'one size fits all', and the portfolio limits suggested are indicative only. It is for each society to determine its own approach, based on its risk appetite, corporate plan, risk management capabilities and management expertise. Boards should set appropriate individual limits for each relevant activity, having regard to those indicated for each defined approach. The PRA expects boards to monitor compliance with their chosen approaches, and to keep the PRA informed of any material changes in the relevant policies of their societies.

Responses and next steps

1.10 The PRA welcomes views on the draft supervisory statement by Monday 4 July 2016. Please address any comments or enquiries to CP12_16@bankofengland.co.uk.

2 Proposed amendments to the supervisory statement

General

2.1 SS20/15, published in April 2015, is a re-formatted version of the guidance formerly contained in the Building Societies Sourcebook (BSOCS) published by the Financial Services Authority. SS20/15 was published as part of Policy Statement 7/15 'The PRA Rulebook: Part 2',[1] which was the second in a series of publications over two years redrafting the Handbook inherited from the Financial Services Authority to create the PRA Rulebook. As part of the Rulebook consultation, the PRA stated its intention to review SS20/15 in 2015, and consult on proposed changes.

2.2 The revised statement (see Appendix) incorporates most of the text from SS20/15, but the material has been reorganised under six headings:

(a) introduction;

(b) overview of PRA expectations;

(c) lending;

(d) financial risk management;

(e) changes to supervisory approaches; and

(f) business model diversification.

2.3 The main text is supported by a number of tables included as appendices.

2.4 The introduction and overview chapters have been expanded to explain in more detail the rationale for the supervisory statement, and how it is intended to be used.

2.5 The most significant changes have been made in the lending and financial risk management chapters of the new statement, bringing together in one place the relevant material from the previous SS20/15 and expanding further on areas of activity that have changed in scope or significance since the original publication of the Sourcebook in March 2010.[2] Further detail on the changes and additions proposed is provided below.

2.6 The section on changes of approach is largely new, and is intended to set out more clearly the PRA's expectations on how societies should consider the implications of proposed changes to their business activities that may result in a need for additional risk management capabilities.

2.7 The section on business model diversification is largely unchanged.

2.8 The tables in the appendices have been simplified from earlier versions, with fewer suggested limits and some widening of those that have been the subject of supervisory discussion with individual societies over the past few years.

---

1 Available at www.bankofengland.co.uk/pra/Pages/publications/ps/2015/ps715.aspx.
2 Financial Services Authority, Policy Statement 10/5: www.fca.org.uk/static/pubs/policy/ps10_05.pdf.

Lending

2.9 The particular changes and enhancements proposed for the section on lending activities include:

(a) an update to the section on buy-to-let (BTL) lending, to help identify when a society should treat the lending as 'commercial' rather than 'residential' for underwriting purposes (it proposes a maximum of 3 properties before the loan should be treated as commercial in performing the underwriting assessment);

(b) the inclusion of a new section on management of the risks involved in self-build lending;

(c) an extension of the section on equity release (lifetime mortgages and home reversion plans) to highlight the issues associated with hedging the complex risks associated with uncertainty over the expected maturity of the loan and its interaction with both interest rate risks and collateral valuation risks. The new wording proposes that only societies capable of operating on the Comprehensive approach for treasury management should consider carrying out lifetime mortgages at fixed interest rates, with interest roll-up;

(d) an update to the previous text covering commercial real estate (CRE) lending, highlighting the risks that emerged from lending before the 2008 downturn and emphasising the risks and costs of small-scale activity in what can be a complex type of lending; and

(e) the removal of text on the use of automated valuation models (AVMs), which was considered to be too detailed for the statement.

2.10 The two tables, covering expectations for credit risk management controls and lending limits per defined approach, have been left as Appendices but updated. The principal changes are:

(a) the inclusion of more explicit expectations regarding the pricing mechanism for loans;

(b) the removal of explicit expectations for the level of business flow limits to be applied for each of the defined approaches. Societies will, however, still be expected to set their own limits;

(c) increases in suggested limits for lending at higher loan-to-value (LTV) without external insurance;

(d) new suggested limits for self-build loans that are in the construction phase; and

(e) reductions in suggested limits for lifetime mortgages, and link to the Comprehensive treasury approach for those with fixed rate roll-up features.

Financial risk management

2.11 The particular changes and enhancements proposed for the section on treasury activities include:

(a) separating the text into a number of subsections covering different aspects of treasury and financial risk management (eg liquidity, counterparties, funding, currency, interest rate risk and treasury operations);

(b) setting additional supervisory expectations on the content of policy statements, including how updates should be communicated to supervisors;

(c) updating the liquidity risk management expectations to reflect changes in the regulatory regime (ie the recent introduction via EU Directives of the Liquidity Coverage Ratio, and prospectively of the Net Stable Funding Ratio);

(d) expanding the range of expectations on managing funding risk to distinguish between different types and tenors of funding, and on the setting of encumbrance limits;

(e) revising the subsection on interest rate risk management to reflect the most recent guidance from the European Banking Authority (EBA); and

(f) including further explanation of supervisory expectations for product pricing and funds transfer pricing methods, proportionate to the size and sophistication of each society.

2.12 The five approaches set out in SS20/15 have been reduced to four, by removing the 'trading' approach. As no building society currently has a trading book, this approach is redundant. Given the restrictions in s.9A of the 1986 Act, it is unlikely that any society would ever have a trading book, but should one decide to have a trading book, the supervisory expectation would be for the society to adopt a suitably extended version of the Comprehensive approach with a suitable 'extension' (see below).

2.13 The remaining four approaches have been reviewed and amended to take account of current market trends, and particularly the increased level of customer demand for fixed rate loan products. The PRA recognises that societies need to be able to respond to such demand, and that many have therefore improved their treasury risk management capabilities to be able to control the additional risks (particularly interest rate basis and margin compression risk) that can arise from running balance sheets containing higher levels of fixed rate assets and liabilities. In recognition of this, the adjustments proposed to all four approaches involve a decrease in the expected minimum level of administered rate assets (and in the case of the Comprehensive approach, removing the suggested limit altogether) and an increase in the strength of the risk management function and systems employed in overseeing treasury risk. This is in line with the general approach of the statement in setting expectations that risk management capability should match risk appetite.

2.14 The tables in the appendices of the draft statement have been updated to reflect the text, in particular by:

(a) adjusting the risk management and balance sheet structure expectations as explained above;

(b) setting out more specific supervisory expectations for risk analysis systems and management information about balance sheet positions;

(c) listing the components that should be taken into account in pricing products and/or internal transfer pricing;

(d) aligning the increased range of liquidity instruments that are available to be included within the LCR calculation with the expected level of counterparty risk management capabilities under each of the approaches; and

(e) establishing expectations for the level and term of wholesale funding from financial markets, and overall encumbrance levels (excluding assets pledged to a central bank).

Changes to supervisory approaches

2.15 The current statement is largely silent on the PRA's expectations on how societies can transition between approaches (should they so wish), and also on the implications of adopting a policy/risk management strategy that is not completely in line with defined approaches.

2.16 The revised version therefore contains a largely new section, setting out supervisory expectations for both types of change:

(a) 'extensions' to limits or control systems that take place within a supervisory approach would be subject first to internal consideration by the society and its board, and then subject to supervisory evaluation in light of updated policies and implementation plans; and

(b) changes of approach would be treated in a similar way, but subjected also to review by internal audit and a more detailed discussion with supervisors about the implications for future strategy.

2.17 In both cases, the PRA would adopt internal processes designed to ensure that supervisors treat such changes consistently across societies.

Business model diversification

2.18 The current statement includes an expectation that societies will pre-notify the PRA of any diversification not covered in the statement, where the level of investment would exceed 5% of own funds, or the expected revenue would exceed 10% of post-implementation income. This expectation remains unchanged in the revised version.

3 Statutory obligations

3.1 The PRA has a statutory duty to consult when introducing new rules and a public law duty to consult widely on any other measures that significantly affect firms. In discharging its general functions the PRA must, as far as it is reasonably possible, act in a way that advances its general objective and its insurance objective.

3.2 The main intention of the proposals in this CP is to set out the PRA's expectations for the alignment of risk appetite and risk management capability in the lending and treasury activities of building societies. The PRA believes that this will help promote sound governance of these firms and groups.

3.3 The PRA has consulted with the FCA in relation to the contents of this CP.

Cost benefit analysis

3.4 Since the supervisory statement contains no rules, just an explanation of supervisory expectations, the PRA has concluded that a full cost benefit analysis is not required to be performed.

3.5 In any case, the PRA is not required to perform a cost benefit analysis if it considers that the impact of its proposals is of minimal significance. In respect of the proposed amendments to SS20/15, the PRA considers that the costs of implementing the updated statement are materially exceeded by the benefits that arise.

3.6 The costs for societies include:

(a) using the revised statement text to gain an understanding of PRA supervisory expectations;

(b) considering whether any changes to existing policies or risk management approaches will be needed, and drafting appropriate board papers to address inconsistencies or identified gaps;

(c) discussing with supervisors their intended approach and implementation plans; and

(d) keeping PRA supervisors updated on progress against plans and future changes.

3.7 If any changes of business model arise from implementing the new statement, these will be the consequence of the board, in conjunction with supervisors, remediating newly identified weaknesses in the existing business model. If left unchanged, these weaknesses could result in crystallised risks that impact both members of the society and, potentially, cause wider financial stability issues. Restrictions placed by boards on certain types of new business activity would therefore be an outcome of better management of risks, rather than a supervisory statement derived constraint on business that has the aim of reducing business activity.

3.8 The benefits arising from the updated statement will be:

(a) improved understanding by boards and management of societies of the issues and risks that the PRA expects to be addressed as part of their risk management and other systems of control;

(b) better alignment of risk appetite and risk controls within societies;

(c) improved, and more efficient dialogue between societies and their supervisors, based on a clear understanding of the key issues and supervisory expectations;

(d) reduced costs of assessing new business lines and products given foreknowledge of regulatory implications; and, ultimately

(e) improved management of the business, with reduced crystallised risk arising from lending and financial risk management activities.

3.9 Overall, the PRA considers that calculating amounts of costs and benefits arising from the statement would not be appropriate, given the absence of additional rules. In any case, the costs are not believed to be significant, and would mainly be incurred by societies in the course of establishing and maintaining proper governance and risk management; while the benefits of improved risk management in terms of reducing firm failures, or near failures, could be significant – as demonstrated during the financial crises years from 2007 to 2010.

Impact on mutuals

3.10 When the PRA proposes to make a rule which would apply to both mutuals and other authorised persons, the PRA is required[1] to make a statement as to whether the impact of the proposed rules will be significantly different to mutuals than to other persons. In the case of this supervisory statement, no rules are proposed so the requirement does not apply.

3.11 The PRA believes the proposals will be beneficial rather than harmful to the sector, as highlighted in the 'competition implications' section below.

Competition implications

3.12 The PRA also has a duty to facilitate effective competition as a secondary objective subordinate to its general safety and soundness objective.

3.13 The revised supervisory statement will apply only to building societies, so has no direct impact on other types of regulated firm. The rationale for limiting the scope of the statement just to building societies is that:

(a) it contains specific cross-references to the statutory requirements of societies set out in the 1986 Act that do not apply to other types of firm;

(b) building societies have a very particular business model, as a consequence of the restrictions in the 1986 Act, and there is therefore more scope for the PRA to set out its expectations as to how risks in the model should be managed than exists in the case of other firms with more diversified business models;

(c) the PRA considers that it will be helpful to societies and their boards to understand its supervisory expectations in advance of making plans or commitments that would subsequently be the subject of supervisory intervention; and

[1] Section 138K of the Financial Services and Markets Act (FSMA).

(d) the corporate structure of societies, as mutual organisations owned by their customers, provides a stable business base that is less adaptable than other corporate forms (such as limited companies) in times of stress. In particular, access to external capital resources, while possible, is less straightforward, and there is therefore a need to preserve existing capital from losses that could arise from lending or financial risk management activities.

3.14 In terms of competitive impact, the PRA does not believe that providing building societies with information on supervisory expectations gives them a competitive advantage compared with other firms, since the same high level rules and principles (from which the PRA's expectations for societies flow) apply to such firms.

3.15 Similarly, the PRA does not consider that building societies are disadvantaged by having a supervisory statement addressed to them but not to their competitors. As set out above and in the statement itself, the supervisory statement does not apply any restrictions to building societies' activities beyond those already set out in primary legislation. All 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. If curtailment of business activities does arise, that will be the consequence of:

(a) either a society's own initiative, following an assessment of its internal governance arrangements as compared with supervisory expectations; or

(b) the PRA's intervention, acting on its supervisory judgement that a particular society does not have the necessary risk management systems and controls to be able prudently to undertake its proposed business activities;

rather than of specific supervisory restrictions arising directly from the statement.

Compatibility with the Regulatory Principles

3.16 The PRA has had regard to the Regulatory Principles and has determined that the proposed policy is consistent with the Principles. The PRA considers that the benefits of these proposals are proportionate to the costs, as analysed above. Setting out the PRA's proposed approach to building society supervision in a supervisory statement helps societies to understand the PRA's expectations, and so uses the resources of both societies and the PRA efficiently. In addition, the benefits as set out above in relation to advancing the PRA's objectives of safety and soundness contribute to the desirability of sustainable growth in the United Kingdom in the medium term.

Equality and diversity

3.17 The PRA is also required by the Equality Act 2010[1] to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.

[1] Section 149.

Appendix: Draft supervisory statement (revised SS20/15)

Contents

1 Introduction

1.1 This statement sets out expectations of the Prudential Regulation Authority (PRA) in respect of societies' compliance with the requirements of the Building Societies Act 1986 (the 1986 Act), the Financial Services and Markets Act 2000 (FSMA), the PRA Rulebook and Supervisory Statement 24/15.[1] This supervisory statement is applicable to all building societies.

1.2 The purpose of this supervisory statement is to set out the PRA's approach to its supervision of building societies' lending and treasury activities. The supervisory statement aims to build on the principle that the risk appetites of societies should be properly aligned to their risk capacity, in order to promote the safety and soundness of societies as deposit-taking institutions.

1.3 The statement describes the key lending and treasury risks to which societies are exposed, and sets out a framework describing different potential models ('approaches') for managing and controlling these risks. There are three approaches for lending ('Traditional', 'Limited', 'Mitigated') and four approaches for treasury ('Administered', 'Matched', 'Extended', 'Comprehensive').

1.4 The statement is designed to provide clarity on supervisory expectations for the risk management characteristics and organisation that should be in place commensurate with the level and types of risk taken by each society. The PRA expects each society to adopt the approaches (lending and treasury) that are most appropriate to its business model and risk management capabilities, recognising that the small scale of some societies may preclude having a separate risk management function – and therefore limit the types of activities that can be undertaken prudently.

2 Overview of PRA expectations

2.1 The PRA expects societies to be forward looking and for their boards to consider all the risks to which they are exposed. It is the responsibility of the boards and management of building societies ('societies') to ensure that they understand the financial and other risks to which the business is exposed, and to have appropriate systems in place to manage and control those risks.

2.2 While the statement highlights the key risks in the area of lending and treasury activities, it is not intended to provide exhaustive coverage of all topics that boards should be aware of, and monitor.

2.3 The general principle of aligning risk appetite with risk capability applies equally to all financial institutions supervised by the PRA, and the expectations included in this supervisory statement are therefore potentially of interest to other types of firms than building societies. However, the statutory restrictions on the business of all building societies have resulted in a relatively concentrated business model that necessitates specific guidance. Their mutual status

---

[1] 'The PRA's approach to supervising liquidity and funding risks', June 2015; www.bankofengland.co.uk/pra/Pages/publications/ss/2015/ss2415.aspx.

means that there are particular constraints on societies' access to external capital that make safe management of the business and conservation of capital resources a high priority.

2.4 The lending and treasury approaches set out in this statement are not intended to be 'one size fits all' and the portfolio limits suggested are indicative only. It is for each society to determine its own approach, based on its risk appetite, corporate plan, risk management capabilities and management expertise. Boards are expected to set appropriate individual limits for each relevant activity, having regard to those indicated for each defined approach. The PRA expects boards to monitor compliance with their chosen approaches, and to keep the PRA informed of any material changes in relevant policies.

2.5 The PRA recognises that, over time, societies may wish either to change individual limits or to move to more sophisticated approaches, as their business develops. The statement explains in Chapter 4.174 the supervisory expectations of how this may be achieved.

2.6 The PRA also recognises that a society may wish to diversify its business, within the constraints of the 1986 Act, into areas that are not covered by this supervisory statement. Where such diversification is significant, the PRA expects to be pre-notified of such intentions, as set out in Chapter 0 of this statement.

3 Lending

3.1 This chapter sets out the PRA's expectations for the management and mitigation by societies of risks arising from their lending activities. The section outlines factors that the PRA will consider when assessing whether a society meets these requirements in relation to lending risk management, and sets out the supervisory framework, using three 'approaches' to lending ('Traditional', Limited' and 'Mitigated'), that have been designed to help firms evidence compliance with the requirements in the General Organisation Requirements and Risk Control Parts of the PRA Rulebook, and against which such compliance by individual societies will be evaluated.

General risks of mortgage lending

Affordability

3.2 The primary risk associated with mortgage lending is that the borrower will be unable or unwilling to service the loan (ie meet interest payments when due and repay the capital amount lent within the agreed term). Some types of mortgages present greater affordability risks than others. In particular, risks are likely to be increased for lenders (and in some cases also for consumers) as regards:

(a) residential lending to owner occupiers, where repayment commitments represent an unusually high percentage of disposable income; or

(b) buy-to-let mortgages, where the rental income received by the borrower is close to the repayment commitment made; or

(c) commercial lending, where the repayment commitment represents an unusually high percentage of the income generated by the property or by the business operated from the property.

3.3 The propensity of borrowers to repay can be lower where the:

(a) loan-to-value (LTV) is high, and thus incentives for the borrower to retain control of the property by maintaining payments are weaker; or

(b) the borrower has an impaired credit history that may indicate previous unwillingness to pay.

3.4 The PRA expects societies to ensure – and to be able to evidence – that they consider the affordability risk profile of the different types of lending that they undertake, have book and/or origination flow sub-limits and other mitigating controls in place where they consider it appropriate, and price their lending to reflect the perceived residual risks.

3.5 Societies are also expected to consider the affordability impacts that arise when product features such as fixed interest rates or discount periods expire, and to determine whether to set maturity profile limits. If large numbers of mortgage loans reach a product break-point or reset point simultaneously, the society may experience financial and/or operational strain in dealing with potential loss of earnings from redemption, together with associated administration and customer query costs.

3.6 Should the interest rate on follow-on products be significantly higher than at inception, societies may need to respond to a significant number of customers experiencing payment shock at the same time. In such a situation, a society may experience increased arrears levels, and potentially increased impairment charges.

3.7 While non-sterling mortgages expose a society to foreign exchange risks as well as all other risks which normally attach to mortgage lending, they may also expose the borrower to exchange rate risk which, if it crystallises, impacts on their ability to afford the loan. The PRA expects that societies (other than those with the most sophisticated lending and treasury risk management controls) will therefore set very conservative limits for such business, and confine such loans to borrowers with income denominated in the relevant currency.

3.8 There may be cases where borrowers are relying upon a non-sterling income to service a sterling mortgage secured on UK property, or the reverse[1]. Such mortgages are subject to additional requirements under the Mortgage Credit Directive, and clearly require additional consideration of affordability given the potential for exchange rate movements to affect ability to meet monthly instalments. Appropriate systems are expected to be in place for identifying and managing these exposures.

3.9 Societies must also comply with the general law and any other regulatory requirements relating to affordability when granting a mortgage.

Assessment and valuation of security

3.10 If a mortgage fails to perform, a society ultimately relies upon realising its security to safeguard its interests and avoid losses, so the saleability of the security at a sufficiently high price to repay the loan (plus accrued interest) is essential. In order to achieve this, the society needs to have both a clear and comprehensive policy setting out the types of security that are acceptable, and a robust process for valuing that security. Societies may wish to consider purchasing mortgage credit insurance as a mitigant to the risk (in respect of higher LTV

[1] See FCA rule MCOB 2A.3

mortgages) that realisations from sale of a property in possession may not be sufficient to allow full recovery of the mortgage loan plus accrued interest.

3.11 In respect of security types, the relevant factors include title/tenure, construction type, state of repair and insurability. In respect of leasehold tenures, length of lease and leaseholder obligations are also relevant factors.

3.12 In placing reliance on security valuations[1], the integrity, competence and expertise of the valuer are important, particularly where experience in more complex valuation areas is needed (for example, related to commercial lending). If a society uses an automatic valuation model (AVM), either as part of its loan origination process or subsequent revaluation for credit decision purposes, it is expected to do so within the terms of clear and well-considered policies.

3.13 In addition to general property price movements, significant local price variations can occur. Therefore lending outside a society's home area (or for larger societies, lending on overseas property) can carry an increased risk if local price drivers are not fully understood.

3.14 Societies are expected to consider such risks in setting their lending policy, balancing the potential impact against the advantages of lowering the geographical concentration risk to which they might be exposed.

Pricing of Risk

3.15 Different types of lending carry different levels of credit risk to the lender, and it is vital that these are appropriately reflected in the price charged to the borrower. Calculation of the risk premium to apply can involve a combination of science and judgement: for the most sophisticated lenders, statistical models may be used to calculate (based on historical performance over a long period) the 'probability of default' (PD), 'exposure at default' (EAD) and 'loss given default' (LGD) for a given exposure or portfolio. Calculating the 'expected loss' (EL) arising from different types of lending allows the lender to calculate the risk premium necessary to achieve a target rate of return on capital (eg 'risk-adjusted return on regulatory capital' or return on 'economic capital' allocated to the exposure).

3.16 Having the capability to calculate EL under different economic scenarios will become increasingly important for societies that report results on an International Financial Reporting Standards (IFRS) accounting basis, given the impending implementation of IFRS 9 requirements for calculating impairments. However, even those societies adopting UK Generally Accepted Accounting Principles (UK GAAP) standards (eg FRS 102) need to be able to estimate the level of their expected losses in order to be able to price new lending appropriately.

3.17 At a minimum, societies are expected to have risk pricing methodologies that take into account the:

(a) information available from credit reference bureaus at inception of the loan (more sophisticated societies would also take account of up to date behavioural information derived either internally or based on bureau data);

---

[1] The MCD places requirements on residential mortgage property valuations – see Article 19 (2) MCD & FCA MIPRU 1.3.2

(b) outcome of their own internal stress testing;

(c) underlying cost of funding the loan (see paragraphs 4.112 – 4.118 in Chapter 4); and

(d) board's target return on capital.

3.18 Societies should be careful in using peers and competitor prices as comparators: market prices will reflect an individual firm's assessment and understanding of a given risk, but such assessments can be incorrect so it cannot be assumed that risks have always been priced correctly. Moreover, competitor costs (of funding and administration) may not be reflective of the society's own costs. Societies are therefore expected to determine their pricing independently, based on their own risk appetite and profitability criteria.

3.19 Societies are particularly expected to be aware of the risk of 'adverse selection' ie that, in pricing risk relative to the market, they may attract the more risky cases and end up with a portfolio of worse quality than intended.

Non-traditional residential lending

3.20 Non-traditional lending can present additional risks, when compared with conventional prime owner-occupied lending to individuals. The PRA expects societies to recognise this within their risk assessment and management processes, procedures and lending policy.

Impaired-credit lending

3.21 While the risk of default on lending to borrowers with impaired credit histories may initially be greater (all other things being equal) than that for traditional prime lending, the PRA recognises that this risk may reduce over time as a repayment track record is established. In these circumstances, the PRA accepts that societies may wish to reclassify impaired credit lending as prime (for the purposes of internal policy limits) after five years, provided that there have been no arrears in the previous three years.

Buy-to-let lending[1]

3.22 While buy-to-let (BTL) lending is secured on residential property and therefore falls within the 1986 Act nature limit (the statutory requirement that at least 75% of lending should be secured on residential property), it presents different risks to those of conventional residential mortgages to owner-occupiers.

3.23 BTL includes a range of borrowers from, at one end of the scale, individual borrowers with a single property held for investment purposes to, at the other end of the scale, property investors with a large number (possibly hundreds) of properties that are owned and managed as a trading business. The types of properties that are purchased for BTL purposes also range from low yield ones (where the principal objective of the purchaser is to achieve capital gain, ie essentially speculative), to high yield properties (where the risks may be more concentrated on compliance with landlord legislation and costs of maintenance/repairs). Whereas the individual with a single BTL property (an 'individual investor') may be able to cover repayments due over rental void period using alternative sources of income, the 'portfolio landlord' property investors may have surplus rental income from other properties but may not have other sources of income available to cover a higher than expected percentage of voids and

1 Societies are referred to CP11/16 'Underwriting standards for buy-to-let mortgage contracts', March 2016; www.bankofengland.co.uk/pra/Documents/publications/cp/2016/cp1116.aspx.

other letting expenses. While individual investors may not have the time or resources to be proactive property managers (so act more as passive investors), 'portfolio landlords' would normally treat portfolio management as their main economic activity, investing time and resources accordingly. Understanding the type of BTL property and borrower, the scale of his/her activity, the margin of security, the rental cover and the availability of other income, are all therefore key elements of safe lending.

3.24 The PRA expects societies undertaking BTL lending to have regard to the potential commercial nature of this type of business. The PRA considers that borrowers with four or more mortgaged BTL properties should be treated as 'Portfolio Landlords'.

3.25 The PRA expects societies to recognise that existing experience and skills acquired in residential mortgage lending and BTL lending to individual investors do not automatically translate into equivalent skills when assessing Portfolio Landlords. Lending to Portfolio Landlords is inherently more complex given the quantum of debt in aggregate, the cash flows and costs arising from multiple tenancies and potential risks of property and/or geographical concentrations.

3.26 These complexities mean that a specialist underwriting approach is appropriate. Societies' underwriting processes for Portfolio Landlords are therefore expected to assess:

(a) the borrower's experience in the BTL market and their full portfolio of properties and outstanding mortgages;

(b) the assets and liabilities of the borrower, including any tax liability arising from the letting of property;

(c) the merits of any new lending in the context of the borrower's existing BTL portfolio together with their business plan; and

(d) historical and future expected cash flows associated with all of the borrower's properties.

3.27 Societies are expected to put in place, and operate in accordance with, a written policy detailing their approaches to BTL lending, differentiating between underwriting standards for BTL lending and lending to Portfolio Landlords (and taking into account that some BTL lending is FCA regulated). Relevant factors which societies are expected to consider and address within their lending policy include:

(a) the degree to which the investor/borrower is dependent on the cash flow performance of the investment property to service the loan;

(b) the source and reliability of repayment of the loan principal (given that much BTL lending is interest-only);

(c) the impact on borrowers of personal taxation provisions, and how these might change over time;

(d) the basis on which the security is valued and rental income is assessed for underwriting purposes (including how rental voids are treated);

(e) the availability of security other than the BTL property itself (either through supported guarantee or through cross-collateralisation of other BTL properties owned by the borrower);

(f) the legal ability via the security charge to appoint a receiver for rents;

(g) the tenancy basis and types of BTL that are considered to be acceptable;

(h) the information required to assess the extent of the investor-borrower's broader exposure to the BTL sector (eg total number of properties in portfolio and whether encumbered or unencumbered);

(i) the maximum permitted exposure to an investor-borrower or connected investor-borrowers (which may be based on value and/or number of investment properties held); and

(j) the post-completion loan administration that is required (and the extent to which this is appropriate and proportionate to the underlying commercial nature of BTL lending) including:

- the impact on costs (and therefore pricing) of monitoring of exposure on a scheduled basis (eg annual review); and

- any requirements for the investor-borrower to provide financial information on a periodic basis which enables the lender to have an appropriate understanding of their overall exposure.

Self-build lending

3.28 Self-build lending encompasses a range of borrower types covering those who directly organise the design and construction of their new home. At one end of the spectrum, the self-builder selects their design and then undertakes much of the construction work themselves, and at the other end the borrower selects a 'custom built' option where the borrower contracts with a specialist developer who organises both site acquisition and the construction work. Within the spectrum are cases where the self-builder arranges for an architect or contractor to build their home for them, and pre-fabrication arrangements where the self-builder acquires the plot, arranges for the foundations to be laid and organises the pre-fabricator to assemble the property for them.

3.29 The main risk associated with self-build lending arises in the period from commencement of construction until the building has been completed or made habitable[1] - a half-built property has limited marketability and poses site security risks that may have significant implications for the value of the property, should the society need to realise its collateral. The risks here can in part be mitigated by the society taking out build-out insurance, and the PRA would expect societies to consider taking out such insurance. Societies will also need to ensure that monies are released in stages during the build of the property, against architects' certificates or updated valuations of the property, in order to ensure that funds are used in construction of the property and in line with the original construction budget. It would be normal practice to ensure that the customer's own financial contribution is injected into the project ahead of any loan drawdown.

1 This assumes that the lender has checked that appropriate planning permission is held, and that the resultant property will be truly marketable to other buyers than the borrower (ie the property will be accessible and connected to relevant services).

3.30 Self-build lending therefore needs additional expertise compared with traditional mortgage lending, and is more costly to undertake because of the need for regular review and control (including site visits) during the construction phase. However, once the construction period is complete and the borrower has taken up occupation, the mortgage loan should perform similarly to traditional mortgage lending and may be reclassified as such.

3.31 Societies are expected to therefore consider placing appropriate limits on self-build lending (of all types), particularly in respect of the number/value of loans in the most risky build stage. Systems for classifying and reclassifying such lending would also be appropriate.

Shared ownership lending

3.32 Shared ownership lending can be more complex than mainstream mortgage lending. In addition to assessing the borrower's ability to afford the loan, which may be more complicated than for traditional lending, the value of collateral may be affected by conditions imposed by the social landlord on resale, for example to market the property only to those groups identified as a priority by the local authority/housing association.

3.33 Also, administering such lending is likely to be more resource-intensive than conventional lending, since the mortgage agreement is three-way and relationships with both the borrower and social landlord need to be maintained. Particular matters that societies are expected to consider include (but are not necessarily restricted to) the following:

(a) In the event of default, if monies raised by repossession and sale of the share purchase are insufficient to cover the debt, the society has protections allowing it to recoup certain losses from the social landlord's share of the property so long as they have complied with required procedures at the time of extending the original and any subsequent amounts and before taking action for arrears. Societies should ensure that they understand what protection is available and have procedures to ensure compliance with procedural requirements.

(b) Security is held over the leasehold on the owned portion of the property, not the freehold. If the borrower fails to pay rent to the social landlord, the lease may be terminated by the landlord; if terminated then security for the loan would be lost.

(c) While a social landlord must inform a society and give it time to remedy the breach to retain the security (costs recoverable under the mortgage protection scheme) the PRA expects societies to consider how they will manage such risk situations and decide as a matter of policy which if any costs they will consider paying.

3.34 Given the added complexity and costs of administering such lending, societies are expected to set a maximum proportion of their lending book for such loans, to ensure that they retain a balanced portfolio.

Lifetime mortgages and home reversion plans

3.35 Lifetime mortgages create a residential mortgage exposure with an uncertain maturity that is generally triggered by the mortality or morbidity of the borrower(s). Such loans also carry a valuation risk related to the willingness and/or ability of the borrower to maintain the property. The PRA recognises that there are different types of lifetime mortgage products, including:

(a) interest (fixed or variable rate) roll up;

(b) interest only, where the rate is fixed; and

(c) interest only where the rate is variable;

any of which may be offered with or without a 'no negative equity guarantee' (NNEG). Hybrids of these types may also exist (eg interest only for a period, then roll-up).

3.36 Lifetime loans with interest roll-up features are particularly risky, because repayment is dependent on the future value of the property held as security at the time the borrower either dies or sells. Many such lifetime mortgages are at fixed rates and include NNEGs that protect the borrower (and their family), but add to the complexity of risk management for the lender. Essentially, they involve a combination of interest rate risk, house price risk and morbidity/mortality risk, in an exposure with uncertain maturity and no intervening cashflows. While some hedging instruments may be available, most have break clauses that are earlier than the expected maturity date, and involve cash collateralisation that can become significant in both cost and liquidity management terms. Quantifying the cost of any NNEG is also extremely challenging.

3.37 Given the risks and complexities involved in hedging long term fixed rate mortgages of uncertain duration (with or without NNEGs), the PRA expects only those societies with the most sophisticated level of treasury risk management capabilities (ie those capable of operating on the Comprehensive approach) to offer the products referred to in paragraph 3.35 (a) and (b).

3.38 More generally, because of the risk characteristics of lifetime mortgages the PRA expects societies to extend loans on an interest roll-up basis only after a full evaluation of longevity risks, and to set the initial LTV of loans at levels which allow for interest roll-up in line with assessed life expectancy. If larger LTV advances are proposed for borrowers with shorter life expectancy, societies need to ensure that they have appropriate actuarial expertise to enable them to assess the associated risks. By implication, societies undertaking such business will be expected to have the appropriate specialist treasury and risk management skills to measure and mitigate the risks involved.

3.39 Lifetime mortgages where interest is paid (paragraph 3.35 (b) and (c)) pose fewer risk management problems but do carry higher credit and/or interest rate risks than 'lending into retirement' for a fixed term. For (b), the availability of suitable hedging instruments and the behavioural analysis required need more sophisticated treasury risk management, while for (c) (which relates to variable rate lending), an increase in interest rates could make the loans unaffordable for borrowers on fixed retirement incomes. Consequently, both types need additional risk management skills and volumes as a proportion of the loan book need to be strictly controlled.

3.40 Home reversion plans are likely to carry even more complex risks, since they not only have an actuarial risk but also expose lenders directly to variations in the market value of the property with which the individual plan is associated. As such, only societies with the most sophisticated risk management capabilities would be expected to enter those markets.

3.41 For all types of lifetime mortgages, societies are expected to set conservative book limits on the amount of such business that can be originated, particularly bearing in mind that the balances of interest roll-up products will grow over time (at least initially) in line with the interest, potentially inflating the proportion of the overall loan book represented by the product.

Commercial real estate (CRE) lending

3.42 Commercial property will generally require different valuation skills to owner-occupied housing, and historically has a significantly higher default rate than conventional residential mortgage lending. The PRA expects societies' stress testing to take account of this latter point. CRE lending may or may not fall within the nature limits, depending on whether the business of the commercial enterprise is secured on residential property – but all lending for commercial purposes needs to be captured by internal risk limits, regardless of the nature limit definitions.

3.43 CRE lending can be divided into three broad types: i) owner occupied, ii) development and iii) investment, the latter two being further sub-divided by property type (residential use, and various forms of commercial use eg retail, industrial, office, or warehouse/distribution). Each of these broad types typically has different associated risk profiles and is likely to require different resource levels, underwriting expertise and risk management capabilities.

3.44 Individual commercial loans tend to be large relative to the total book, particularly those falling into the commercial development and investment categories. Therefore, when considering the risks associated with any commercial lending, societies need to be mindful of the absolute size of individual loans, their total exposure to commercial lending, and the extent to which they are exposed to concentration risk, whether geographic concentration, concentration to particular counterparties, particular property types or to particular sectors of the economy.

3.45 Societies need to recognise the risks involved where they lend on an interest-only basis – and in particular that, on maturity, the borrower may not be able to dispose of the property or refinance the loan and so repay the capital amount lent. Societies also need to take account of the length and terms of any underlying leases, particularly where these expire before the loan maturity, and be mindful of the additional complexity that may attach where commercial property is owned by a special purpose vehicle, or where it is financed by a syndicated loan.

3.46 Societies undertaking commercial lending would need to establish that a realistic alternative use exists for the property in case they later have to enforce the security.

3.47 In general, the PRA considers it quite unlikely that smaller societies will be able to justify the cost of the specialist individuals and systems needed for CRE lending, bearing in mind the likely overall size of the book and the level of additional risk involved. Even larger societies may find that the economic costs of implementing adequate risk controls outweigh the potential benefits in terms of margin uplift and diversification.

Social landlords (including Registered Social Landlords)

3.48 Lending to housing associations can be difficult to evaluate and for smaller societies these can represent significant sized loans relative to their book. While lending may be low LTV, margins also tend to be low, whilst the saleability of underlying properties varies, and would usually not be with vacant possession.

3.49 Societies considering such lending need to consider not only the portfolio valuation but also the financial management record of the landlord, including arrears management and cashflow strength to accommodate voids, and the regulatory and/or political environment in which it operates. The skills necessary to undertake such assessments are those of underwriting commercial lending rather than residential lending, combined with a good understanding of the sector and its risk profile.

3.50 Therefore, societies are expected to ensure that they have appropriate underwriting skills for this type of lending and that they set a maximum proportion of their lending book for these loans, to ensure that they retain a balanced portfolio.

Lending policy

3.51 To comply with the PRA Rulebook (General Organisation Requirements 2.1 and Risk Control 2.1), all societies should have a lending policy. This should be consistent with each society's strategic plan and its financial risk management policy statement.

3.52 Societies are expected therefore to adopt formal, board-approved lending policy statements that include limits on the type of lending that will be undertaken (both as a proportion of periodic flows and of stocks), as well as set out the key underwriting policies and controls. The aim of a society's lending policy should be to ensure that, as far as possible:

(a) credit risks arising from its lending are aligned with its management expertise and risk appetite through careful underwriting; and

(b) any additional risk taken is appropriately priced and managed so that loss levels sustained under stressed conditions would not result in failure of the society.

3.53 Societies are expected to inform their supervisors of all material changes to their lending policy, and provide a marked-up version on request. Supervisors will review lending policies periodically as part of their assessment of credit risk management and, among other things, against the guidance in this supervisory statement.

3.54 The board and management are expected to take steps to ensure that those staff particularly involved in any aspects of lending are fully aware of the lending policy, both on an ongoing basis and, particularly, where the lending policy has been changed. The steps that would be most appropriate to achieve this will depend on the number of staff concerned and the complexity of the lending policy.

3.55 To comply with General Organisation Requirements 2.8, the PRA expects societies to check, on a regular basis, that staff are complying with this lending policy.

Contents of lending policy

3.56 This section sets out the expectations of the PRA on the issues which it would expect to be addressed in the lending policy. The list of issues is not exhaustive, not all points will be relevant to all societies and societies may wish to combine some of the subjects within sections of their policy.

3.57 The introduction section would include:

(a) background to the society's approach to the management of credit risk, including its high-level lending strategy and its risk appetite expressed in a clear and numeric way that can be easily understood by all staff;

(b) a ratification process for obtaining board approval, including amendments to the policy statement as well as complete revisions; and

(c) arrangements for, and frequency of, review (which is expected to be conducted at least on an annual basis).

3.58 The objectives of the policy would cross-refer to the society's general statement of risk appetite (as set out in its Individual Capital Adequacy Assessment Process (ICAAP) for Pillar 2 capital adequacy purposes), and would outline the society's general philosophical approach to lending.

3.59 The policy would set out the society's business and operational characteristics, including:

(a) board controls and organisational structure/reporting lines;

(b) high level framework for ensuring compliance with FCA's Mortgage Conduct of Business (MCOB) and other regulatory requirements;

(c) delegation process and authorities;

(d) new product development process and approved sources of new lending business;

(e) marketing and administration controls; and

(f) processes for ensuring compliance with policy (including arrangements for internal audit review).

3.60 The risk management section would include a description of:

(a) the risk management structure and reporting lines;

(b) controls over underwriting quality and adherence to delegated limits;

(c) how risks associated with untypical cash flow characteristics (including interest roll-up and payment holidays) are to be managed;

(d) training and competence requirements for underwriters and mortgage sales staff;

(e) the process for developing internal risk scoring systems and procedures for risk categorisation including monitoring of manual overrides;

(f) large exposure limits for connected counterparties, by loan and borrower type;

(g) concentration risk exposure limits by portfolio or product type, borrower type, security type, introducer and geographical area (expressed in terms of the overall lending book: societies would also consider whether it would also be appropriate to set limits as a proportion of new lending in a given period, and similar limits for the volume of reversions to standard lending rates);

(h) limits on the acquisition of individual loans or portfolios of loans, either by way of sub-participation or syndication;

(i) the processes for ensuring how the success of risk management is to be assessed and potential lessons captured and used to amend underwriting policy as necessary; and

(j) the management information to be reported to the board.

3.61 The section setting out permitted lending would include details of the lending which the society is prepared to undertake, specified by borrower type, property/security type and origination source including, as applicable (the list below is not intended to be exhaustive and this section of the policy statement would include details of any other particular types of lending undertaken):

(a) prime residential mortgage lending to individuals (by LTV band, with or without mortgage indemnity insurance);

(b) near/sub-prime residential mortgage lending to individuals;

(c) BTL mortgage lending to individuals and corporate bodies;

(d) shared-ownership residential lending to individuals;

(e) self-build lending;

(f) second-charge residential lending to individuals;

(g) lifetime mortgage lending to individuals (sub-divided as appropriate between the various categories of lifetime mortgages as referred to in paragraph 3.35 above);

(h) home reversion plans for individuals;

(i) commercial mortgages for owner-occupiers;

(j) commercial mortgages for investors (both individuals and corporate bodies, potentially split by property type – see paragraph 3.43 above);

(k) commercial property development loans, both on residential and commercial real estate;

(l) lending to registered social landlords; and

(m) unsecured lending to individuals (by way of personal loan, overdraft, credit card or otherwise).

3.62 The policy would also set out:

(a) which types of security are acceptable (title, tenure, construction, location etc.);

(b) the maximum original LTV ratio permitted for each lending type;

(c) requirements for additional security from borrowers such as guarantees, charges over other assets, life cover, accident/sickness/unemployment cover;

(d) requirements for additional credit insurance (eg mortgage indemnity guarantee or similar), including procedures for checking that such insurance can be relied upon and is effective, and arrangements for checking the credit worthiness of the provider;

(e) requirements for buildings insurance cover; and

(f) arrangements for obtaining a reliable security valuation (including procedures for appointing valuers and use of automated valuation models).

3.63 The underwriting requirements for each type of loan would be specified in the policy, including:

(a) minimum required levels of income (or rent) net of expenditure to confirm affordability of the loan for the borrower (including at higher rates of interest);

(b) information requirements for verifying stated income/outgoings levels (for both individuals and corporate borrowers);

(c) credit checks, credit scoring requirements, manual override flexibility arrangements;

(d) requirements for face-to-face interviews, site visits, use of specialist advisers;

(e) evidential requirements to establish the previous track record of the borrower; and

(f) any requirements for third party references.

3.64 The policy would set out the basis for pricing new lending, including:

(a) the required hurdle rate of return for new lending products;

(b) requirements for adjusting pricing to reflect risk, term, etc.;

(c) the approach to setting fees, routine charges and early repayment charges, etc.; and

(d) the methodology for setting and collecting early repayment charges.

3.65 The policy would be consistent with the provisions relating to conduct of business that apply to the society.

Risk management

3.66 The PRA expects that all societies will put in place risk management controls that are appropriate and proportionate for the types of business that they intend to undertake. Risk control arrangements are expected to ensure that there is segregation between:

(a) staff whose duties involve acquiring new lending business; and

(b) staff whose responsibility is to underwrite such lending business, in order to minimise conflicts of interest and ensure dispassionate evaluation of the credit risks involved.

3.67 The scale and breadth of the risk function is expected to reflect the scale and breadth of the activities that are undertaken by the society, and to keep pace with the development of the business. The key objective of the risk function is to provide a 'second line of defence': that is, independent challenge, from a risk management perspective, of proposals that are made by the society's management, and the provision of information to management and the board that explains and informs them of risk trends/positions.

Supervisory standards for managing risks in the lending book

3.68 The PRA has devised three models ('approaches') of increasing sophistication for lending book management to assist societies in meeting supervisory expectations for the level of risk management that would apply to different business models. These supervisory lending 'approaches' are named as 'Traditional', 'Limited' and 'Mitigated'. This section outlines the three supervisory approaches to managing the lending book.

3.69 The PRA expects each society to conduct its lending activities in accordance with the most suitable of these three models in order to demonstrate that it has complied with General

Organisational Requirements 2.1 and Risk Control 2.1 in the context of loan book management.

Risk management expectations

3.70 Appendix 1 sets out indicative standards for:

(a) The types of assets that are expected to be originated or held;

(b) the type of risk management controls that societies are expected to put in place (and, where appropriate, to document clearly within their lending policy);

(c) the expectations of the PRA on credit risk management processes and procedures; and

(d) the criteria which societies would use in assessing their controls over their lending book under each of the three defined lending approaches.

3.71 The specification of indicative prudential standards and limits for each approach is designed to draw management and supervisory attention to those areas of a society's credit risk management strategy or policy which go (or seek to go) beyond the PRA's general expectation for societies on each respective lending approach, bearing in mind the level of risk management capability expected to be in place for that approach.

3.72 Societies can expect their supervisors to focus in greater detail on those areas of difference, to identify whether business risks have been fully evaluated and whether controls are aligned with those risks. Where this is judged not to be the case, supervisors will expect the society, to develop plans to address the misalignment or to re-assess the business strategy. As such, the approach standards in Appendix 1 should not be interpreted as hard requirements, but as input into the process of establishing appropriate policies, and as the basis for supervisory dialogue.

Lending types and lending limits

3.73 The actual lending limits, which societies following one of the three lending models will have in their lending policies, need to be set by reference to available management expertise and risk management capability. The PRA expects these limits therefore to resemble those set out in Appendix 2. As with the risk management characteristics table in Appendix 1, the limits suggested are designed to draw management and supervisory attention to those areas of a society's lending activity which go (or seek to go) beyond the PRA's general expectation for societies that adopt each of the lending approaches.

3.74 If a society plans to become exposed for the first time to mortgages of sub-types not covered in paragraphs 3.20 – 3.41 above, they are expected to speak to their supervisor before entering the market, and again if their exposure reaches an internal limit pre-notified to the society's supervisor, based on the perceived risk characteristics of the sub-type.

3.75 Societies can expect their supervisors to focus in greater detail on those areas of difference between internal limits and those set out in Appendix 2, to identify whether business risks and controls are aligned and, if not, to understand plans to address that misalignment. As such, the limit expectations set out in Appendix 2 should not be interpreted as hard requirements, but as input into the process of establishing appropriate policies, and as the basis for supervisory dialogue.

3.76 Under section 6 of the 1986 Act, societies are required to ensure that a minimum of 75% of their commercial assets is fully secured on residential property. Since such lending will always be such a significant part of a society's business, it is essential that the risks arising from further concentrations within the total lending book are properly managed and mitigated to align with the board's risk appetite.

Supervisory lending 'approaches' - definition

Traditional approach

3.77 Societies adopting the traditional lending approach category would restrict their lending activities mainly to prime quality residential mortgages for owner-occupiers. The traditional approach would suit small societies where lending decisions are fully underwritten on an individual basis, typically by the Chief Executive or a direct report, under clearly delegated mandates.

3.78 Societies adopting this approach would have board-approved lending policies that:

(a) set a minimum limit of at least 85% of the loan book for prime owner-occupied mortgages (subject to a mortgage indemnity guarantee or other recognised collateral for LTV in excess of 80%);

(b) limit other types of lending within the maximum 15% balance (by setting sub-limits) to prime owner-occupied >80% to <90% LTV without external insurance, prime BTL, 'custom' self-build, shared ownership, social landlords and small ticket (<£1m per connection) secured commercial lending to owner occupiers (including loans fully secured on other land) only;

(c) require the use of approved independent valuers;

(d) require stress tests to be undertaken at least annually to identify potential shortfalls in the value of security and allow it to review the appropriateness of its lending limits; and

(e) limit exposure to connected counterparties to <10% capital resources.

Limited approach

3.79 The limited lending approach would be suitable for societies that have a slightly higher appetite for credit risk than those on the traditional approach. Societies adopting this approach would control the amount of risk assumed through a comprehensive system of policy limits and specialist underwriters. These limits would prevent the society from becoming over-exposed to non-traditional lending, and should take account of the differing risks associated with the type of lending and the type of security held.

3.80 In general it is anticipated that the limited approach would suit medium-sized and larger societies where:

(a) there is operational segregation between underwriting and the review/audit/compliance functions that check compliance with policy and legislation and that review lending/underwriting quality;

(b) there is operational segregation between underwriting and the mortgage sales function;

(c) lending decisions are fully underwritten on an individual or systematically credit-scored basis, under clearly delegated mandates; and

(d) relevant specialist expertise is employed for non-traditional lending, adequate to cope with the additional time commitments associated with the regular monitoring required of such lending, and with access to appropriate sources of external and/or internal information to be able to monitor/challenge how risks are developing.

3.81 Societies adopting this approach would have board-approved lending policies that:

(a) set a minimum limit of at least 65% of total loan book for prime owner-occupied mortgages;

(b) set sub-limits in terms of total loan book for other types of lending within the maximum 35% balance (see Appendix 2 for guidance on sub-limits); and

(c) require stress-testing and scenario analysis of outcomes to be undertaken at least semi-annually.

Mitigated approach

3.82 The mitigated lending approach would be suitable for societies that undertake a diverse range of lending. Societies adopting this approach would mitigate their risk through sophisticated credit risk management systems that control the amount of risk assumed through a comprehensive system of policy limits, specialist underwriters, self-developed stochastic risk models, and through use of risk transfer or insurance techniques to protect against concentrations or catastrophic credit events.

3.83 In general, it is anticipated that the mitigated approach would suit only the largest societies where:

(a) there is a segregated and independent risk function headed by a CRO, reporting directly to the board (or a board risk committee);

(b) there is full segregation between credit underwriting and the review/audit/compliance functions that check compliance with policy and legislation, and which review lending/underwriting quality;

(c) underwriting is independent of the mortgage sales function;

(d) lending decisions are underwritten on an individual or systematically credit-scored basis (but subject to manual override), under clearly delegated mandates; and

(e) relevant specialist expert teams are employed for non-traditional lending, with access to appropriate sources of external and internal information on how risks are developing.

3.84 Societies adopting this approach would:

(a) have board-approved lending policies that set appropriate limits for each type of lending; and

(b) undertake full econometric risk analysis, stress-testing and scenario analysis of outcomes at least quarterly.

4 Financial risk management

Introduction

4.1 This chapter sets out the expectations of the PRA on financial risk management within treasury operations. As part of the implementation of the Capital Requirements Directive and Capital Requirements Regulation (known collectively as CRD IV) and the Markets in Financial Instruments Directive (MiFIDk)[1], provisions relating to a society's organisational and risk systems and controls have been included in the General Organisational Requirements, Compliance and Internal Audit and Risk Control Parts of the PRA Rulebook. This chapter generally explains the application of the PRA Rulebook in the context of financial risk management.

4.2 The chapter describes the key financial risks to which societies are exposed and also sets out the framework within which the PRA will supervise the treasury and financial risk management activities of societies.

4.3 The importance of financial risk modelling, the complexity of some financial instruments, and the size of individual transactions, combine to make treasury operations a high risk activity that needs particularly strong oversight. The impact of losses arising in the treasury area can be both significant and immediate.

4.4 Boards have ultimate responsibility for deciding the degree of risk taken by their societies, including all categories of treasury assets and risks arising from the management of treasury activities.

Key financial risk categories

4.5 The key financial risks which societies are expected to manage and control are:

(a) liquidity risks: arising from maturity transformation (ie short-term borrowing financing long-term lending, creating a maturity mismatch that leaves the society at risk of deposit flight);

(b) funding risk: arising from the relative stability of different funding sources and reliance on new funding to replace outflows;

(c) wholesale counterparty credit risk: where a wholesale counterparty fails and cannot not complete a transaction (eg cannot repay a term deposit placement by the society);

(d) currency risk: arising from the effects of changing exchange rates on unmatched assets and liabilities denominated in different currencies;

(e) interest rate risks to a society's earnings (most significantly to its interest margin) and to its economic value (the present value of future cash flows): arising from repricing, yield curve and basis risks, and also from optionality effects, all of which may impact on its interest earnings or value of its assets and liabilities; or arising from the structural positioning of its balance sheet;

[1] Including future versions, as and when they come into force.

(f) product pricing risks: arising particularly where products are not immediately profitable and where longer term payback is dependent upon the achievement of specific cost and/or pricing assumptions (including assumptions for the performance of non-interest elements such as RPI or quoted share prices);

(g) settlement risk: the risk of losses arising from failure to settle transactions accurately, or on a timely basis; and

(h) operational risks in treasury and related activities: including failure of internal controls or procedures, and the risk arising from errors in legal documentation.

Internal controls on treasury financial risk management

Policy statements

4.6 In order to meet the requirements in Risk Control 2.3, in the context of financial risk management, all areas of treasury activities should be governed by a board-approved policy statement[1] that records the rationale and strategic framework for the policy, ie why and how treasury activities are expected to support the society's core business, the supervisory 'approach' category being followed, the conditions under which authority is delegated to a board sub-committee or to management, the operating limits and high level controls that will maintain exposures within levels consistent with the policy, and the procedures/controls on both existing position and those that would arise from the introduction of new products or activities. The policy statement is expected to set out how the relevant financial risks set out in paragraph 4.5 above will be measured, managed and monitored within a comprehensive and consistent risk framework.

4.7 Policy documents should be consistent with the type of business undertaken by the society and compliant with sections 7 and 9A of the 1986 Act. It should also be noted that, under section 5 of the 1986 Act, a society's principal purpose is that of making loans that are secured on residential property and are funded substantially by its members, not undertaking, and trading in, financial risk for profit.

4.8 Copies of the policy statements are expected to be made available to, and evidenced as read by, all personnel involved in treasury operations. They should also be provided to PRA supervisors on request, or when substantial changes to policy approaches or limits are made.

Policy limits

4.9 Policy limits are expected to confine risk positions within levels considered by the board and management to be prudent, given the size, complexity and capital needs of the society's business.

4.10 Where applicable, limits would normally also be applied to individual instrument types, asset/liability portfolios, and to separate business activities or subsidiary undertakings. Limits are expected to cover both the quantum and term/run-off of positions and to take due account of the intended impact on business flexibility and profitability – both in normal times and under stress.

---

1 A society may choose between having a single policy statement covering all the risk categories set out in paragraph 4.5 , or having separate policies for each risk category but cross-referencing these. The PRA's expectation is that the outcome should be a consistent policy framework that is clear to all those that have to operate within it.

4.11 The structure of limits should enable the board and management to monitor actual levels of sensitivity, under different pre-defined market, interest rate and exchange rate scenarios, against the policy specified maxima, to ensure that corrective action can be taken if required.

4.12 The number and type of limits to be applied will depend upon the relative sophistication of a society's treasury operations.

4.13 Limits should be set as part of the overall board policy, and these are expected to be treated as absolute. Any limit breaches should be treated as abnormal and escalated immediately, so the policy needs to make clear what action is expected of management in those circumstances. Breaches of board limits are expected to be reported to both the board and the society's supervisor.

4.14 Operating limits, set by management within the overall board limit structure, are similarly expected to be subject to clear guidelines covering measurement, management and reporting.

Risk management skills and resources

4.15 The PRA expects all societies to put in place systems and controls that are appropriate and proportionate for the types of business that they intend to undertake. Operational arrangements for treasury activities are expected to ensure, as far as is practicable (given the relative size and complexity of the society), that there is functional segregation within the first line of defence between:

(a) staff whose duties involve initiating treasury deals with external counterparties ('front office' or 'treasury dealers');

(b) staff whose duties involve checking, confirming and settling such deals and applying the correct accounting for treasury instruments ('back office'); and

(c) staff responsible for managing balance sheet positions, implementing agreed hedging strategies and providing treasury position reports to the governing body at board, board committee and management committee levels ('Asset and Liability Management' (ALM), which may be designated as part of 'front office' or 'middle office').

4.16 In all but the smallest societies, there would ideally be physical segregation between the front and back offices. Where physical segregation is not possible, steps would be taken to ensure that the same individual cannot both initiate a deal and then handle the settlement of that deal. Where possible, the reporting lines of front and back offices would be different.

4.17 In addition to functional segregation in the front line, societies would also be expected to have an appropriately segregated second line of defence, delivering risk management oversight of all treasury activites undertaken. Within the second line, there would be:

(a) staff whose responsibility is treasury risk limit checking/monitoring and obtaining independent market valuations eg of high quality liquid asset holdings or derivatives (may be allocated to 'middle office' monitoring or to 'back office'); and

(b) staff responsible for risk policy development who challenge and test treasury activities against risk appetite and who monitor the operation of the internal treasury control framework ('middle office' risk control).

4.18 The scale and breadth of the various functions are expected to reflect the scale and breadth of the activities that are undertaken by the society, and to keep pace with the development of the business. Some smaller societies with simple business models may not have sufficiently complex treasury operations to need a distinct 'middle office' In these cases, the checking and monitoring functions may be undertaken by the back office or finance function, supplemented by senior management oversight. However, all societies are expected to ensure that second line risk oversight is provided within the operational framework – where the business model and product set is simple, risk management may be performed by senior management (eg the CFO or CEO of the society) or a board committee. For these societies, the key objective would be to ensure that provision for challenge by individuals who are familiar with treasury risks is built into the decision-making process.

4.19 At board level, societies are expected to have amongst their non-executives individuals who are familiar with treasury issues and are able to provide appropriately robust challenge to management proposals relating to financial risks. These individuals may be expected to be members of appropriate board committees that cover risk management – typically a Risk Committee (possibly combined with Audit as an Audit & Risk Committee) or a more specialist board Assets and Liabilities Committee (ALCO). For larger and more sophisticated societies, a management ALCO (without non-executive attendees) may be used for day-to-day operations, with the most important decisions reserved to the board, but for smaller societies a single ALCO with both non-executive and executive attendees may be sufficient. It is for each society to determine what arrangements will give the most effective and efficient level of oversight.

4.20 Appendix 3[1] sets out the PRA's expectations for financial risk management skills and resources by reference to four supervisory 'approaches' of increasing sophistication to assist societies in assessing their operational approach to financial risk management and treasury operations. These set out some criteria that societies are expected to use in determining the type and scale of financial risk management resources needed to cover the functions set out in paragraph 4.15 above, and skill sets expected for their chosen business model.

Risk management systems

4.21 This section relates to Risk Control 2.1 and 2.2 specifically in the context the treasury management activities carried out by back office and ALM.

4.22 A society is expected to have in place treasury information systems capable of logging transactions and reporting accurately on:

(a) all new transactions and/or cash flows which will affect calculations of structural risk exposures;

(b) the settlement timetable and processes for individual treasury instruments; and

(c) the current market values of high quality liquid assets, other marketable instruments and derivatives (including complex derivatives).

4.23 A society is expected to have in place treasury information systems that are capable of permitting ALM to report accurately and promptly, to management and to the board (and, if

1 See also paragraph 4.125 and following for an explanation of the four 'approaches'.

requested, to the PRA) on all the relevant risks for the society from those set out in paragraph 4.5 above, including specifically:

(a) the level of risk, funding risk, currency risk, and counterparty risk inherent in its balance sheet;

(b) the potential impact of interest rate changes on both its earnings and its economic value (including the effect of any standard interest rate shock as specified by the PRA);

(c) all material treasury risk positions including the information necessary to prepare an ICAAP and Internal Liquidity Adequacy Assessment Process (ILAAP), and the results of stress testing for liquidity, interest rate and structural risk in the banking book; and

(d) credit risk and settlement risk positions incurred with individual and groups of counterparties.

4.24 The scale and scope of the risk capture, measurement and reporting systems employed need to reflect the sophistication of a society's treasury operations. Those societies wishing to undertake more sophisticated activities require more complex models to capture different facets of risk, such as optionality. In particular, more sophisticated approaches will require methodologies and systems for quantifying behavioural aspects of customer balances eg prepayment of fixed rate loans and the duration of non-maturity deposits (ie retail liabilities which contractually have short maturity but which have behaviourally proved to be both stable and rate insensitive), and for simulating the development of their balance sheets under multiple forward interest rate scenarios.

Stress testing

4.25 The risk measurement systems put in place should be able to evaluate the impact, on income and economic value as appropriate, of abnormal market conditions. The amount and type of stress testing required will depend upon the sophistication of treasury operations undertaken and the level of risk taken, but where required, is expected to be regular and systematic.

4.26 Within the range of scenarios tested, it is good practice for the scenario to reflect the events that would cause the society's business model to fail without any mitigating management action. Boards and management are expected to periodically review the extent of that stress testing to ensure that any 'worst case' scenarios remain valid. Contingency plans need to be in place to deal with the consequences should those scenarios become reality.

Board information reporting

4.27 The PRA attaches considerable importance to the quality, timelines, and frequency of the management information which the board uses to satisfy itself that treasury activities are being undertaken in accordance with its policies and guidelines. Information obtained by the board is expected to include the outcome of regular and systematic stress testing, as described above, which should be taken into account when policies and limits are established or reviewed.

Independent review

4.28 This section relates to Compliance and Internal Audit 3.1 in the context of treasury management. Each board is expected to ensure that its society's internal audit function has the skills and resources available to undertake an audit of the treasury function.

4.29 Internal audit is expected to evaluate, on a continuing basis, the adequacy and integrity of the society's controls over maturity mismatch, over the level of structural risk taken and to assess the effectiveness of treasury management procedures.

4.30 Societies with complex treasuries or lacking internal auditors with treasury expertise could consider co-sourcing or outsourcing treasury audit to an audit firm with the appropriate expertise and experience.

4.31 The work of outsourced internal audit needs to be fully integrated into a society's overall audit procedures and plans, with appropriate reporting lines into the audit committee. However, in order to avoid conflicts of interest, internal audit should not be contracted out to a society's own external auditors, even if the function were to be performed by a completely different branch of the audit firm.

Liquidity risk management and Treasury investments

Introduction

4.32 This section sets out the expectations of the PRA for societies' management of their treasury investments in compliance with GENPRU 1.2 and General Organisational Requirements, Skills, Knowledge and Expertise, Compliance and Internal Audit and Risk Control Parts of the PRA Rulebook[1]. It outlines factors that the PRA will consider when assessing the adequacy of a society's ILAAP during a Liquidity Supervisory Risk Evaluation Process (L-SREP), and in reviewing liquidity risk management policies and capabilities.

4.33 Treasury investments may be held for a variety of purposes which broadly fall into three categories:

(a) High Quality Liquid Assets (HQLA) eligible for inclusion in a society's liquid assets buffer, held to meet the 'overall liquidity adequacy requirement' (OLAR) and the Liquidity Coverage Requirement (LCR);

(b) HQLA and other assets held operationally for matching and cash flow management purposes; and

(c) investment assets that management have decided to hold in order to generate income.

Liquidity risk management

Liquidity risk attributes

4.34 By nature, all societies specialise in long-term mortgage lending which is financed mainly by liabilities which are contractually short-term. This feature of societies' businesses creates maturity mismatches which can give rise to cash flow imbalances – and a risk that there could be insufficient cash resources to meet payment outflows when they fall due.

4.35 Specifically, maturity mismatch may give rise to liquidity and funding risks arising from:

(a) unexpected demand for deposit withdrawals;

---

[1] Societies should also comply with Supervisory Statement 24/15 'The PRA's approach to supervising liquidity and funding risks', June 2015; www.bankofengland.co.uk/pra/Pages/publications/ss/2015/ss2415.aspx.

(b) unexpected inability to refinance term wholesale borrowings on a roll-over date due to general market conditions (which may or may not be related to the position of the society itself);

(c) the bunching of roll-over dates for wholesale funding or maturities of term retail funding;

(d) concentration on a limited number of funding providers, giving rise to increased dependence, particularly on roll-over days;

(e) the uncertain timing of drawdown of mortgages, and inherent in the early withdrawal characteristics of certain retail savings products (ie behavioural as opposed to contractual maturity risks); and

(f) the potential reliance on receiving inward payments before being able to fund outgoing payments on the same day.

4.36 A society is required by Commission Delegated Regulation (EU) No 2015/61 of 10 October 2014 (supplementing Regulation (EU) No. 575/2013) to hold an adequate buffer of liquid assets to meet the LCR for credit institutions.

4.37 However, the LCR is intended to cover a generic scenario across all firms. It may not capture all the types of stress that could affect a society, and therefore does not give full assurance that a society would always be able to meet its obligations when they fall due. Societies are therefore expected to manage and mitigate the liquidity risks listed in paragraph 4.35 above by setting and adhering to their own OLAR, based on their specific Liquidity Risk Appetite (LRA).

Liquidity policy

4.38 As set out in Individual Liquidity Adequacy Assessment 3, all societies should have board-approved liquidity policy statements, which, among other things, are expected to set out the strategies, policies, processes and systems in place to manage liquidity risk, and the liquidity risk tolerance to be accepted.

4.39 A liquidity policy statement ought to be consistent with the society's strategic plan and the related policy statements on funding and interest rate risk management. In the statement, the board is expected to establish its objectives for liquidity risk management, including:

(a) meeting obligations as they fall due (including any unexpected cash outflow that could arise under stress);

(b) smoothing out the effect of maturity mismatches; and

(c) maintaining public confidence.

4.40 A liquidity policy statement would establish the framework for operating limits within which liquidity would be maintained, the range of treasury investments in which the society can invest and the high level controls under which authority is exercised. The statement would have regard to the need to meet OLAR, LCR and any additional Pillar 2 requirements, and would cross-refer to the board's policy on counterparty credit assessment, ratings and exposure limits.

4.41 Where a society chooses to hold treasury investments other than for the purposes of meeting its LCR liquid assets buffer, the society's liquidity policy statement would include objectives, provisions, limits and requirements relating to such investments. The need to earn a return on treasury investments may also be recognised as an objective, although this would be expected to be secondary to the security of the assets.

4.42 A liquidity policy statement should be a working document, and personnel in the treasury and settlement areas are expected to be familiar with its contents, as are members of relevant committees (eg the Asset and Liabilities Management Committees (ALCO) and/or the Finance Committee). When aspects of the policy or limits change, the policy document needs to be amended as frequently as necessary. The board is expected to agree all substantive changes.

4.43 Societies are expected to inform their supervisors of all material changes to their liquidity policy, and provide a marked-up version of the policy statement on request. Supervisors will review liquidity policies periodically as part of their assessment against the guidance in this supervisory statement, and in accordance with EBA/GL/2014/13 Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP), in particular as set out in paragraph 401 et seq.

4.44 Societies are encouraged to cross-reference their ILAAP and their liquidity policy statement to the documentation required to satisfy the EU Directive 2014/59/EU Bank Recovery and Resolution Directive as relating to liquidity contingency plans.

Contents of liquidity policy statements

4.45 A society's liquidity policy statement is expected to include at least the following (this is a non-exhaustive list, and societies ought to consider whether additional elements are required for their business model):

4.46 An introduction section that includes:

(a) background to the society's approach to liquidity risk management, including the setting of its risk appetite;

(b) the ratification process for obtaining board approval, including amendments to the policy statement as well as complete revisions; and

(c) arrangements for, and frequency of, review (which is expected to be conducted at least on an annual basis).

4.47 A background section setting out the society's business and operational characteristics, which impact on the amount and composition of liquidity and treasury investments.

4.48 A summary, setting out key policy limits, including the intended ranges and trigger values for the loans to customer deposit ratio and liquidity measures, both regulatory and business specific, and both gross and net of mortgage or other lending commitments.

4.49 A risk management section that includes:

(a) an overview of operational and settlement risk controls, including: the framework of board authorisation, delegations and operating limits (including dealer limits, transaction and day limits), deal authorisation, confirmation checking, segregation of duties;

(b) the policy in regard to use of repo and reverse repo facilities and the potential encumbrance of treasury investments held;

(c) procedures and criteria for authorisation of exceptional overrides in relation to dealing, operational rules, limits and settlement; and

(d) the policy for liquidity risk management information and reporting to the board.

4.50 A maturity structure section, to include the policy for maturity mismatch and a 'maturity ladder' of treasury investments. This would give a clear view of the maturity pattern of treasury investments to be followed, showing the maximum proportions to mature within each time band.

4.51 A section covering permitted categories of assets and activities, setting out the society's policy for the acceptable level of holdings of:

(a) assets held in the liquid assets buffer to meet OLAR and LCR, including the risk appetite for concentration risk;

(b) inter-society and local authority deposits;

(c) repo/reverse repo (both gilt-edged stock and non-gilt-edged securities);

(d) mortgage backed securities and covered bonds;

(e) foreign currency securities and the handling of foreign currency exposures;

(f) commercial paper;

(g) bank deposits, certificates of deposit and other bank securities; and

(h) collateral eligible for use in the Bank of England's Sterling Monetary Framework.

4.52 The society's policy for membership and use of any central clearing counterparty for derivatives or repo activity would be set out clearly, including a section dealing with authorisation and operational controls. Liquidity implications arising from the role of standby facilities would be included in the policy statement.

Custody arrangements and advice

4.53 If a society takes advice from, or makes arrangements with, an external advisor, its liquidity policy statement needs to contain a section on the role of external professional advisers in liquidity management, where applicable, setting out the basis on which advice is given and the adviser's role in the execution of any transactions.

4.54 If a society has entered into an agreement involving the provision of advice, it needs to ensure that no transaction is undertaken without its prior consent. The society ought to ensure that it differentiates between advice and discretionary fund management, and to make certain that all transactions undertaken on a discretionary basis are within the terms of its liquidity policy statement.

4.55 If a society enters into an arrangement with a broker whereby its securities are held in custody by the broker's custodian, the society needs to ensure that it retains legal ownership of, and unfettered access to the investments held in custody. Custody arrangements need to be clearly set out in a customer agreement between the broker and the society.

Wholesale counterparty credit risk management

4.56 This section sets out the expectations of the PRA for societies' management of their treasury counterparty relationships. Societies are expected to have in place wholesale counterparty credit risk policies that would include credit limits for all counterparties, both for making treasury investments and for transacting derivative contracts.

4.57 Such counterparty credit policy limits would cover:

(a) exposure policies, including controls and limits as appropriate, for countries, sectors and groups of connected counterparties, including exposure to brokers;

(b) acceptable risk exposure types (eg deposits or marketable instruments);

(c) valuation of market risk exposures (eg mark-to-market positive value of swaps, plus appropriate addition for potential future exposure increases arising from changes in market rates); and

(d) settlement risk exposures (eg currency deals where amounts are paid out before funds are received).

4.58 Boards are expected to determine the extent to which the authority to set counterparty limits is delegated to management, but delegation to a single individual ought not to be permitted. Personnel with dealing mandates should not be given authority to set new or increased counterparty limits. No dealings should take place with counterparties which do not have pre-approved limits.

4.59 Limits need to be established on the basis of a robust methodology, which should be fully documented and reviewed regularly. The methodology would be expected to cover:

(a) the use of credit ratings, including the minimum quality acceptable and procedures for ensuring credit ratings are up to date;

(b) other information such as market intelligence, which would be reviewed when considering limits on treasury investments; and

(c) the policy of assessment to be adopted towards counterparties and sectors that are non-rated.

4.60 For societies with more active treasury operations, a separate wholesale credit risk committee with responsibility for preparing a wholesale counterparty credit policy statement and counterparty list may be appropriate. Less active societies may incorporate a section on credit risk within their liquidity policy statements and ILAAP, with appropriate cross-references to other policy and procedures statements.

4.61 In all cases, the counterparty list and individual limits would be subject to formal credit review at least annually, with interim arrangements in place to add, amend or remove limits as appropriate.

4.62 Where credit ratings are used, if these are downgraded (or put on 'watch' with 'negative implications'), or if a society becomes aware of information on a counterparty which might affect its perceived creditworthiness (whether or not this results in a rate change), it is expected to have systems for reviewing individual counterparty limits and, possibly, suspending or removing individual names from authorised lists in an expeditious manner.

4.63 Arrangements for obtaining information on counterparties, where this is in the public domain, would also be included in procedures manuals.

4.64 Exposures to counterparties are expected to be monitored on a consolidated basis, aggregating exposures of the society and any subsidiary undertakings (where applicable), and setting total exposure limits for groups of connected counterparties. Similarly, country, sector and market concentrations need to be monitored continuously against internally agreed limits.

Funding risk management

4.65 This section sets out the expectations of the PRA for societies' management of their retail and non-retail funding activities. Societies' core business (set out in statutory 'nature' limits[1]) of financing long-term residential mortgages mainly with short-term personal savings necessarily involves a high degree of maturity transformation, and this creates major funding risks that all societies need to manage.

Retail funding risks

4.66 Retail deposits from individuals have historically proved to be a good source of stable funding, but the extent of that stability differs by product type. Much retail funding from individuals is contractually withdrawable on demand, but in practice has tended in aggregate to remain stable even when markets are under stress or showing acute instability – although the extent of this stability depends significantly on the extent to which such accounts are remunerated: those targeted at rate-sensitive depositors via best buy tables will inevitably show less stability than lower balance transactional accounts where interest earnings may not be the prime motivation for the depositor. However, the threat that loss of confidence could lead to a deposit 'run' is one of the main reasons for holding precautionary levels of liquidity.

4.67 In order to reduce the risk of a run, and to provide additional certainty about the availability of funding over an extended period, societies have introduced retail deposit types with one or a combination of withdrawal restrictions such as:

(a) limiting the number or size of withdrawals during a given period;

(b) requiring customers to give a period of notice if they wish to withdraw money; and

(c) offering deposits with fixed maturities (normally also with fixed interest rates).

4.68 Although such restrictions can be effective in improving stability for a period, some can also have the effect of incentivising deposit outflows once the restriction period ends. Thus, a product with limited withdrawals may exhibit larger outflows as the remaining number of permitted withdrawals reduces (and depositors take action to maintain access to their money). Similarly, depositors may give precautionary notice of withdrawal, even if none is actually intended. A retail bond with a fixed term provides funding up to the maturity date, but implicitly forces the depositor into a decision about where to redeposit the money at term: the extent to which such funding rolls-over is therefore dependent upon the rates offered for follow-on products, and their relative competitiveness in the market. Thus, although the fixed term funding is available for a specific period, as it approaches maturity the risk of withdrawal increases significantly, and retaining the deposit may require paying rates that are damaging to

1 Building Societies Act 1986, sections 6 & 7.

the net interest margin. For all these reasons, societies are expected to undertake appropriate cash flow modelling to understand the funding risks, and to ensure that they use a variety of different retail funding products to manage vulnerabilities arising, and to avoid over-concentration.[1]

4.69 Specifically, societies are expected to consider setting policy limits for the proportions of retail funding taken (both in aggregate and as a flow of business), in the form of:

(a) fixed term retail investment bonds (where limits would also be in place governing the volume of such deposits that can reach term within a given month/quarter);

(b) instant access, internet-only deposits; and/or

(c) fixed term/rate Individual Savings Accounts (ISAs) (since all are treated as withdrawable within 30 days for LCR calculation purposes).

Non-retail (corporate) deposits

4.70 In addition to deposits from individuals, societies may seek to attract deposits from local businesses and professional firms (eg solicitors). Such funding may be covered by Financial Services Compensation Scheme (FSCS) arrangements, improving its stability, and may also be treated as 'retail funding' for the purposes of the 1986 Act funding restriction[2].

4.71 However, although similar to retail funding from individuals, funding from such sources may have some different behavioural characteristics and societies are expected to take steps to understand these in determining how much reliance to place on this source. In particular, professional firms depositing client money may be particularly sensitive to anything indicating a lack of creditworthiness or a change of reputation for the society, and there is potential for groups of such depositors to act simultaneously.

4.72 Therefore, boards are expected to set limits on the size of individual deposits and the total volume of such non-retail deposits as a proportion of their funding base.

Wholesale funding risks

4.73 Wholesale markets may provide funding that carries a more definite maturity than retail deposit funding, but the size of wholesale tranches may concentrate the refinancing risks societies face, and wholesale tenors may still be less than those of any mortgages thus funded. Exposure to re-financing risk needs careful management, and avoidance of over-reliance on an assumption of continued access to the wholesale market.

4.74 To access the wholesale markets, some societies have been credit rated by external agencies. Carrying such a rating is often essential in order to enable a society to access

---

1 See also the EBA Guidelines on retail deposits subject to different outflows for purposes of liquidity reporting under Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms, and amending Regulation (EU) No 648/2012 (Capital Requirements Regulation – CRR) - www.eba.europa.eu/documents/10180/515704/EBA-GL-2013-01+(Retail+deposits).pdf.

2 Section 7 of the Building Societies Act 1986 was amended by paragraphs 2 and 3 of Schedule 9 to the Financial Services (Banking Reform) Act 2013. The amendment changed the calculation of the funding limit so that a limited amount of the value of deposits by small businesses will not count towards the value of total group funds. That means, for the purpose of the funding limit, that a limited amount of the deposits of small businesses will no longer be treated as 'wholesale funds'. A limit is set on the amount of small business deposits that will not count, so that no more than 10% of the value of total group funds can be disregarded in calculating the funding limit.

wholesale funding markets, but does expose it to the danger of a change in market view of the sector or the society, so the process of obtaining and continuing management of the rating therefore needs careful consideration and monitoring.

4.75 Societies using wholesale funding are expected to manage their wholesale maturity profile so that it does not cause excessive volatility in their liquid assets buffer. In particular, societies would manage their wholesale funding in a way that ensures stability of supply and availability over time. This implies that, the greater the volume of wholesale funding used as a proportion of funding liabilities, the longer the maturity profile of that funding would be. Societies need to consider their realistic levels of access to market funds, including in stressed circumstances.

4.76 Societies are expected to manage their funding in accordance with any future EU or PRA policy on the Net Stable Funding Ratio (NSFR)[1] once enacted. Specifically, societies need to ensure that their funding liabilities have sufficient stability to finance their asset mix, which will include a high proportion of long term, residential mortgages.

Encumbrance

4.77 Certain types of funding (eg covered bonds, non-recourse finance such as securitisations, and repurchase agreements - repo) involve pledging assets as security for loans. In addition, collateral may be pledged in respect of ‘out of the money’ derivative positions, either under credit support annex arrangements or as initial/variation margin. Such pledged assets are referred to as ‘encumbered’. Typically the assets pledged will be subject to a ‘haircut’, ie more collateral will be required than the value of the funding, and the extent of such over-collateralisation will reflect the credit quality and liquidity of the pledged assets. Therefore, availability of secured funding is limited by availability of collateral: given that the best assets tend to be pledged first, the amount of collateral required will increase significantly as the available quality declines, to a point where secured funding becomes unavailable, uneconomic, or both. Moreover, as the level of encumbrance increases, the position of senior creditors of the societies is weakened and the availability of unsecured funding will reduce – or its price will increase – to a point where it too becomes unavailable or uneconomic.

4.78 Societies that wish to operate in secured funding markets are expected to therefore have in place robust systems for identifying and monitoring collateral (both pledged and received), and set internal limits to control the level of encumbrance to within their risk appetite.

Large shareholdings and deposits

4.79 Undue dependence on individual funding sources that account for a large proportion of a society's overall liabilities could cause liquidity problems should those funds be withdrawn or not be available for roll-over. These potential problems apply whether the funds in question are raised from the retail or the wholesale markets.

4.80 A small society is relatively more exposed to this type of risk, and is expected therefore to consider the implications of concentration on individual shareholders or depositors when assessing its funding approach, bearing in mind the consequences for liquidity levels and the

1 In October 2014, the Basel Committee of the Bank for International Settlements published proposals for a Net Stable Funding Ratio (NSFR) to accompany the LCR, see www.bis.org/bcbs/publ/d295.pdf.

potential need for committed facilities. In the management of large retail investment accounts, a society would normally avoid:

(a) obtaining funding from a single shareholder or depositor which exceeds 1% of shares, deposits and loans; and

(b) allowing the aggregate total of funding, from those single shareholders or depositors which individually represent more than one-quarter of 1% of funding liabilities, to exceed 5% of funding liabilities.

Funding and encumbrance limits

4.81 The statutory funding limit (section 7 of the 1986 Act) sets a 'nature limit' of a minimum of 50% share account funding as a percentage of total funding liabilities[1].

4.82 For prudential monitoring purposes, societies are expected to set an internal policy limit based on a maximum level of funds raised by means other than the issue of shares (ie an inversion of the 'nature limit'). In order to avoid any possibility of an inadvertent breach of the 1986 Act, these internal policy limits would generally be set at levels below the 50% statutory maximum.

4.83 In undertaking their corporate planning process, societies are expected to develop a funding plan covering all expected funding requirements over the period of the corporate plan, and use this to set funding limits. The plan would assess sensitivities and their impact on funding levels, but while contingencies would be catered for, agreed funding limits would not be set at levels where usage is either unplanned or highly unlikely.

4.84 Wholesale funding can be divided into three broad types originating from different sources:

(a) offshore/overseas retail deposits up-streamed to the society;

(b) deposits from non-financial /non-individuals (sub-divided between SME funding with the statutory limit and other corporate funding); and

(c) wholesale funding from the financial markets (sub-divided into unsecured debt and secured debt).

4.85 Boards are expected to set policy sub-limits for each of these sources as well as an overall limit (eg a society might set an overall deposit liabilities limit of 30%, with sub-limits of 25% for wholesale deposit funding and 10% for offshore/overseas funding, the total of the sub-limits exceeding the overall limit only on the basis that both could not be used to their full extent simultaneously or to the extent that some of the funding is both wholesale and offshore/overseas).

1 Section 7 of the Building Societies Act 1986 was amended by paragraphs 2 and 3 of Schedule 9 to the Financial Services (Banking Reform) Act 2013. The amendment changed the calculation of the funding limit so that a limited amount of the value of deposits by small businesses will not count towards the value of total group funds. That means, for the purpose of the funding limit, that a limited amount of the deposits of small businesses will no longer be treated as 'wholesale funds'. A limit is set on the amount of small business deposits that will not count, so that no more than 10% of the value of total group funds can be disregarded in calculating the funding limit.

4.86 The board is also expected to set encumbrance limits to ensure that funding secured on the society's assets is undertaken in a controlled way that limits the risk to members and balance sheet management. Where appropriate, the wholesale funding policy statement should set out the board's risk appetite for encumbrance, and should include specific sub-limits for securitised funding, collateral requirements in central bank facilities, and repo activities.

Committed facilities

4.87 A society with high levels of maturing funding, or vulnerable to withdrawal of individual deposits, may consider arranging committed facilities (as an alternative to maintaining higher than average levels of liquidity).

4.88 In arranging committed facilities, a society is expected to consider:

(a) the credit standing and capacity of the provider of the facility;

(b) the documented basis of the commitment (ie is it an unconditional commitment or a 'best endeavours' arrangement); and

(c) the cost/fee structure compared to alternatives.

4.89 In extreme cases, there remains a risk that a provider may renege on a contractual commitment to provide funding, or purport to rely on widely drawn 'events of default' or 'material adverse change' clauses in the funding facility documentation, ie they may risk the legal consequences (if any) of refusing drawdown rather than lend money to a society in difficulties.

4.90 Societies should not, therefore, become over reliant on committed facilities to plug short term cash flow difficulties, and are expected to be cautious in their treatment of such facilities in their liquidity stress testing.

Funding policy statements

4.91 In order to exercise proper control over funding risks, each society is expected to put in place a board-approved statement of funding policy, setting out the key attributes of the society's approach including limits and control structures and cross-reference this to their ILAAP and/or contingency funding plan.

4.92 Societies would have in place an overall funding policy, approved by their boards, that links to the total funding plan and covers holistically:

(a) retail funding product and maturity limits;

(b) large shareholdings and deposits;

(c) wholesale funding and encumbrance limits; and

(d) committed funding facilities.

4.93 A funding policy statement would be a working document, and personnel in the marketing/product management, treasury and settlement areas are expected to be familiar with its contents, as are members of relevant committees (eg the Asset and Liabilities Management Committees (ALCO) and/or the Finance Committee). When aspects of the policy or limits change, the policy document needs to be amended as frequently as necessary. The board is expected to agree all substantive changes.

4.94 Societies are expected to inform their supervisors of all material changes to their funding policy, and provide a marked-up version of the policy statement on request. Supervisors will review liquidity policies periodically as part of their assessment against the guidance set out in EBA/GL/2014/13 Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP).

Currency risk management

4.95 Societies are expected to aim to eliminate, as far as is practicable, all exposures to risk arising from movements in currency exchange rates. Societies are precluded by section 9A of the 1986 Act from acting as a market maker or trading in currencies (subject to some de minimis exemptions).

4.96 The PRA expects that only larger societies with more complex business models will wish to consider originating foreign currency assets or liabilities, given the additional operational and risk management overheads that are necessary to manage such activity.

4.97 If a society decides to raise wholesale funding in currency to support its sterling operations, it would be expected to enter into a cross-currency swap to neutralise exchange risk, both at maturity and in respect of coupon payments. Similarly, if a society decides to acquire treasury investment assets denominated in currency, it would normally be expected to swap out the exchange risks. Matching of treasury assets and liabilities in terms of currency and tenor could also be an effective risk mitigant.

4.98 If a society decides to raise retail deposits in a foreign currency, the PRA would expect the currency risk to be hedged by holding assets (including liquid assets) in the same currency. If a society decides to originate or purchase retail assets denominated in currency, the PRA would expect these to be match funded in terms of currency and tenor.

4.99 Any society proposing to operate in foreign currencies is expected to inform its supervisor before entering into any transactions. The PRA will expect such societies to be able to demonstrate that they have the appropriate knowledge, skills and controls in place to be able to transact such business prudently.

Interest rate and structural risk management

Introduction

4.100 In meeting the requirements of the General Organisational Requirements and Risk Control Parts of the PRA Rulebook, in the context of financial risk management, a society should have an adequate system for managing and containing financial risks to the net worth of its business, and risks to its net income, whether arising from fluctuations in interest or exchange rates or from other factors.

Interest rate risks

4.101 Most societies are susceptible to interest rate risks (commonly called 'interest rate risk in the banking book' or 'IRRBB') arising not only as a result of changes (or potential changes) in the general level of interest rates, but also from:

(a) repricing mismatches, eg where, in a rising interest rate environment, liabilities reprice earlier than the assets which they are funding; or, in a falling rate environment, assets reprice earlier than the liabilities funding them (in both cases leaving the society with a reduction in future income). Repricing risk is inherent in fixed rate instruments, the market value of which will change inversely with interest rate movements (eg gilts), and in unhedged fixed rate retail products (eg unhedged fixed rate mortgages funded by variable rate liabilities would yield less margin should the cost of the liabilities increase due to changes in market rates before the end of the fixed rate period);

(b) yield curve risk, where unanticipated changes to the shape or slope of the yield curve will cause mismatched assets and liabilities to reprice relative to each other, possibly exposing positions which were hedged against a parallel shift in rates only;

(c) interest basis risk, arising from the imperfect correlation of rates on instruments with similar repricing characteristics, eg between LIBOR rates and mortgage rates (both of which are variable but are subject to different market forces); or between LIBOR/base rate and administered rates paid on deposits; or between LIBOR and reference gilt rates or other indices; or between 3 and 12 month LIBOR rates. Risk can also arise where the underlying market rate is the same for matching assets and liabilities, but the margin paid relative to the offer rate diverges from the margin received relative to the bid rate (spread risk), as well as from margin compression risk arising between assets and liabilities that are both at administered rates but subject to margin caps or effective floors (eg the 0% 'zero bound' for deposit balances);

(d) optionality risk, arising from both explicit/contracted option contracts, such as 'caps', 'collars' and 'floors', which confer the right, but not the obligation, to fix an interest rate for an agreed amount and for an agreed period; and from embedded/implied options included within products, such as early withdrawal or redemption entitlements. Optionality can magnify the effect of other interest rate risks. In particular, societies may be subject to implied optionality in respect of retail savings rates (for which a minimum rate payable –a 'floor' – above 0% may need to be assumed), and from prepayment of mortgages/pre-withdrawal of deposits (where the customer may effectively have an 'option' which may not be adequately 'hedged' by way of early repayment charges; and/or

(e) structural risk, arising from the mix of interest rate characteristics in assets and liabilities that may limit the extent to which future interest margin can be managed.

Management of interest rate risks

4.102 Societies are expected to adopt a risk-averse approach to maturity mismatch and to structural risk management. A degree of maturity mismatch and structural risk is inherent in normal society operations, but boards of societies are expected to adopt policies that either:

(a) ensure that, as far as possible, exposures to changes in interest rates are measured and managed within the agreed risk appetite; or

(b) where interest rate positions are to be taken, restrict potential reductions in income or economic value, estimated under robust stress testing scenarios, to levels that would not compromise the current or future viability of their societies.

4.103 Societies are expected especially to have regard to the specific structural risks created by managing their balance sheets with a large proportion of assets and liabilities which have interest rates that are either fixed rate, or contractually linked to interest rates set by market indices or by the central bank. Significant exposure to such assets and liabilities reduces the ability of a society to manage its net interest margin through movement of its own administered rates. This can give rise to prudentially dangerous margin compression and thus to an unexpected shock to income. Thus, in the event of a fall in market interest rates, structural imbalances may crystallise as a risk that it may not be possible to decrease administered savings rates in line with decreases in money market (LIBOR) rates or Bank Base Rate without losing the funding (or because deposit rates cannot realistically fall below 0%), resulting in a serious margin squeeze where lending rates are LIBOR-linked. Similarly, in the event of a rise in rates, margin compression may arise from the inability to raise rates on fixed rate assets, and price competition for floating/administered rate assets combined with rising funding costs.

4.104 The PRA expects societies to manage their balance sheet in such a way as to retain the ability to flex interest margin management within a reasonably short time in order to deal with such shocks. This is a fundamental tenet of financial risk management for societies and needs to be reflected with high importance and visibility in their approach to management of financial risks.

4.105 Structural risks can also arise from the approach taken by societies to manage the variability of net interest income arising from assets financed by reserves and/or non-maturity deposits[1] (NMDs). More sophisticated societies may wish to manage earnings risk by treating these NMD liabilities as fixed rate with a defined (and behaviourally modelled) term profile that can be matched with fixed rate assets (or derivatives). The resultant fixed rate positions can pose economic value (EV) risk – were capital to be eroded or NMD balances decline), so the trade-off between managing risks to net interest income and EV needs to be carefully managed. The PRA generally expects that only those societies with more sophisticated risk management systems will be capable of modelling and managing these structural risks. Less sophisticated societies would normally treat capital as having no fixed repricing date and would not model NMDs.

Interest rate risk and structural risk management policy

4.106 The arrangements, processes, and mechanisms required in Risk Control 2.1 and 2.2 should include systems and procedures for identifying, monitoring and controlling all material maturity mismatch, interest rate, base rate, foreign exchange and similar (eg index-related) risks, and for reporting exposures to senior management and the board of the society on a regular, and timely, basis.

4.107 All societies are expected to have board-approved policy statements, which, among other things, would set out the strategies, policies, processes and systems in place to manage interest rate risk and structural risk.

4.108 The policy statement would be consistent with the society's strategic plan and the related policy statements on funding and liquidity risk management. In the statement, boards would establish the:

(a) objectives for interest rate risk management, including risk appetite and controls in place for managing the impact of rate changes on both future earnings and on economic value (and in particular the value of portfolios held at fair value);

1 Non-maturity deposits have short contractual maturity but behave as long term, interest-insensitive liabilities. The most common type would be current account balances held for transactional purposes.

(b) assumptions to be used in the measurement of interest rate risks, including rate stress scenarios, treatment of reserves and methodologies for determining the duration ascribed to non-maturity deposits;

(c) methodologies to be employed in measuring interest rate risks, and the systems to be used for this;

(d) governance arrangements for managing and mitigating interest rate risks; and

(e) arrangements for allocating capital to interest rate risk positions.

4.109 Interest rate risk policy statements would establish the framework of operating limits within which risks would be maintained, including gap limits (both spot and cumulative), changes in earnings limits, and changes in economic value limits under defined scenarios.

4.110 The policy statement would be a working document, and personnel in the society's treasury are expected to be familiar with its contents, as are members of relevant committees (eg the Asset and Liabilities Management Committees (ALCO) and/or the Finance Committee). When aspects of the policy or limits change, the policy document is expected to be amended as frequently as necessary. The board would be expected to agree all substantive changes.

4.111 Societies are expected to inform their supervisors of all material changes to their policy, and provide a marked-up version of the policy statement on request. Supervisors will review interest rate risk and structural risk policies periodically, as part of their assessment against the guidance in this Supervisory Statement, and in accordance with EBA/GL/2014/13 Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP).

Product pricing and funds transfer pricing

4.112 Societies are expected to have interest margin management and other measures in place to estimate the expected impact on profitability of new mortgage and savings products, and to project forward the cumulative effect of new business originations, taking account of any product incentives and loyalty schemes.

4.113 It is particularly important that societies have a clear understanding of their own cost structure, and especially the real cost of funding that will apply over the life of a new lending product. Given their lack of scale and market share, smaller societies are frequently price-takers for new lending, so it is essential that they are able to identify product opportunities that add to earnings, rather than pricing their products only by reference to what else is available in the market. Their funding and administrative cost structures are unlikely to mirror exactly those of the larger market players.

4.114 Special care needs to be taken in using realistic estimates of funding costs in pricing new lending. If the current blended cost of funds is used to set loan prices, but the society actually pays a higher rate for new funding taken to finance the new loans, the overall blended cost of funding will gradually increase and the actual longer term margin on new lending will be overstated. Therefore, unless the new lending will be financed from existing funding (eg by reducing the level of treasury assets), it may be more appropriate to use the marginal cost of funding as the basis for pricing decisions.

4.115 In addition to pure funding costs, societies need to consider the impact on pricing of lending of other relevant cost elements, specifically the:

(a) costs of holding additional liquidity in support of the additional funding (given that new funding generates a requirement to hold additional liquid assets, reducing the amount available for lending, and that those liquid assets may earn a coupon less than the cost of funding – therefore reducing earned margin);

(b) expected life of the loan asset (bearing in mind that the behavioural life of a mortgage may be less than its contractual term) and the additional cost of funding to match its expected life (the premium that will need to be paid to fund the loan through its expected life);

(c) revenues and/costs arising from fees (eg cash backs or arrangement fees) and commissions (eg broker commissions);

(d) operational costs associated with originating and servicing the new lending;

(e) capital cost associated with new risk assets (ie the expected loss, as a margin component);

(f) hedging costs associated with managing interest rate risk, basis risk or currency risk (including settlement and clearing house initial/variation margin costs); and

(g) premium needed to achieve the society's target return on capital.

4.116 Similarly, for pricing funding products, societies need to consider the impact of the:

(a) underlying market rate for funding, and level of competition for a given maturity term;

(b) society's own credit spread cost compared to the market rate and how that may adjust over time;

(c) expected behavioural life of the funding (which may be longer than the contractual life for easy access deposits); and

(d) the costs associated with raising the additional funds.

4.117 The extent and sophistication of systems that support pricing decisions is expected to be proportionate to the society's business model. However, for pricing new lending, all societies need, as a minimum, to be able to:

(a) estimate the marginal cost of new funding;

(b) calculate the liquidity costs associated with such funding;

(c) allocate the estimated operational costs that will be incurred in support of the new lending; and

(d) project their future interest rate margin (both planned and under stressed interest rates).

4.118 In addition to these basic elements of pricing capability, societies with more complex product ranges (both lending products and funding products) need to be able to:

(a) estimate the expected all-in cost of funding at future periods;

(b) model the expected customer behaviour for products with in-built optionality (eg early redemption rights for fixed rate loans, withdrawal rights in respect of fixed term deposits such as fixed rate ISAs);

(c) define and model pricing treatments for non-maturity deposits, ie deposits that have a behavioural life considerably in excess of their contractual term, and where balances are relatively interest rate insensitive (eg personal current accounts);

(d) calculate the capital cost that needs to be recovered via the product margin, to meet expected credit losses; and

(e) include in pricing the cost of any currency, interest rate risk and/or basis risk hedging arrangements.

4.119 Funds transfer pricing (FTP) systems are expected to be in place for societies with more complex treasury operations, and the output should be used actively to manage the type and volume of new business origination. In particular, societies are expected to consider using FTP systems and processes to:

(a) understand the relative contribution to net interest margin arising separately from assets and liabilities;

(b) provide appropriate incentives to those responsible for originating new assets and liabilities to ensure that their contribution to net interest income (NII) stability is properly recognised;

(c) allow estimation of the net interest margin arising from proposed new product offerings; and

(d) allow estimation of return on capital implied by the margin earned, in order to differentiate between the relative attractiveness of different product options.

Operational risk management

4.120 Any extension of society activities into more complex forms of funding, liquidity and off balance sheet instruments will dramatically increase the operational risks involved. Societies are expected to ensure that they are fully aware of the specific operational, legal and systems requirements associated with more complex treasury instruments and positions.

Settlement risks

4.121 Societies are expected to ensure that settlement activity is strictly segregated from dealing activity, so that it is not possible for a single individual both to originate and settle a transaction. Such settlement procedures would ensure that:

(a) controls over standard settlement instructions to ensure that bank details are verified, changes to details need at least dual verification, and that all settlement payments can only be directed to the pre-notified and agreed bank account;

(b) payments in settlement of transactions are made securely and with segregation between payment set up and release; and

(c) settlement accounts are regularly reconciled, and any unreconciled items are reviewed urgently.

Legal and accounting risks

4.122 The documentation, accounting treatment and settlement procedures for such instruments can be highly complex, with significant costs and penalties arising from operational mistakes.

4.123 Societies involved in these areas of activity need rigorous management procedures and control systems to ensure that robust legal documentation is used, that compliance with market practice is achieved, that the accounting treatment is clear, robust and agreed with external auditors and that deal recording and settlement systems are effective (with appropriate contingency arrangements in place).

IT security risks

4.124 Reliance on electronic dealing, information, treasury management and risk assessment systems renders societies particularly vulnerable to software or hardware failure. Boards of societies are expected to:

(a) ensure that treasury IT systems' access, both physical and logical, is subject to robust security;

(b) exercise strong control over the development and modification of treasury IT systems; and

(c) involve specialist internal auditors in reviewing the development or modification of treasury IT systems.

Supervisory standards for treasury activities

4.125 The PRA has devised four models ('approaches') of increasing sophistication, to assist societies in assessing their approach to financial risk management and treasury operations. These 'supervisory treasury approaches' are named as 'Administered', 'Matched', 'Extended', and 'Comprehensive'[1].

4.126 The PRA expects each society to conduct its treasury activities in accordance with the most suitable approach of these four models, in order to demonstrate that it has complied with General Organisational Requirements 2.1 and Risk Control 2.1 and 2.3 in the context of financial risk management. Where societies have treasury operations in subsidiary undertakings, these are expected to adopt the same approach category as the parent society.

4.127 Appendices 3-5 sets out information on supervisory expectations for each of the four approaches and societies can use these to help determine their own chosen approach. The specification of indicative prudential standards and limits for each approach is designed to draw management and supervisory attention to those areas of a society's financial risk management strategy or policy which go (or seek to go) beyond the PRA's general expectation for societies on each respective approach, bearing in mind the level of risk management capability expected by the PRA to be in place for that approach.

4.128 Societies should expect their supervisors to focus in greater detail on those areas of difference between internal limits and controls and those set out in Appendices 3-5, to identify whether business risks and controls are properly aligned, and, if not, to understand plans to address that misalignment. As such, the limit expectations set out in Appendices 4 and 5 are not intended to be interpreted as hard requirements, but as input into the process of establishing appropriate policies, and as the basis for supervisory dialogue.

---

1 The original Building Societies Sourcebook included a fifth approach, 'Trading', which was essentially the same as the Comprehensive approach, but for societies with a trading book. In practice, this approach was not used or required so it has been removed. In theory, a society could have a trading book, but the application of section 9A of the 1986 Act would severely constrain its activity. Any society wishing to operate a trading book could propose to operate under a specific extension to the Comprehensive approach.

Supervisory approaches to treasury management

Administered approach

4.129 Societies in the Administered approach category would have balance sheets where loan assets and funding liabilities are entirely in Sterling, and predominantly (>90%) subject to administered interest rates.

4.130 It is anticipated that the Administered approach would tend to suit small, or very small, societies where balance sheet management is typically undertaken by the CEO and CFO (or Finance Manager) in conjunction with the board.

4.131 A society adopting the Administered approach to treasury management would hold its liquidity buffer, as required to meet the liquidity coverage ratio in accordance with Article 412(1) of Regulation (EU) No 575/2013 (LCR), in instruments that are within its risk management capabilities. Total liquidity would be sufficient to meet its own OLAR. Both the LCR and OLAR buffers need to be useable in the event of a liquidity stress.

4.132 Societies in this category would not hold any treasury investments (including as part of its liquidity buffer), nor issue any funding instruments, that contain complex structured optionality, whether this optionality relates to interest payable or receivable, instrument term or any other variable. It is expected that liquidity and treasury investments would be focused on short-dated Gilts and Treasury Bills, and short-term deposits with banks and/or other societies (not floating rate notes, medium term notes, covered bonds or securitisation notes).

4.133 The PRA would not expect societies on the Administered approach to access wholesale funding from financial markets, nor to have external ratings of their debt. Funding from non-retail sources would be limited to a maximum of 10% of funding liabilities. Apart from in the case of special facilities provided by the central bank, societies on this approach would not be expected to undertake repo or reverse repo activities, nor to encumber their assets.

4.134 Administered approach societies would have very limited exposure to fixed interest rate or market floating rate (eg base rate or LIBOR-linked) assets or liabilities; any retail assets with such characteristics would not represent more than 10% of the balance sheet and would be matched with retail liabilities for the same duration and with the same interest rate characteristics; similarly, retail liabilities with such characteristics would not represent more than 10% of the balance sheet and be similarly matched to retail assets. Any fixed rate instruments (eg held for liquidity purposes) or loans would be limited to a maximum repricing tenor of 3 years.

4.135 Administered approach societies would have pricing systems and procedures sufficient for them to be able to estimate individual product profitability based on marginal funding costs, implied liquidity costs and allocated administrative costs. Societies would be able to model the impact on future margins of tranches of new business origination, especially where these involve customer incentives or rates that are not directly in the control of the society itself.

Matched approach

4.136 Societies adopting the Matched approach would have balance sheets where assets and liabilities are entirely in Sterling, and predominantly (>50% of total assets and >50% of total liabilities) on administered rates. They would be capable of using derivative hedging contracts (or appropriate matching of assets and liabilities with similar interest rate and maturity features) to neutralise any significant interest rate or basis risk arising from the non-administered rate elements of their balance sheet, on a tranche by tranche, product by product basis.

4.137 It is anticipated that this approach would normally suit small to medium sized societies, with limited availability of treasury skills and resources. Typically the CEO of such societies would be supported by a CFO or Finance Manager, and would be primarily responsible for day-to-day risk management through an executive committee or ALCO. The reporting line would be direct to the board, on treasury matters (or through an appropriate board ALCO or Risk Committee), with management information on risk positions provided by an independent source responsible for risk monitoring and aggregation.

4.138 A society adopting the Extended approach to treasury management will be expected to maintain its liquidity buffer required to meet the liquidity coverage ratio in accordance with Article 412(1) of Regulation (EU) No 575/2013, in instruments that are within its risk management capabilities. Total liquidity needs to be sufficient to meet its own OLAR.

4.139 Societies in this category would not hold any treasury investments, nor issue any funding instruments, that contain complex structured optionality, whether this optionality relates to interest payable or receivable, instrument term or any other variable. It is expected that liquidity and treasury investments would be focussed on Gilts and Treasury Bills, and short-term deposits with banks and/or other building societies (not floating rate notes, medium term notes, covered bonds or securitisation notes).

4.140 The PRA would not expect societies adopting the Matched approach to access significant wholesale funding from financial markets, nor to have external ratings of their debt. Funding from wholesale and non-retail sources would be limited to 15% of funding liabilities. Apart from in the case of special facilities provided by the central bank, societies on this approach would not be expected to encumber their assets, except for collateral provided in support of derivative contracts and small scale repo activity in respect of liquid assets.

4.141 Matched approach societies would have limited exposure to fixed interest rate or market floating rate (eg base rate or LIBOR-linked) assets or liabilities; any loan assets or funding liabilities with such characteristics would not represent more than 40% of the relevant side of the balance sheet, and would be matched with liabilities/assets or derivative hedges for the same duration. Any fixed rate instruments (eg held for liquidity purposes) or loans would be limited to a maximum repricing tenor of 5 years.

4.142 In managing the risks of non-administered balances, the policies of such societies could use standard hedging products for transactions permitted by section 9A of the 1986 Act, (for example interest rate swaps; and plain vanilla over the counter (OTC) options such as swaptions, caps, collars and floors (options purchased only)) for the purpose only of matching individual products. Structural hedging of the whole balance sheet would not be undertaken if following this approach.

4.143 Interest rate risk management for such societies would be monitored internally through:

(a) matching reports (detailing individual products and the hedging instruments associated with them); and

(b) gap analysis. For gapping purposes, reserves would be treated as having no fixed repricing date, and gap limits would be set at the minimum level necessary to give flexibility in timing the hedges for individual mortgage and investment products, with some allowance for marginal, residual risks and for holdings of short to medium term fixed rate liquid assets. Basis and marginal interest rate risk would be minimised by setting cautious limits for mismatches, appropriate to the capabilities and resources of such societies to manage the risks.

4.144 Gap monitoring reports would be updated and considered by the board (or appropriate sub-committee) at least monthly. By implication, societies adopting this approach would not be taking an interest rate view across the balance sheet in determining a hedging strategy.

4.145 Matched approach societies would be able to estimate individual product profitability, including liquidity and administrative costs, and to understand the implications on future margins of tranches of new business origination, especially where these involve customer incentives. They would also be able to evaluate and manage the risks associated with pricing products using interest rate derivatives, and estimate the cost of term funding to match fixed rate product features. The outcome of these methodologies would be used in new product development and pricing decisions.

Extended approach

4.146 The principal difference between the Matched and the Extended approaches lies in the:

(a) range of treasury instruments and operations used;

(b) availability of independent risk management resource to provide challenge and feedback to the executive directors; and

(c) capability to measure and hedge interest rate risk and structural risk across the whole balance sheet, including reserves, rather than just hedging individual transactions.

4.147 Societies adopting the Extended approach would be capable of managing more complex balance sheet positions, including higher levels of wholesale funding (some of which might be in Euros or US Dollars), and a mixture of market interest rate positions that would provide more challenges in interest margin management than where such rates are predominately administered by the society itself.

4.148 Management of treasury and similar financial risks for such societies would typically be controlled by the board acting through an Assets and Liabilities Committee (ALCO) or equivalent sub-committee, which would normally be responsible for agreeing strategy and limits. Reporting to the ALCO, there would typically be a Treasurer running a small treasury department with robust segregation between dealing and settlement activities, monitored and challenged by an independent risk management function reporting to a Head of Risk.

4.149 A society adopting the Extended approach to treasury management will be expected to maintain its liquidity buffer required to meet the liquidity coverage ratio in accordance with Article 412(1) of Regulation (EU) No 575/2013, in instruments that are within its risk management capabilities. Total liquidity needs to be sufficient to meet its own OLAR.

4.150 In addition to bank deposits and government securities, it is anticipated that societies on this approach might wish to hold limited positions in market-quoted debt securities, including senior debt, covered bonds and senior notes issued under securitisation transactions, subject to internal policy limits. Exposure to longer-dated fixed rate instruments would particularly be subject to internal limits.

4.151 The PRA would expect societies adopting the Extended approach to have the systems and capabilities to transact repo business, and to have in place repo lines, having obtained full legal advice before agreeing counterparty documentation.

4.152 Societies on the Extended approach would be expected to limit their wholesale funding from financial markets (including from securitisation) to a maximum of 25% of funding liabilities, with sub-limits covering the maturity structure of such funding (to avoid over-reliance on short-term debt) and the maximum amount to be obtained from a single source. Such funding might require the society to obtain and maintain an external debt rating. Societies will in any case need to meet any future EU or PRA guidance or rules on the Net Stable Funding Ratio (NSFR)[1] once implemented in the United Kingdom.

4.153 Under the Extended approach, societies would set internal limits on the level of encumbrance that they may be subject to – normally this would not be expected to exceed 20% of balance sheet assets (excluding assets encumbered under special facilities provided by the central bank), and there would be sub-limits by type of exposure (repo, covered bond, securitisation, derivative margin, etc.)

4.154 A society on the Extended approach could potentially fund and hold assets denominated in Sterling, Euros or US dollars. However, the proportion of the balance sheet so held would be appropriate to the nature of its business as a building society and its capability to manage such additional risks, including any additional reporting requirements arising.

4.155 Extended approach societies would have strong internal controls on their exposure to fixed interest rate or market floating rate (eg base rate or LIBOR-linked) assets or liabilities. Balances where the society currently sets an administered rate (or which will revert to administered rates within 12 months) would typically represent a minimum of 40% of the total loan assets and total funding liabilities of the society. Fixed rate instruments (eg held for liquidity purposes) with a repricing tenor beyond 5 years would be limited to a maximum of 5% of funding liabilities. Societies would set internal limits on the level of basis mismatch that may be carried, both in aggregate, and against different sub-types of interest rate.

4.156 In managing its interest rate risk and structural risk, a society adopting the Extended approach would adopt policies and systems to enable it to undertake the hedging of individual transactions within the context of an overall strategy for structural hedging, based on detailed analysis of its balance sheet and the expected behaviour of individual products and instruments under an interest rate stress.

4.157 Societies on this approach would agree a risk appetite for balancing earnings risks and economic value risks arising from the investment of free reserves. Some boards might choose to prioritise stabilising their society's net interest income against the impact of adverse interest rate movements by allocating reserves across specific repricing bands representing a considered view of the characteristics of those reserves, and then originating fixed rate receivables to match that profile. Other boards might prefer to prioritise the stability of economic value, by allocating reserves to the overnight repricing band, thereby accepting the earnings volatility that would emerge from the impact of changes in rates on returns from the assets financed by reserves in that repricing band.

1 In October 2014, the Basel Committee of the Bank for International Settlements published proposals for a Net Stable Funding Ratio (NSFR) to accompany the LCR, see www.bis.org/bcbs/publ/d295.pdf.

4.158 In the event that a board decides to prioritise earnings stability, the PRA would expect that any allocation profile of reserves to repricing bands would be agreed as part of the corporate planning process and would be used to define an interest rate risk 'balanced' position under which the society would operate for the duration of the plan. This 'balanced' position would need to reconcile the board's tolerance of earnings instability with its tolerance for economic value instability, that is, the allocated duration of free reserves would be set strategically by the board with the intention of producing a more stable earnings profile while not creating excessively large economic value instability (the longer the tenor of the profile chosen for earnings stabilisation purposes, the greater the potential change in economic value that could arise on a change in interest rates). The chosen earnings and economic value stabilisation objectives would be reviewed only as part of the next corporate planning process. Therefore, any profile allocated to reserves would not be altered repeatedly to adjust tactically for changes in the society's own expectations for both short-term changes in interest rates and longer term yield curve shifts.

4.159 Risk management would be based on full balance sheet gap analysis, supplemented by static simulation of both earnings and economic value under an interest rate stress. Gap limits might allow some leeway for positions caused by imperfect hedging (eg of pipeline and prepayment risk), to be controlled by board-approved sensitivity limits covering potential changes in both future NII earnings and economic value.

4.160 Hedging instruments available to be authorised by the board would be the same as for the Matched approach, with the addition of: forward rate agreements/futures; and foreign exchange swaps/forward contracts/options (purchase only).

4.161 Extended approach societies would employ a basic funds transfer pricing (FTP) methodology to enable them to calculate and report individual product profitability, taking account of liquidity and administrative costs, and the funding structure of their balance sheets (both term and source). They would be able to model future margins on tranches of existing and new business, taking account of expected customer behaviour in respect of product incentives and embedded optionality that could affect prepayment or deposit withdrawal rates relative to the prevailing term structure of interest rates. Extended approach societies would have specific controls to ensure that future NII is protected from the impact of fixed margins on earnings flexibility in the event of stress. Such societies would also be capable of allocating, by product, a charge for capital that is aligned to their ICAAP and business plan. The FTP methodology would be an integral part of the new product approval process.

Comprehensive approach

4.162 The principal differences between the Extended and the Comprehensive approaches lie in the:

(a) depth and quality of the risk management systems and controls;

(b) frequency and complexity of position and risk analysis undertaken; and

(c) range of instruments and currencies in which treasury operations are carried out .

4.163 As with the Extended approach societies, it is expected that Comprehensive approach societies would manage risk using a board/ALCO/Treasurer reporting structure, but the treasury department would have a well-defined and separate 'middle office' risk management function, segregated from 'front office' (dealing) and 'back office' (settlement/accounting) and reporting to a Chief Risk Officer operating at (or just below) board level.

4.164 Societies adopting the Comprehensive approach would be capable of managing complex balance sheet positions, including high levels of wholesale funding in a mixture of currencies, and a range of market interest rate positions that require sophisticated risk measurement and mitigation, using a range of OTC and exchange traded instruments and derivatives. Positions would be managed through a set of internally agreed and monitored limits, calibrated to control for concentration risks (both in assets and liabilities) and to ensure that the society has sufficient capacity to manage risks to its interest margin and economic value.

4.165 A society adopting the Comprehensive approach to treasury management is expected to maintain its liquidity buffer required to meet the liquidity coverage ratio in accordance with Article 412(1) of Regulation (EU) No 575/2013, having regard to its risk management capabilities and internal risk appetite. Total liquidity needs to be sufficient to meet its own OLAR.

4.166 Societies on the Comprehensive approach would normally be expected to carry an external debt rating, and to set limits on their wholesale funding from financial markets within the statutory maximum of 50% of funding liabilities, with sub-limits covering the composition (by source, funding instrument type and currency) and maturity structure of such funding (to avoid over-reliance on short-term debt). Societies will in any case need to meet any future EU or PRA policy on the Net Stable Funding Ratio (NSFR)[1] once implemented in the United Kingdom.

4.167 Comprehensive approach societies would set internal limits on the level of encumbrance that they may be subject to, including sub-limits by type of exposure (repo, covered bond, securitisation, derivative margin, etc.).

4.168 A society on the Comprehensive approach could fund and hold assets in a range of currencies. However, the proportion of the balance sheet so held would be appropriate to the nature of its business as a building society and its capability to manage such additional risks, including any additional reporting requirements arising.

4.169 Comprehensive approach societies would have strong internal controls on their exposure to interest rate risk: the impact of rate changes on both earnings and economic value would be assessed by appropriate stress testing internally on a regular basis. Societies would set internal limits of the level of basis mismatch that may be carried, both in aggregate, and against different sub-types of interest rate index.

4.170 In managing its interest rate risk and structural risk, a society adopting the Comprehensive approach would adopt policies and systems to enable it to model the expected behaviour of individual products and instruments under an interest rate stress and to implement policies that would require appropriate hedging strategies to be implemented in respect of revealed risks.

4.171 Societies on this approach would normally employ structural hedging techniques to stabilise earnings on free reserves against the impact of adverse interest rate movements, setting an investment term for capital that represents the board's considered view of the

1 In October 2014, the Basel Committee of the Bank for International Settlements published proposals for a Net Stable Funding Ratio (NSFR) to accompany the LCR, see www.bis.org/bcbs/publ/d295.pdf.

characteristics of those reserves, and its risk appetite for balancing future NII earnings risks against economic value risks. Any such allocation of reserves would be treated interest rate change neutral, that is, the allocated duration of free reserves would be set strategically by the board with the intention of producing a more stable earnings or economic value profile, and would be reviewed only periodically. The profile of the allocation would not be altered repeatedly to adjust tactically for changes in the society's own expectations for short-term changes in interest rates. If the society has developed an interest rate view and wishes to position its balance sheet to take advantage of that view, it would do so by setting mismatch sensitivity limits set by the board or ALCO and incorporating basis risk assessment or control limits so that the impact and eventual outcome of these positions can be separately measured.

4.172 Risk analysis would be based on full balance sheet analysis of both earnings and economic value under an interest rate stress, and would extend beyond static gap/static sensitivity analysis to include:

(a) dynamic simulation (projecting forward balance sheet elements and simulating the impact of different interest rate scenarios);

(b) duration for individual portfolio elements, or present value of a basis point move calculations, to highlight sensitivity to non-parallel shifts in the yield curve; and

(c) foreign exchange mismatch (ie exchange rate exposure), which would be subject to appropriate risk management over foreign exchange movements.

4.173 Hedging instruments available for use under agreed board policy could include those for the Extended approach plus (as far as permitted by section 9A) potentially:

(a) complex interest rate swaps;

(b) complex interest rate caps/collars/floors (purchase only);

(c) House Price Index derivatives; and

(d) credit derivatives.

4.174 Comprehensive approach societies would be expected to operate a fully-fledged funds transfer pricing (FTP) model incorporating all the elements set out in paragraphs 4.112 to 4.120 . The model would take account of all relevant costs including structural costs, liquidity costs, administrative costs, credit expected losses, hedging costs and an appropriate charge for capital. The FTP methodology would be used proactively to influence balance sheet structure as well as volume and pricing of new business flows. Such societies may implement an enterprise-wide solution which delivers business unit profitability and transfers all risks to a specific unit to increase visibility and enhance risk management.

5 Changes to supervisory approaches

Introduction

5.1 As explained in paragraph 2.5 , the supervisory approaches outlined in Chapter 3 (for lending) and Chapter 0 (for financial risk management of treasury activities) are not intended to be 'one size fits all', and the portfolio limits suggested in the appendices are indicative only of PRA expectations for each of the defined approaches. It is ultimately for each society to determine its own individual approach, based on its specific risk appetite, corporate plan, risk management capabilities and management expertise. Boards are expected to set appropriate individual limits for each relevant activity, having regard to those indicated for each supervisory defined approach. The PRA does not expect boards simply to 'copy out' the indicative limit structure into their own policy statements.

5.2 The PRA recognises that some societies have developed distinctive business models that do not fit the standard archetypes, and also that existing business models can evolve over time. The expectations set out in this supervisory statement are designed to encourage the development of risk management skills and practices that are commensurate with the risk appetite of the society, as agreed by its board, and the PRA therefore expects boards to select the most appropriate of the defined approaches for its business. Although the chosen approach is expected to form the backdrop to the society's business model and control structure it is for boards to tailor their internal limits and organisational structure to the types of business undertaken.

5.3 The PRA expects to be kept informed of any material changes in relevant policies, and envisages two alternative types of change that could arise:

(a) 'extensions' to limits or control systems that take place within a supervisory approach; and

(b) changes of approach – where a society wishes to move from its existing approach to a more sophisticated one (or, more rarely, to drop back to a less sophisticated one).

5.4 The defined supervisory approaches are specified within a continuum, and the boundaries between approaches are deliberately not distinct. As such, the approach categories need to be seen, not as discrete compartments, but rather as stages in the continuous evolution of risk management and systems, with a change of approach marking a milestone in that progress. It is expected that any society wishing to move to a more sophisticated approach will develop their risk management and systems to the level appropriate to support the scale and nature of their business ambitions.

5.5 The PRA envisages that it would be possible to stay within a defined approach and still have some internal limits that are larger than the PRA's indicative expectations, provided that the management capability and control structure is adequate for those areas of additional risk: such limits would be seen as 'extensions'. If, however, the board of a society wishes to adopt policies and pursue business opportunities that take the society's risk profile well beyond what is envisaged for its existing approach (eg where numerous indicative limits would be exceeded), the PRA is likely to conclude that it would be appropriate for the society to adopt the next, more sophisticated approach (ie change approach) rather than seek 'extensions'. Where there is potential for doubt about whether an 'extension' or a change of approach is needed, societies are expected to discuss their plans with their supervisors.

'Extensions' within supervisory approaches

5.6 Where societies identify a need to make changes to their lending, funding, treasury investments or interest rate risk or structural risk profile, it is likely that the move to achieve this will be gradual. The PRA would expect to discuss with each society its plans, which would include an appropriate period of time over which any realignment would be implemented.

5.7 In considering approach 'extensions', societies are expected to assess whether they have the requisite expertise, management information systems, accounting systems and risk controls to undertake the additional business to be undertaken. As set out in Chapters 3 and 4, there are specific additional considerations associated with different types of lending and treasury activity, and it is important for boards to satisfy themselves that their societies have the capabilities and resources to undertake these activities safely.

5.8 A society planning to extend its approach is expected therefore to propose changes to relevant policy statements and have these approved by the relevant committees and the board itself. Societies may be asked to provide their PRA supervisor a copy of the board paper, which will be expected to:

(a) set out the clear business rationale for the change;

(b) clarify and quantify the additional risks and benefits from undertaking the new activities, both in 'steady state' and under stress;

(c) explain how the proposed internal risk limits for the new activity have been calibrated, and how performance against these limits will be reported to relevant committees and the board; and

(d) provide a detailed timeline and operational plan of how the society is intending to implement the change.

5.9 Where, following notification of the proposed change and review of any documents requested, the PRA has any questions or observations on the proposal, it will provide commentary and feedback to the society. If the PRA identifies significant issues that need to be addressed, the society will be expected to resolve these before implementing the approach extension. The PRA will maintain consistency in its judgement by discussing and agreeing internally its feedback with a panel of supervisory managers and technical specialists.

Moving between supervisory approaches

5.10 Whatever their existing positioning within the three approaches to managing the lending book, or the four approaches to treasury risk and financial risk management, the PRA expects societies to continue to develop their expertise, and to change their approach if and when necessary. Any society that wishes to move approaches should contact its PRA supervisor at an early stage to discuss its plans and the work it envisages to be needed as part of the change.

5.11 The PRA will expect a society changing approach to demonstrate that it has in place the requisite expertise, management information systems, accounting systems and risk controls before any significant change in its lending policy or treasury activities is implemented.

5.12 A society planning to change approach is expected therefore to prepare a revised set of policy statements compatible with the approach(es) it now wishes to adopt, and have these approved by the relevant committees and the board itself. Societies can expect to be asked to provide to the PRA a copy of the board paper, which would:

(a) set out the clear business rationale for the change;

(b) explain how the society will be capable of managing any increased risks to which it will be exposed, including a detailed analysis of control systems, IT and operational capabilities, regulatory reporting requirements and MI production that will be needed to operate safely under the new approach;

(c) include a forward-looking assessment of the extent that a changed risk appetite might impact on the safety and soundness of the society and its regulatory requirements (eg capital, liquidity, and conduct). This would cover both the upside gains anticipated from making the change, and the downside risks, with the latter calibrated through appropriate scenario analysis and stress testing;

(d) include clear new policy limits that express the board's risk appetite; and

(e) provide a detailed timeline and plan of how the society is intending to implement the change.

5.13 Societies changing approach will be expected to ask their internal auditors to review and comment on the proposed changes to provide assurance that all relevant risks have been properly identified and mitigated, and that the implementation plans are achievable. The report from internal audit would be considered alongside the board paper, and societies can expect the PRA to ask for a copy of it.

5.14 The PRA, following notification of the proposed change and review of any documents requested, will provide commentary and feedback to the society, the proposal having been reviewed by technical specialists and discussed at a panel of supervisory managers in order to ensure consistency of expectations as compared with other societies (and equivalent expectations for banks). If the PRA identifies significant issues that need to be addressed, the society will be expected to resolve these before it implements the revised approach.

5.15 From time to time, the PRA may judge that an approach currently followed by a society is no longer suitable, either in light of changes to its business model or on supervisory reassessment of its risk management capabilities. This view will be communicated to the board of the impacted society, and the PRA would expect the society in question to adjust its business activity accordingly. If the society wishes to remain on its original approach, it will need to enhance its business processes and risk management to a level compatible with that approach. Until that has been achieved, the PRA would not expect the society to operate at the higher approach. Either way, the society would be expected to review its risk management policies and internal limits in light of PRA feedback.

6 Business model diversification

Pre-notification of business model diversification

6.1 Any society which proposes to embark on any diversification into an area (whether regulated or unregulated, associated with the retail housing market or otherwise):

(a) which is not covered by the tables in the appendices; and

(b) where the investment (of any type) required to set it up exceeds 5% of own funds, or the projected post implementation income within any of the 3 years following the diversification exceeds 10% of projected net interest margin plus other income net of commission paid for that year;

is expected to pre-notify the PRA and provide a copy of the board paper setting out the risks and benefits of the proposed diversification.

6.2 In particular, this paper is expected to include:

(a) central case projections of balance sheet, profit and loss (P&L), capital and liquidity before and after the diversification;

(b) the outcome of severe but plausible stress tests of those projections, based on relevant scenarios;

(c) a clear analysis of the risks arising from the diversification and how these are to be mitigated; and

(d) an analysis of potential exit costs, should the diversification prove to be unsuccessful.

6.3 In some cases, particularly where the proposed diversification is to be by acquisition, a revised ICAAP will need to be approved by the board and submitted for supervisory review and evaluation before proceeding. This is in order that appropriate individual capital guidance can be given for the revised business plan.

6.4 Societies should also note and comply with the provisions of section 92A of the 1986 Act in relation to acquisition or establishment of a business.

Appendices

Appendix 1 – Credit risk management controls

	Traditional	Limited	Mitigated
Risk management structure	If no dedicated risk management function, CEO/CFO will fulfil this role	Risk management function (fully independent of lending and sales functions) reporting direct to CEO	Head of Risk function (senior executive or Director level) supported by risk management team, reporting to credit risk committee (or similar)
Risk appetite statement	Approved by board at least annually Reviewed to consider continued applicability at least semi-annually	Approved by board at least annually Reviewed to consider continued applicability at least semi-annually	Approved by board or Risk Committee (or similar) at least annually Reviewed to consider continued applicability at least quarterly
Lending policy statement	Approved by board and reviewed at least annually		
Limit structure	Lending limits covering both stocks and flows of different types of lending business		
Risk Pricing	Basic risk pricing methodology, incorporating bureau data, the outcome of internal stress testing and the board's required return on capital	Broad risk pricing methodology incorporating behavioural analysis, risk grading, and minimum return on capital requirements	Comprehensive risk pricing methodology, with PD, EAD and LGD modelling to calculate EL and a board approved hurdle rate of return on risk-adjusted capital
Large loan exposure restrictions	Lending policy restricts loan exposure to connected counterparties to <= 10% of capital resources	Lending policy restricts loan exposure to connected counterparties to <= 15% of capital resources	Lending policy sets limits on exposures to connected counterparties within statutory or regulatory limits
Underwriting	Cases fully underwritten on an individual basis Limited delegation under mandates Board to approve all loans where aggregate exposure to borrower and/or connected clients => 2.5% of capital resources Appropriate underwriting expertise for all lending (including specialists for any non-standard lending – e.g. Buy-to-let and Self-build). Fraud checks against external databases.	Independent underwriting function Cases underwritten individually or systematically credit scored Hierarchy of fully delegated mandates (with exception reporting to senior management) Appropriate specialist underwriting expertise for all categories of lending undertaken (e.g. Buy-to-let, Self-build) May use specialist anti-fraud systems	Independent underwriting function Cases systematically credit scored (with manual over-ride where appropriate) Hierarchy of fully delegated mandates Appropriate specialist underwriting teams for all categories of lending undertaken Use specialist anti-fraud systems PD/EAD/LGD modelling

	Traditional	**Limited**	**Mitigated**
Risk mitigation	Risks mitigated by combination of: • underwriting criteria • risk pricing • conservative LTV or external insurance on higher LTV exposures • other collateral	Risks mitigated by combination of: • underwriting criteria • risk pricing • conservative LTV or external insurance (including stop-loss/excess of loss insurance) • other collateral	Risks mitigated by combination of: • underwriting criteria • risk pricing • conservative LTV or external insurance (including stop-loss/excess of loss insurance at pool or portfolio level) • other collateral • credit default swaps • loan book sales
Valuations	Undertaken by independent valuer AVMs within parameters recorded in policy statement	Undertaken by external or staff valuer AVMs within parameters recorded in policy statement	Undertaken by external or staff valuer AVMs within parameters recorded in policy statement
Segregation of duty between:			
Underwriting function and mortgage sales function (providing 'four-eyes' check over lending)	Segregation at executive manager level	Segregation at an operational level	Full segregation
Underwriting function and the lending review/audit/ compliance functions which check (1) compliance with underwriting and fraud policy and legislation; and (2) lending/ underwriting quality (by review of MI, live fraud cases, bad debt cases, etc.).	Segregation at executive manager level	Segregation at an operational level	Full segregation
Stress testing	Simple stress testing (changes in security values based on appropriate HPI movements) undertaken on annual basis, or more frequently if market conditions warrant	Stress testing and scenario analysis (at level of individual asset pools) on semi-annual basis	Econometric analysis and full stress testing/scenario analysis on at least quarterly basis
In this table: AVMs = automated valuation models HPI = house price index LTV = loan to value	Other recognised collateral = charge over acceptable assets, 3rd party guarantees, etc.		

Appendix 2 – Lending – Indicative Limits

	Traditional		**Limited**	
Lending types	**Normal loan to value at origination and other limits applying**	**Asset limits** as % total loan book	**Normal loan to value at origination and other limits applying**	**Asset limits** as % total loan book
Prime owner-occupier	In total, of which	>=85%	In total of which:	>=65%
	<= 80% LTV, or >80% to 95% LTV with external insurance	>=85%	<= 80% LTV, or >80% to 100% LTV with external insurance	>=50%
	> 80% to <= 90% LTV without external insurance	<=10%	> 80% to <= 95% LTV without external insurance	<=15%
Prime Buy to Let to individuals (<=3 properties per borrower)	<= 70% LTV (min ICR 130%,)	<=15%	<=80%LTV (min ICR 125%) Within which: LTV >60% and <=80%	<=30% <=20%
Impaired credit history (all types)		0%	LTV <= 70%	<=10%
Shared ownership	<= 90% of share purchased by borrower	<=10%	<= 95% of share purchased by borrower	<=15%
Shared equity		0%	< 25% equity share	<=5%
Social Landlords	<= 80% LTV	<=7.5%	<= 80% LTV	<=15%
Self-build (in construction phase)	<=80% LTV	<=5%	<= 85% LTV	<=15%
Commercial/FSOL	Owner occupied <= 50% LTV (max £1m per loan connection)	<=5%	<= 60% LTV	<=10%
Lifetime mortgages (Note 1):				
• fixed rate interest, rolled up (with or without no negative equity guarantee)	None	0%	<= 25% LTV (min age of youngest applicant =>65)	<=5%%*
• interest only at fixed rate (only societies adopting the Comprehensive approach)	None	0%	<= 25% LTV (min age of youngest applicant 60)	10%*
• interest paid and at variable rate	None	0%	<= 25% LTV (min age of youngest applicant 60)	<=10%
Non-sterling mortgages		0%	Only where borrower also has income in the relevant currency	<= 5%
Mitigated				
Own board-approved comprehensive limit structure, in compliance with statutory requirements and covering both stocks and flows of specified lending types. Limits need to be broken down by borrower type and risk mitigant requirements (security, insurance etc.) (but see Note 1)				
In this table: FSOL = fully secured on land, Shared ownership = part-owned by the occupier and part by a social housing provider. Shared equity = where the society takes a part equity interest in the property.				
Note 1: Lifetime mortgages at fixed rates, with or without interest roll-up, are only expected to be undertaken by societies capable of operating on the Comprehensive approach to financial risk management.				

Appendix 3 – Financial Risk Management – Indicative Control Framework

	ADMINISTERED	MATCHED	EXTENDED	COMPREHENSIVE
RISK MANAGEMENT STRUCTURE	• CEO (+CFO/FM) + Board • Dealing / settlement segregation (minimum 4 eyes)	• CEO + CFO (or FM) + Board • Dealing / settlement segregation (minimum 4 eyes) • Risk oversight by executive committee / Board ALCO	• (CEO)/CFO + Treasurer + ALM Management ALCO • Front Office / Back Office segregation • Independent risk manager/team in second line, reporting to CRO + Board RiskCo	• CFO + Treasurer + ALM + Management ALCO + Daily Treasury Committee • Front + Middle + Back Office segregation • Fully independent second line reporting to Risk Director (ALM review in second line) • EWRM capability
BALANCE SHEET STRUCTURE	• Commercial (loan book) assets: Minimum 90% on administered rates • Liabilities: Minimum 90% SDL on administered rates • Fixed rate lending <=2 years, only if predominantly matched by fixed rate retail deposits of same duration • Non-administered variable rate (e.g. base rate/LIBOR linked) lending and funding only if with tracking period limited to <3 years	• Commercial assets: A minimum of 50% either on administered rates or due to revert to administered rates in the next 12 months and of that a minimum 40% already on administered rates • Liabilities: Minimum 50% SDL on administered rates • Fixed rate lending/funding max 3 years to reprice date (subject to limits) • Non-administered variable rate (e.g. base rate / LIBOR linked) lending and funding only if with limited tracking period • Max fixed rate lending/funding 75% loans advanced/retail funding p.a.	• Commercial assets: A minimum of 40% either on administered rates or due to revert to administered rates in the next 12 months, and of that a minimum 25% already on administered rates. • Liabilities: Minimum 40% SDL on administered rates • Internal limits on repricing maturity and volume of new lending/funding at fixed rates. • Internal limits on reversions to variable rate with a period.	• Internal limits on level of administered rate assets and liabilities • Internal limits on repricing maturity and volume of new lending/funding at fixed rates • Internal limits on reversions to variable rate with a period. • Internal limits on volume/stock of variable rate tracker assets and liabilities.

	ADMINISTERED	MATCHED	EXTENDED	COMPREHENSIVE
RISK ANALYSIS	• Matching Report + Static Gap analysis (if any fixed rate lending / funding) - (monthly) • Net interest margin analysis • Basis risk report. • MTM of fixed rate liquid assets (at least monthly) • Forward looking corporate plan (incorporating stress scenario)	• Matching Report (min monthly) • Net interest margin analysis and projection • Basis risk analysis and projection • Forward looking corporate plan (incorporating interest rate stress scenario)	• Run-off B/S Gap or VaR / PV01 Analysis (min 2 x monthly) • NII static / run-off B/S simulation modelling using a range of stressed assumptions (min quarterly) • Basis risk modelling and projected impact (min 2 years) • Forward looking corporate plan (incorporating a range of interest rate stress scenarios)	• Run-off B/S Gap or VaR / PV01 Analysis (min weekly) • Dynamic balance sheet simulation modelling of NII (incorporating future business flows, optionality) under multiple interest rate stress scenarios and yield curves assumptions • Structural basis risk modelling (using projected business flows) • Behavioural modelling (NMDs, prepayment) • Corporate planning system fully integrated with ALM systems (incorporating 'what if' analysis and stress testing)
TREASURY ANALYSIS SYSTEMS	• Management accounting system • Loan/deposit matching capability (if lending/funding at fixed rates) • Cashflow projection capability.	• Management accounting system • Basic ALM IT capable of matching and static/run-off balance sheet modelling • Cashflow and interest rate basis projection capability	• ALM system capable of static / run-off balance sheet modelling under dynamic rate conditions • Optionality modelling capability (particularly to capture prepayment propensity)	• ALM system capable of projecting forward balance sheet and simulating different interest rate environments, plus measuring embedded optionality, basis risk, etc.
CURRENCY	• Sterling only	• Sterling only	• GBP, EUR, USD only. • No mismatch • Min 90%SDL Sterling	• Multi-currency (subject to policy) • Minimal FX mismatch (subject to limits)
RISK LIMIT STRUCTURE	• EV sensitivity limit measured under standard interest rate shock • NII sensitivity limit (min current and next financial year) • Minimal gap limits • Basis risk limits • Structural risk limits	• EV and minimum 24 month NII sensitivity limits measured under standard interest rate shock • Low gap bucket limits (to cover residuals, prepayment and pipeline only) • Basis risk limits • Structural risk limits	• EV & minimum 24 month NII sensitivity limits measured under standard, bespoke and non-parallel rate shock scenarios • Gap limits (bucket and cumulative) • Basis risk limits • Structural risk limits	• Range of EV and NII sensitivity limits measured under multiple scenarios • Range of mismatch limits • Basis risk limits • Structural risk limits

	ADMINISTERED	MATCHED	EXTENDED	COMPREHENSIVE
INTEREST RATE VIEW	• Interest rate outlook used for business planning only	• Interest outlook used for pipeline management and business planning only - No positioning for interest rate view	• Interest view used to inform business outlook and minimal open positions (subject to risk limits)	• Interest view used to inform business outlook and strategic/open positions (subject to risk limits)
HEDGING ACTIVITY	• Any fixed rate lending matched with fixed rate funding (& vice versa) • No derivatives	• Fixed interest rates matched product by product (in tranches) • Simple derivatives, subject to achieving hedge accounting. • No structural hedging	• Natural hedging (of offsetting balance sheet net mismatch positions) • Net hedging of rate positions using a range of vanilla instruments • Minimal open positions (subject to limits) for pipeline and residual balances	• Natural and structural hedging (of balance sheet net mismatch positions) • Full range of derivative instruments available for hedging • Open positions (subject to limits)
FREE CAPITAL HEDGING	• None	• None	• Earnings / economic value stabilisation on free reserves – duration set in corporate plan. No other position taking in support of an interest rate view	• Earnings / economic value stabilisation on free reserves – duration set in corporate plan. Some position taking in support of an interest rate subject to agreed limits and appropriate regulatory capital allocation.
INTEREST RATE INSENSITIVE ASSET & LIABILITY (NMD) HEDGING	• None	• None	• None	• Behavioural modelling of non-maturity deposits • NII hedging within limits that balance NII stability benefits against EV risks incurred
HEDGING INSTRUMENTS	• None	• Match funding • Vanilla interest rate swaps • Vanilla interest rate caps/collars/floors (purchase only) • FTSE swaps (receive only)	• Match funding • Vanilla interest rate swaps • Vanilla interest rate caps/collars /floors (purchase only) • Swaptions (purchase only) • FRAs / Futures (purchase only) • FTSE swaps (receive only) • FX swaps/forward contracts (purchase only) • FX options (purchase only)	• All market available instruments, subject to compliance with Section 9A of the 1986 Act

	ADMINISTERED	MATCHED	EXTENDED	COMPREHENSIVE
PRICING COMPONENTS	• Marginal cost of funding • Liquidity cost overlay • Operational costs	• Marginal cost of funding (adjusted for term) • Liquidity costs • Hedging costs • Operational costs • Minimum return on Capital	• Funds Transfer Pricing system (incorporating liquidity, term, optionality, hedging costs) • Behavioural modelling (prepayment) • Target return on regulatory capital	• Funds Transfer Pricing system (incorporating liquidity, term, optionality, hedging costs) • Behavioural modelling (prepayment, non-maturity deposits) • Credit EL estimates • Target return on economic capital
INTERNAL AUDIT	• Non-specialist Internal Audit	• Non-specialist Internal Audit supplemented by outsourced/co-sourced specialist support for Treasury	• Specialist IT and Treasury Internal Audit	• Specialist IT and Treasury Internal Audit

In this table:

ALCO = Assets and Liabilities Committee
HPIs = house price indices
MTM = mark to market
NII = net interest income
NPV = net present value

Appendix 4 – Liquidity & Treasury Investments – Indicative Limits

LIQUIDITY	ADMINISTERED	MATCHED	EXTENDED	COMPREHENSIVE
MINIMUM BUFFER LIQUIDITY	LCR + regulatory Pillar 2 add-ons			
INTERNAL LIQUIDITY	OLAR			
COUNTERPARTY LIMITS	• Single name/connected group limits • Instrument type and maturity limits	• Single name/connected group limits • Country limits • Instrument type and maturity limits	• Single name/connected group limits • Country limits • Sector limits • Instrument type limits • Currency limits	• Comprehensive limit structure covering single names, groups, sectors, instruments, countries and currencies
INSTRUMENT/COUNTERPARTY LIMITS STRUCTURE (Buffer liquidity & Treasury Investments) - Indicative limits				
Bank of England	No max	No max	No max	No max
Call deposits: banks	Board determined	Board determined	Board determined	Board determined
Term deposits: banks (includes CDs)	Max 15% SDL	Max 15% SDL	Max 15% SDL	Board determined
Term deposits: societies	Max 10% SDL	Max 10% SDL	Max 10% SDL	Board determined
Term deposits: Local Authorities/Regional Govt.	Max 10% SDL	Max 10% SDL	Max 10% SDL	Board determined
Gilts <3 years	Board determined	Board determined	Board determined	Board determined
Gilts <5 years	None	Board determined	Board determined	Board determined
Gilts >5 years	None	None	Max 5% SDL	Board determined
Supranational FRNs	None	Max 3% SDL	Max 5% SDL	Board determined
Supranational Fixed rate Bonds <5 years	None	None		Board determined
Treasury bills	Board determined	Board determined	Board determined	Board determined
FRNs, MTNs or fixed rate bonds <5 years	None	None	Max 5% SDL	
UK RMBS (senior securitised position only)	None	None	Max 5% SDL	Board determined
UK covered bonds (CRD compliant only)	None	None	Max 5% SDL	Board determined
Qualifying money market funds	Max 5%TA/SDL	Max 5%TA/SDL	Own limits	Board determined
Reverse repo	None	Gilts only, up to limits above	Up to limits above	Board determined
BANK OF ENGLAND DEPOSIT FACILITIES				
Reserves Account	✓	✓	✓	✓
Standing deposit facility	(if eligible)	(if eligible)	✓	✓

Appendix 5 – Funding – Indicative Limits

	ADMINISTERED	MATCHED	EXTENDED	COMPREHENSIVE
LARGE SHAREHOLDINGS & DEPOSITS	Max 1% SDL per deposit Max 5% SDL all large deposits	Max 1% SDL per deposit Max 5% SDL all large deposits	Board determined	Board determined
NON-RETAIL FUNDING FROM CORPORATES	Max 10% SDL	Max 15% SDL	Board determined	Board determined
TOTAL WHOLESALE FUNDING FROM FINANCIAL MARKETS	None	Max 15% SDL	Max 25% SDL	Board determined limit, within statutory requirements (max 50% SDL)
SINGLE WHOLESALE SOURCE	Max 5% SDL	Max 7.5% SDL	Max 10% SDL	Board determined
ENCUMBRANCE	Bank of England only	Bank of England + Market Repo only	Max 15% TA (excluding central bank encumbrance). Own sub-limits	Board determined limits & sub-limits
FUNDING STABILITY	NSFR*	NSFR*	NSFR*	NSFR*
MATURITY STRUCTURE OF MARKET WHOLESALE FUNDING	Max 5% SDL <3mths	Max 5% SDL <3mths	Board determined	Board determined
	Max 10% SDL <12mths	Max 10% SDL <12 mths	Max 10% SDL <12 mths	Board determined
			Max 15% SDL <2yrs	Board determined
			Max 20% SDL <3yrs	Board determined
MARKET FUNDING INSTRUMENTS	Term deposits Loans Overdrafts	Term deposits Loans Overdrafts Repo	Term deposits Loans Overdrafts Repo CDs MTNs - FRNs and Fixed rate Covered bonds ABS - RMBS/CMBS/ etc. CP	All market available instruments
EXTERNAL RATINGS	No	No	Likely to be only for covered bonds and ABS	Yes (but optional)

*NSFR parameters as finally determined in Basel/EU