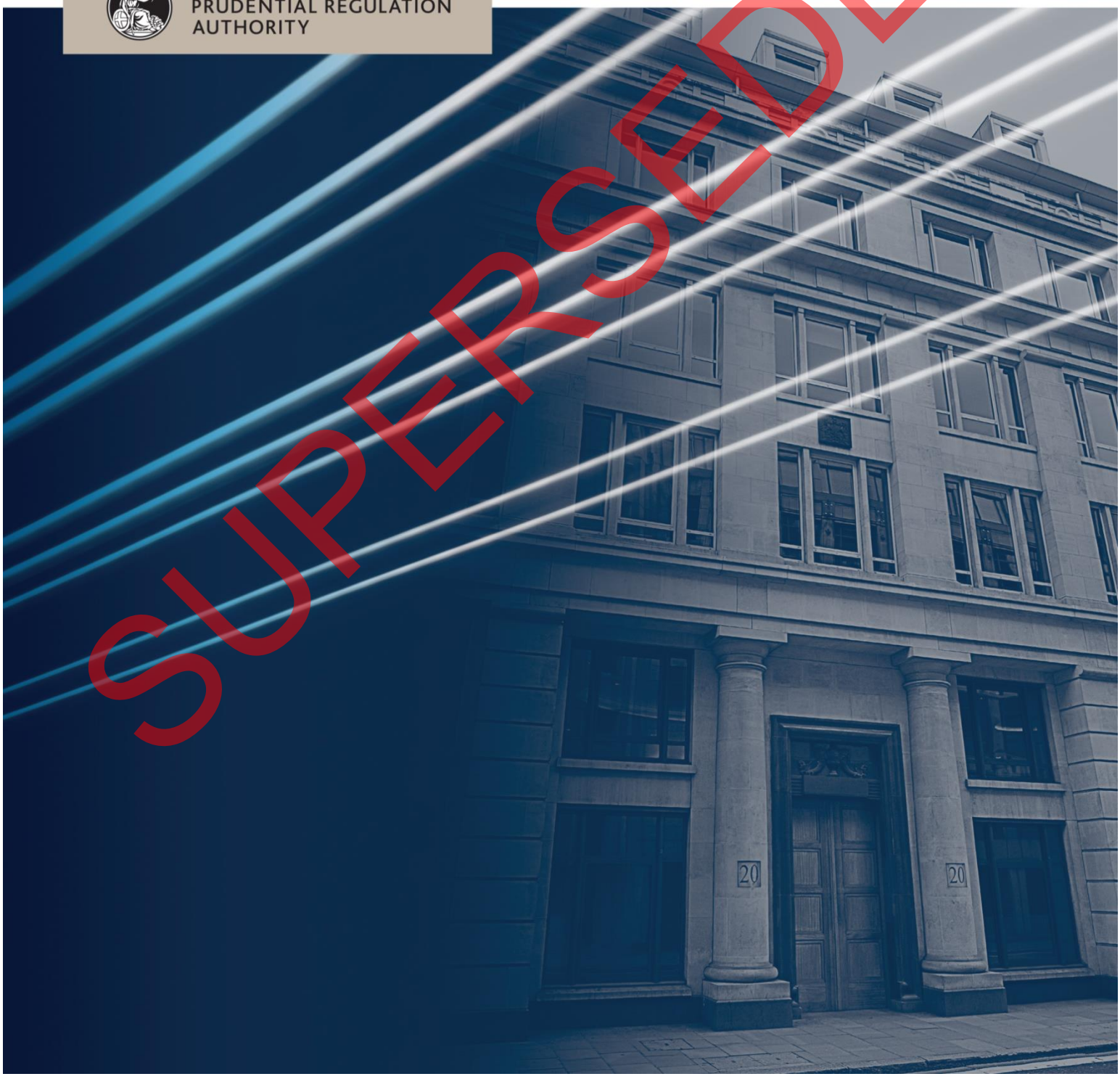
Supervisory Statement | SS20/15

Supervising building societies' treasury and lending activities

February 2020

(Updating January 2017)



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Supervisory Statement | SS20/15

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February 2020

(Updating January 2017)

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Contents

1 Introduction

1.1 This Supervisory Statement (SS)[1] sets out the Prudential Regulation Authority's (PRA's) expectations in respect of building 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 SS24/15.[2] This SS is applicable to all building societies.

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

1.3 The SS 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 SS 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 building society. The PRA expects each building 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 building societies may preclude having a separate risk management function – and therefore limit the types of activities that they can undertake prudently.

2 Overview of PRA expectations

2.1 The PRA expects building 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 SS highlights the key risks in the areas of lending and treasury activities, it is not intended to provide exhaustive coverage of all topics that boards should monitor and be aware of.

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 SS 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 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 SS 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

1 On 24 February 2020, this SS was updated – see Appendix 7.
2 'The PRA's approach to supervising liquidity and funding risks', June 2015; www.bankofengland.co.uk/pra/Pages/publications/ss/2015/ss2415.aspx.

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. Chapter 5 explains 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 6 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 and/or capital repayment is deferred to the end of the mortgage term;

(b) buy-to-let (BTL) 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. This includes appropriate controls over interest-only lending, to ensure that repayment of the loan principal at maturity is achievable.

3.5 The PRA also expects societies 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 all 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.[3] Such mortgages are subject to additional requirements under the Mortgage Credit Directive (MCD), 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 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. Such insurance can be taken into account in estimating the net credit losses that would arise under adverse scenarios as part of the society's stress testing calculations for capital adequacy purposes; and it can be an effective mitigant against catastrophic losses in the event of a generalised market downturn – subject to assessment of reliance on the creditworthiness of the underlying insurer.

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 See FCA rule MCOB 2A.3.

3.12 In placing reliance on security valuations,[4] 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 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 (at product level rather than individual account level) the:

(a) information available from credit reference bureaux 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);

(b) outcome of their own internal stress testing;

(c) underlying cost of funding the loan (see paragraphs 4.120 – 4.126 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.

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

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 under-pricing risk relative to the market may attract the more risky cases and result in a worse quality portfolio than intended.

Non-traditional residential lending

3.20 Traditional prime residential mortgage lending can be characterised as being to owner-occupiers with good credit histories, assessed against evidenced income for affordability (under stress) of regular payments comprising capital and interest, where the loan will be completely repaid by its original term and the loan amount is less than the value of the property mortgaged in order to provide a safety margin of security. Other loans may exhibit many of these lending characteristics, but present additional risks, when compared with traditional prime owner-occupied lending to individuals. The PRA expects societies to recognise this within their risk assessment and management processes, procedures and lending policy. The sub categories below are not exhaustive.

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) once the loan has been fully performing for a reasonably long period.[5]

Buy-to-let lending

3.22 While 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 lending may involve a range of borrowers from, at one end of the scale, individuals 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 periods 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 other letting expenses. While individual investors may not have the time nor 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

5 For regulatory reporting purposes (MLAR E1), loans with Impaired credit history may be reclassified as prime after 5 years (in the case of IVAs, bankruptcy and CCJs greater than £500) , or after two years in the case of arrears equivalent to three months or more of payments overdue) - provided that there have been no arrears in the previous three years. See www.handbook.fca.org.uk/form/sup/SUP_16_ann_19B_20160331.pdf section E3.1.

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 has recently published Policy Statement 28/16 'Underwriting standards for buy-to-let mortgage contracts'[6] and SS13/16 'Underwriting standards for buy-to-let mortgage contracts'[7] specifying its expectations for underwriting standards for BTL mortgage contracts, the provisions of which should be considered in conjunction with this SS.

3.25 As set out in SS13/16, 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' with four or more mortgaged properties (and taking into account that some BTL lending is FCA regulated). In the context of SS13/16, relevant factors which societies are expected to consider and address within their lending policy arrangements 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 of current and known future personal taxation provisions/allowances on borrowers net income arising from purchase/ownership of the relevant BTL property/properties;

(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 potential 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 at underwriting stage 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 additional post-completion loan administration that will be required for portfolio landlords including:

- the impact on costs (and therefore pricing) of regular monitoring of exposures (eg annual reviews, testing loan covenants); and

6 September 2016: www.bankofengland.co.uk/pra/Pages/publications/ps/2016/ps2816.aspx.
7 September 2016 :www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss1316.aspx.

- 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

3.26 Self-build lending encompasses a range of borrower types, ranging from those who directly organise the design and construction of their new home to borrowers who sub-contract all or part the of the planning/construction work to a building company. The range of activities that may be undertaken by the borrower, or outsourced, include:

- identifying the plot and obtaining planning permissions;
- installing services (roads, gas, water, electricity, telecoms etc.);
- designing the building;
- overseeing and/or undertaking the main construction work; and
- finishing off internally.

3.27 The extent of borrower involvement in the development process can therefore vary from case to case, depending on circumstances, skills and locations. Increasingly, 'custom build' developers have emerged to manage and oversee the building process – these typically identify plots, install services and offer bespoking options to allow the future owner to customise the property to their specific requirements, which they may then build (or arrange to be built) under contract.

3.28 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[8] - 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 significantly be mitigated through the involvement of specialist advisers and developers with experience of self or customised house building, who are aware of the pitfalls and can help the borrower to keep control of costs with standardised project management/fixed price building contracts. Societies are expected to consider protecting their position by requiring build-out insurance that will pay for completion, should the borrower (or developer) fail.

3.29 Societies undertaking such lending are expected 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, and the risk can also be further reduced by lending against the value of construction work done, rather than funding such work in advance.

3.30 With appropriate risk management controls, self-build lending (including custom build) therefore can be carried out safely, but it needs additional expertise compared with traditional mortgage lending, and can be 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 specific additional risks will run off, and

8 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).

the mortgage loan should perform similarly to traditional mortgage lending - so it may be reclassified as such.

3.31 Societies are expected to therefore consider placing appropriate limits on the types of self-build and custom-build lending that they are prepared to undertake, particularly in respect of the number/value of loans at any one time in the most risky build stage. Processes for monitoring, classifying and reclassifying such lending would also be appropriate, with a view to distinguishing between the risks involved in different permutations of the self/custom-build proposition and mitigating these appropriately.

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, 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.

Lending in, and into retirement
- Lifetime mortgages (interest roll-up) and home reversion plans

3.35 Lifetime mortgage loans to release equity in a property, where no principal repayment is made until the property is sold, and where interest is meanwhile rolled up into the loan principal, present a range of complex risks for the lender. As a result of compounding interest, balances on lifetime mortgages increase steadily and, unless the value of the property grows at a similar rate to the interest charge (or faster), the LTV will increase over time. In order to protect the borrower (and their family), such loans may be offered with a ‘no negative equity guarantee’ (NNEG) that caps the amount recoverable on the loan to the value of the property on final sale. Hybrid product types also

exist (eg interest initially paid, but only for a period then rolled-up, staged drawdown etc), all carrying degrees of similar risks.

3.36 Repayment of lifetime loans with interest roll-up features is thus dependent on the future value of the property held as security, crystallised at the time the borrower either dies or sells (or, where there is more than one borrower, when the longest surviving borrower dies or sells). Moreover, the realised value of the property may be affected by the willingness and/or ability of the borrower(s) to maintain the property. To mitigate the lender risks involved (whether or not NNEGs are offered), the PRA expects those societies prepared to extend loans on an interest roll-up basis to do so 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 or morbidity expectancy. If larger LTV advances are proposed for borrowers with shorter life expectancy (or earlier morbidity), societies will need to ensure that they have appropriate actuarial expertise to enable them to assess the associated risks.

3.37 In order to provide borrowers with certainty about the speed at which their lifetime loan balance will increase (through roll-up of compounded interest), many lifetime loans are at fixed interest rates that apply until maturity. While some hedging instruments may be available for societies to mitigate the resultant interest rate risk for the lender, most commercially available derivatives are likely to have break clauses that may be exercised by the hedge provider earlier than the likely maturity date of the loan, and they will require cash margin for adverse mark-to-market movements that can become significant in both cost and liquidity management terms. Given that the actual maturity date of each loan is uncertain, extensive modelling at portfolio level is required in order to determine the expected behaviour of loan balances and to estimate exposure levels that need to be hedged – bearing in mind that these will initially increase then amortise over an extended period. Achieving hedge accounting treatment may therefore be difficult, and fair value accounting may expose the society to significant profit volatility.

3.38 By implication, societies undertaking lifetime mortgage business will be expected to have the appropriate specialist treasury and risk management skills to measure and mitigate the many and various risks involved. If all the borrower protection features are included in the product, the society will need to be able to price, manage and mitigate a combination of interest rate risk, house price risk and morbidity/mortality risk, in an exposure with uncertain maturity and no intervening cashflows (assuming that the exposure is in Sterling on UK property – if not there would also be currency and non-UK house price risk). This is likely to be extremely challenging, even for very large organisations with sophisticated risk management expertise. Given the risks and complexities involved, 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) would consider offering lifetime mortgage products.

3.39 Home reversion plans are likely to carry even more complex risks, since they not only have an actuarial and funding rate 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.

3.40 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, because the balances of interest roll-up products grow over time (at least initially) in line with the interest, this may potentially inflate the proportion of the overall loan book represented by the product.

- Other lending in retirement

3.41 Loans to retired borrowers, whether to release housing equity or for other purposes, where interest is covered from income and the capital amount is either amortised, or not amortised but recovered from eventual sale, pose fewer risk management problems than lifetime loans with interest roll-up features. However, they do carry credit risk and, depending upon the interest rate structure applied, can also present some of the interest rate risks associated with interest roll-up lifetime mortgages.

3.42 If rates are fixed for the life of the loan, the risks to affordability will be mitigated to an extent, as long as the available income in retirement is properly assessed and found to be adequate. However, permanent fixed rates that continue until repayment is triggered by the mortality/morbidity of the borrower(s) pose similar risks to lenders as with lifetime roll-up products – there will still be a need to understand the likely amortisation profile at portfolio level in order to determine what term structure is involved, and finding effective interest risk hedging instruments can be highly complex. As a result, the PRA expects that only societies operating on the Comprehensive treasury approach to offer permanent fixed rates with undefined maturities, or long term fixed rates that need to be modelled against the expected amortisation profile of the book.

3.43 In contrast, loans in retirement at variable or short-term fixed rates mitigate the interest risks to lenders, but increase the possibility that the borrower may be unable to afford higher interest instalments should rates rise significantly. Consequently, this type of lending will need careful consideration of retirement earnings prospects, and of initial LTV criteria. The volume of lending in retirement as a proportion of the loan book will need to be controlled in order to avoid a concentration on a single borrower type.

- Lending into retirement

3.44 Traditionally, prime mortgage lending would normally have been undertaken on the basis that the loan will be repaid in full from income earned in employment. However, growth in house prices and the increase in general longevity have made it more common for loans to be taken for longer terms, later in life – resulting in the possibility or likelihood that retirement will occur whilst part of the loan is still outstanding. This is 'lending into retirement', and the PRA expects societies to be cautious in assessing such lending for affordability during the whole life of the loan, and in allowing a significant build-up of this type of lending in their books.

3.45 Lending for long terms (30+ years) shares some of the risk characteristics of interest-only lending – in that capital repayment during the early years of the loan, whilst not nil, can be minimal (especially at higher rates of interest), potentially extending the period of higher LTV exposure if house prices do not increase. Extending loan terms in order to reduce the level of monthly instalments allows borrowers to meet current affordability criteria for larger loans, but also increases significantly the amount of interest that they will pay over the life of the loan. Therefore, it is expected that societies will take special care to understand the rationale for a longer loan repayment period and will consider the lending risks arising.

3.46 Where the proposed end repayment date of a loan, whether long term to a younger borrower or shorter term to an older one, can be expected to fall after the borrower has reached retirement age, the underwriting process will need to seek appropriate information and assurances about the level of retirement income that will be available to meet continuing mortgage instalments. Given the uncertainties surrounding the level of pension income that can be expected to arise from defined contribution schemes, and the implications of statutory freedom to access pension funds from age 55, societies are expected to be rigorous in understanding sources of retirement income or, if the

property is to be sold to repay any outstanding balance at retirement, that sufficient equity will be available post sale to meet the borrower's future housing expectations.

3.47 As with lending in retirement, societies are expected to set internal limits on the volume of lending into retirement as a proportion of the loan book, in order to avoid a concentration on a single type of borrower.

Commercial real estate (CRE) lending

3.48 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.

3.49 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.

3.50 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.

3.51 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.

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

3.53 In general, the PRA considers it 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)

3.54 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.

3.55 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.

3.56 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

3.57 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.

3.58 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.

3.59 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 SS.

3.60 The board and management are expected to take steps to ensure that staff that are 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.

3.61 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

3.62 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.

3.63 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).

3.64 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.

3.65 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).

3.66 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.

3.67 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;

(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 3.49 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).

3.68 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).

3.69 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.

3.70 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.

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

Risk management

3.72 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.

3.73 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

3.74 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.

3.75 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

3.76 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.

3.77 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.

3.78 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

3.79 The actual lending limits, that 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.

3.80 If a society plans to become exposed for the first time to mortgages of sub-types not covered in paragraphs 3.20 – 3.47 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.

3.81 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.

3.82 Under section 6 of the 1986 Act, societies are required to ensure that a minimum of 75% of their commercial assets are 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

3.83 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.

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

(a) set a minimum limit of at least 80% 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%). Self build, shared ownership, shared equity, lending in retirement and lending into retirement can be included as sub-sets of prime owner occupier lending, as detailed in note 3 of Appendix 2;

(b) set limits for other types of lending within the maximum 20% balance: prime BTL, social landlords and small ticket (<£1 million per connection) secured residential investment and 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

3.85 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.

3.86 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.

3.87 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

3.88 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.

3.89 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 Chief Risk Officer (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.

3.90 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 treasury and financial risks management. 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 (MiFID II)[9], 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 risks management activities of societies.

4.3 The importance of financial risk modelling, the complexity of some financial instruments, and the size of individual transactions, combines 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 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;

(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

9 Comprising the Directive, MiFID II (2014/65/EU) Directive 2014/65/EU: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0065; the Markets in Financial Instruments Regulation (2014/600/EU) (MiFIR) Regulation 600/2014: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0600; and Commission Delegated Regulation http://ec.europa.eu/finance/securities/docs/isd/mifid/160425-delegated-regulation_en.pdf.

assumptions (including assumptions for the performance of non-interest elements such as retail price index (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 the PRA Rulebook, 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[10] 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 positions 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 described in paragraph 4.5 above will be measured, managed and monitored within a comprehensive and consistent risk framework.

4.7 Policy statements 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.

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.

10 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.

4.13 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, committee and management committee levels ('Asset and Liability Management' (ALM)).

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 activities 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 individuals amongst their non-executives 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[11] 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 the PRA Rulebook Risk Control 2.1 and 2.2, specifically in the context of 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 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

11 See also paragraph 4.135 and following for an explanation of the four 'approaches'.

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, timeliness, 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 the PRA Rulebook, Compliance and Internal Audit section, paragraph 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 treasury activities.

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 internal audit to an audit firm with the appropriate expertise and experience. Where the whole internal function is outsourced to third parties, societies are expected to ensure that these have the requisite skills and knowledge for the role.

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 the General Organisational Requirements, Skills, Knowledge and

Expertise, Compliance and Internal Audit and Risk Control Parts of the PRA Rulebook[12]. 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 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;

(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 and/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

12 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.

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 overall liquidity adequacy requirement ('OLAR'),[13] based on their specific Liquidity Risk Appetite (LRA).

Liquidity policy

4.38 As set out in Rule 3 of the Individual Liquidity Adequacy Assessment Part, 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 refinancing requirements; 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 would be a working document, and personnel in the treasury and settlement areas would be expected to be familiar with its contents, as would 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 would need 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 their 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 paragraphs 401 – 419.

13 Individual Liquidity Adequacy Assessment 2.1.

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 not an 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 section setting out board expectations for the society's funding maturity profile and for its capability (under a range of market conditions) to monetise its liquid assets. This would give a clear view of the maturity/realisability of different liquid asset types, and set limits governing the minimum/maximum proportions of liquidity that the board requires to be monetisable within a range of time bands.

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 PRA's expectations 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 rating 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.

4.65 Where the senior tranche(s) of Residential Mortgage Backed Securities ('RMBS') have been issued by a society in full to external (ie non-society or non-group) entities, amounts accumulated in the Securitisation Special Purpose Entity ('SSPE') bank account(s) pending disposition to external noteholders may be regarded as exposures of the SSPE rather than of the society in setting internal wholesale counterparty credit risk limits. However, where part or all of an RMBS issue has been taken up by the society (or another group entity) to be pre-positioned/repo'd with the Bank of England or a third party, the expectation is that SSPE bank account exposures will be aggregated with the relevant counterparty exposures.

4.66 Regardless of the operation of internal credit limit structures, societies are expected to remain within the Large Exposures Framework of CRDIV and CRR, subject to the exemptions that apply to smaller firms.

Funding risk management

4.67 This section sets out the PRA's expectations for societies' management of their retail and non-retail funding (business deposits and wholesale funding) activities. Societies' core business (set out in statutory 'nature' limits)[14] 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

4.68 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.

4.69 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).

4.70 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 the net interest margin. For all these reasons, societies are expected to undertake appropriate behavioural and 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.[15]

14 Building Societies Act 1986, sections 6 & 7.

15 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.

4.71 Together with basis risk policies and liquidity optimisation policies, retail funding policies would be expected to shape the society's target liability structure over the corporate plan horizon.

Business deposits risks

4.72 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.[16]

4.73 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.

4.74 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

4.75 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 – except where those mortgages are held within securitisation or similar 'pass-through' structures where amortisation of the assets is used to reduce the outstanding funding. Exposure to refinancing risk needs careful management, and avoidance of over-reliance on an assumption of continued access to the wholesale market.

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

4.77 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 are expected to manage their wholesale funding in a way that ensures stability of supply and availability over time. This implies that, the greater the volume of non-pass-through wholesale funding used as a proportion of funding liabilities, the longer the maturity profile of that funding needs to be. Societies are expected to consider their realistic levels of access to market funds, including in stressed circumstances.

Aggregate refinancing risks

4.78 Societies are expected to measure and project refinancing risk arising from all types of funding relied upon. Such projections would cover the corporate plan horizon, and include internal policy

16 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.

limits for combined retail and non-retail refinance/withdrawal risk to ensure that aggregate gross and net retail plus non-retail outflows are not over-concentrated by rolling quarter.

4.79 Refinancing risk concentrations may reflect the behavioural nature of the funding to be refinanced in any rolling period – typically three months. Therefore, the rolling exposure measured against the limit may include 100% of bullet repayment wholesale maturities but a smaller proportion of stressed retail maturities (based on behavioural analysis). In this way, long term refinance risk monitoring will align with medium and shorter term OLAR and LCR forecasts, and be consistent with the ILAAP stress methodology.

4.80 Where wholesale funding has been raised through secured pass-through structures in which the repayment of funds is generated from the cashflows of the collateral (eg RMBS pass-throughs), the resulting positive impact on a society's refinance risk may be reflected in the methodology. Only the ultimate clean-up call value of the bond specified in the offer documentation and any other features that give rise to cash demands on the society would need to be reflected in the refinance risk profile.

4.81 A focus on aggregate refinance risk will allow greater holistic planning and control of outflows; however, societies are also expected to consider potential wholesale funding concentrations within the refinance risk profile to determine whether concentrations within any one rolling quarter meet their risk appetite. A wholesale funding maturity ladder may be required where reliance on wholesale funding is higher and maturities therefore need to be spread over a longer period. As a guide, maturing wholesale funding (excluding pass-through) exceeding 5% of shares, deposits and loans (SDL) in any one rolling quarter or exceeding 10% SDL in any rolling twelve month period could be regarded as material.

4.82 The Basel Committee has developed a funding stability control metric, the Net Stable Funding Ratio (NSFR)[17], which focuses on exposure to outflows of volatile funding over the ensuing 12 months of operation. Societies are expected to manage their funding in accordance with any future EU or PRA policy on NSFR once enacted. Specifically, societies need to ensure that their funding liabilities have sufficient stability to finance their particular asset mix, which will include a high proportion of long term, residential mortgages.

Large shareholdings and deposits

4.83 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 rollover. These potential problems apply whether the funds in question are raised from the retail or the wholesale markets.

4.84 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 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 SDL; and

17 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.

(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 limits

4.85 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[18].

4.86 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'). 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.

4.87 In undertaking their corporate planning process and under the CRD IV liquidity regime, societies are required to develop a funding plan covering all expected funding needs 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.

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

(a) offshore/overseas retail deposits upstreamed to the society;

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

(c) wholesale funding from the financial markets and central banks (excluding asset swaps) sub-divided into unsecured debt and secured debt.

4.89 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 funding, 10% for business deposits and 10% for offshore/overseas funding, the total of the sub-limits exceeding the overall limit only on the basis that all could not be used to their full extent simultaneously or only to the extent that some of the funding is both wholesale and offshore/overseas).

Encumbrance limits

4.90 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'.

4.91 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. Hence, availability of secured funding (both secured

18 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.

(covered) bonds and through repo) is limited by the availability and quality of collateral. Consequently, societies involved in all types of secured funding markets are expected to plan their collateral generation and usage, to ensure that a spread of suitable assets will be available to raise secured funds as required. In planning future secured fundraising, societies will need a considered strategy for pledging different qualities of collateral in a way that will deliver market consistency and reliable funding results: pledging progressively declining collateral quality will result in rising haircuts, 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.

4.92 Societies that wish to operate in secured funding markets are expected to therefore have in place robust systems for identifying and monitoring collateral (available for future use, pre-positioned, currently pledged and received), and to set internal limits to control the level of encumbrance to within their risk appetite.

4.93 A society's board is also expected to set an encumbrance limit to ensure that market funding (excluding central bank funding/asset swaps) secured on the society's assets is undertaken in a controlled way that limits the risk to members and retains balance sheet management flexibility. The wholesale funding policy needs to set out the board's overall risk appetite for:

(a) Assets encumbered under securitisation/repo funding arrangements with financial markets counterparties, including amounts encumbered under central bank facilities in return for HQLA which are then re-hypothecated to market counterparties;

(b) Amounts encumbered for derivatives margining purposes.

4.94 In the case of re-hypothecation, where collateral / securities are pledged to the Bank of England (or other central bank) in return for Treasury Bills/gilts (or equivalent government bonds) which are then repo'd with a wholesale market repo counterparty in exchange for cash, the internal encumbrance limit would normally include the original amount of collateral encumbered only. Where the Treasury Bills (T-Bills)/gilts/other government bonds received are repo'd with the central bank, or central bank reserves/deposits are received, there would be no need to include this encumbrance in the overall internal limit.

Committed facilities

4.95 A society with high levels of maturing funding, or vulnerable to withdrawal of individual deposits, may consider arranging committed facilities. However, it should be noted that drawdown capacity theoretically available to firms under such facilities is not allowable as an inflow for LCR purposes, nor is it expected that societies would include committed drawdown inflows for OLAR purposes. Consequently, these facilities will be valuable only insofar as they help societies to manage day-to-day operating cashflows.

4.96 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.

4.97 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.

4.98 Societies should not, therefore, become over reliant on committed facilities to meet unexpected short term cash outflows.

Funding policy statements

4.99 In order to exercise proper control over combined retail and wholesale 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 liquidity contingency plan. The policy would cover, holistically:

(a) retail and business deposits product limits, eg for:

- fixed term investment bonds (where limits would also be in place governing the volume of such deposits that can reach term within a given month/quarter);
- instant access, internet-only deposits; and/or
- fixed term/rate Individual Savings Accounts (ISAs) (since all are treated as withdrawable within 30 days for LCR calculation purposes)

(b) aggregate retail and non-retail (business deposits and wholesale) funding refinance risk limits;

(c) large shareholdings and deposits limits;

(d) total wholesale funding, instrument, sector and tenor limits;

(e) encumbrance limits; and

(f) the purpose and maximum permitted usage of committed funding facilities.

4.100 The funding policy would be a working document. Personnel in the Marketing/Product Management, Treasury and Settlement areas would be expected to be familiar with its contents, as would members of relevant committees (eg the Asset and Liabilities Management Committees (ALCO) and/or the Finance Committee). The board would be expected to agree substantive changes and be informed of all other changes. The policy would need to be kept up-to-date and subject to strict version control. All users could be expected to sign to attest that they have read and understood the latest version of the policy within an ALCO specified period, following any changes.

4.101 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 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

4.102 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).

4.103 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.

4.104 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 foreign 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.

4.105 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 foreign currency, the PRA would expect these to be match funded in terms of currency and tenor.

4.106 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

4.107 To comply with 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

4.108 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 rises 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 differently 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 floating rate assets funded by floating rate liabilities eg between:

    (i) SONIA/base rate and mortgage rates (the former being driven by monetary policy and unsecured wholesale markets, the latter by the general level of rates and competition amongst lenders);

(ii) SONIA/base rate and administered rates paid on deposits (the latter being driven by general market rates and competition for funding more generally);

(iii) SONIA and reference gilt rates or other indices;

(iv) overnight and term reference rates; and

(v) legacy market rates and other policy and market rates.

(d) spread risk, which can arise where the underlying market driver 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 - for example due to supply/demand/credit dynamics;

(e) 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;

(f) structural risk, which arises when the mix of interest rate basis characteristics of assets and liabilities are such as to constrain the society's ability to manage its future interest margin. A society that holds higher balance sheet totals at administered rates that can be adjusted to deliver a required margin usually carries lower structural risk than a society whose net margin is largely locked in as a spread to market rates over which it has no control; and

(g) margin compression risk, which is typically driven by asymmetric competition in societies' core retail funding and lending markets, resulting in pricing pressure that cannot be compensated for by adjusting rates on the other side of the balance sheet. This is described more fully in the next section.

Management of interest rate risks

4.109 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.

4.110 Societies are expected especially to have regard to the specific structural and margin compression risks created by originating a large proportion of assets and/or liabilities over which they have no rate setting control (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 potential for an

unexpected shock to income. In the event of a fall in market interest rates, structural imbalances may crystallise as a risk: it may not be possible to decrease administered savings rates in line with decreases in money market rates or Bank Rate without losing the funding (or because deposit rates/fees cannot realistically/practically fall much below 0%), resulting in a serious margin squeeze where lending rates are market-linked. Similarly, in the event of a rise in rates, margin compression may arise from the inability to raise rates on fixed rate assets, at a time of price competition for floating/administered rate assets and rising funding costs.

4.111 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 asymmetric 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. The board is expected to focus closely on achieving a reasonable balance between assets and liabilities carrying similar interest rate characteristics, with any divergence away from the corporate plan agreed target balance sheet structure prompting action – because the timescales required to repair any significant mismatches that have arisen may be long. Where such mismatches exist, the board should agree in the corporate plan a target structure that meets its risk appetite, to be achieved over a specified time horizon. It is expected that the board would view this as a high priority strategic objective.

4.112 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 (NMDs).[19] More sophisticated societies may wish to manage earnings risk by treating reserves and 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 skilled resource and more sophisticated risk management systems will be capable of modelling and managing these structural risks, and that boards of such societies will set prudent duration assumptions that are treated as inputs to longer term corporate planning rather than as parameters that can be adjusted tactically based on changes in market sentiment. 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

4.113 The arrangements, processes, and mechanisms required in the PRA Rulebook 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.

4.114 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.

4.115 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:

19 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.

(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);

(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.

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

4.117 The policy statement would be a working document, and personnel in the society's treasury would be expected to be familiar with its contents, as would 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 would be expected to be amended as frequently as necessary. The board would be expected to agree all substantive changes.

4.118 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 cost of funds

4.119 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.

4.120 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, it is essential that smaller societies 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.

4.121 The PRA does not accept that, because societies' ability to drive market pricing may be limited, they should relinquish control of those aspects of product strategy that they can influence – including, but not limited to, their ability to price within market spreads, and to control product mix and launch timing.

4.122 Special care needs to be taken to use 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 then 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 entirely 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 loan pricing decisions.

4.123 A glossary setting out more detail on the theoretical methodologies and terminology of pricing model components is included at Appendix 6. However, the extent and sophistication of the actual methodologies and systems that support pricing decisions are expected to be proportionate to a society's business model, so the ability to calculate and use the various pricing components is expected to vary according to the approach that each society decides to adopt. Nevertheless, for pricing new lending, all societies need, at a minimum, to be able to:

(a) estimate the marginal cost of new funding, based on a benchmark rate and its required market spread (ie the components described in (a) and (b) in Appendix 6, paragraph 1);

(b) estimate the term liquidity premium that will need to be paid for more stable or cost efficient forms of funding (ie component (e) in Appendix 6, paragraph 1);

(c) project forward their future interest rate margin (both planned and under stressed interest rate scenarios); and

(d) allocate the estimated operational costs that will be incurred in support of the new lending and associated funding (ie component (e) in Appendix 6, paragraph 4).

4.124 In addition to these basic elements of pricing capability, larger and more sophisticated societies with complex product ranges (both lending products and funding products) are expected 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.

4.125 Larger and more sophisticated societies are also expected to understand and incorporate the concepts of funds transfer pricing (FTP) when pricing core products on either side of the balance sheet. There is a clear relationship between funding costs and asset pricing, and boards / management are expected to be able to track, take advantage of and protect their society from changes in the nature of this relationship over time. As societies adopt increasingly complex approaches, we would expect more features of FTP methodologies to be reflected in their pricing disciplines, but it is not expected that such societies will necessarily implement full internal transfer of revenues and costs between business divisions.

4.126 All societies, regardless of approach, are expected to be able to estimate for new products:

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

(b) the comparative price/earnings of different prospective products;

(c) the future net interest margin arising from proposed new product offerings; and

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

Operational risk management

4.127 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

4.128 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

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

4.130 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

4.131 Reliance on electronic dealing, custodian, central clearing, treasury management, valuation 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

4.132 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 'administered', 'matched', 'extended', and 'comprehensive'.[20]

4.133 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 the PRA Rulebook 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.

4.134 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.

4.135 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.

Supervisory approaches to treasury management

Administered approach

4.136 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.

4.137 It is anticipated that the administered approach would 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.

4.138 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.

4.139 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

20 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.

and T-Bills, and short-term deposits with banks and/or other societies (not fixed/floating rate medium term notes, covered bonds or asset-backed securities).

4.140 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 business deposit sources would be limited to a maximum of 10% of funding liabilities. Apart from facilities provided by the central bank, societies on this approach would not be expected to undertake repo or reverse repo activities, or to encumber their assets.

4.141 Administered approach societies would have very limited exposure to fixed interest rate or market floating rate (eg base rate or market rate-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 broadly matched to similar retail assets. Any fixed rate instruments (eg held for liquidity purposes) or loans would be limited to a maximum repricing tenor of three years.

4.142 Administered approach societies would have pricing systems and procedures sufficient for them to be able to estimate individual product profitability and return on capital 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

4.143 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, tranche by tranche, product by product, any significant interest rate or basis risk arising from the non-administered rate elements of their balance sheet.

4.144 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.

4.145 A society adopting the matched 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.

4.146 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 T-Bills, and short-term (ie up to twelve months tenor) deposits with banks and/or other building societies (not fixed/floating rate medium term notes, covered bonds or asset-backed securities).

4.147 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 business deposit sources would each be limited to a maximum of 15% of funding liabilities. Societies on this approach would not be expected to encumber their assets, except for collateral pledged in support of central bank facilities, derivative contracts and small scale market repo activity in respect of liquid assets.

4.148 Matched approach societies would manage the refinancing risk arising from aggregate retail and non-retail liabilities: measurements of refinancing risk (including withdrawal trigger events such as rate expiries or changes) would be aligned with estimated stressed outflow percentages used in determining the LCR and OLAR. Where wholesale funding was taken, wholesale maturities would be limited to a maximum of 5% SDL in any one rolling quarter, and 10% SDL in any one rolling twelve month period.

4.149 Matched approach societies would have exposure to fixed interest rate or market floating rate (eg base rate or market rate-linked) assets or liabilities; and any loan assets or funding liabilities with such characteristics would be matched with liabilities/assets or derivative hedges for the same duration. Contractual balances, where the society currently sets an administered rate (or which will revert to administered rates within twelve months) would typically represent a minimum of 50% of the total loan assets and total funding liabilities of the society. Any fixed rate instruments (eg held for liquidity purposes) or loans would be limited to a maximum repricing tenor of five years.

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

4.151 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.

4.152 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.

4.153 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

4.154 The principal difference between the matched and the extended approaches are in the:

(a) range of treasury instruments and operations used;

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

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

4.155 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 rates predominantly administered by the society itself.

4.156 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 and/or Chief Risk Officer.

4.157 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.

4.158 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.

4.159 The PRA would expect societies adopting the extended approach to have the systems and capabilities to transact repo business, and to have in place a number of repo lines consistent with their planned activity.

4.160 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 instrument types 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)[21] when implemented in the United Kingdom.

4.161 As for matched, extended approach societies would plan and set limits and early warning indicators on future aggregate retail and non-retail refinancing requirements (see 'Aggregate

21 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.

Refinancing risks' paragraphs 4.78 - 4.82). Any methodology would reflect the expected future cash outflow characteristics of a society's liabilities.

4.162 Measurements of refinancing risk (including withdrawal trigger events such as retail rate expiries or rate changes) would be generally aligned with estimated stressed outflow percentages set out in the ILAAP and used to determine the LCR and OLAR. Where wholesale funding is not material, the board may decide that there is no need for a separate ladder of wholesale maturity limits. Wholesale maturities (excluding pass-through structures) would be limited to a maximum of 5% SDL in any one rolling quarter, and 10% SDL in any one rolling twelve month period, to ensure that the risk of higher levels of wholesale funding reliance would be mitigated by a longer average tenor, and to avoid bunching of refinance requirements.

4.163 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 facilities provided by the central bank), and there may be sub-limits by type of exposure.

4.164 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 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.

4.165 Extended approach societies would have strong internal controls on their exposure to fixed interest rate or market floating rate (eg base rate or market rate-linked) assets or liabilities. Contractual balances, where the society currently sets an administered rate (or which will revert to administered rates within twelve 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 five years would be limited to a maximum of 5% of funding liabilities. Societies would set internal limits on the level of basis mismatch in aggregate (max per base) and by major mismatch pairs (eg bank rate/SONIA, bank rate/administered, SONIA/administered, SONIA/term rate, administered/administered).

4.166 In managing its interest rate risk and structural risk, a society adopting the Extended approach would implement 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.

4.167 Societies on this approach would agree a risk appetite for balancing earnings risks and economic value risks arising from the investment of free reserves, but would not model and manage earnings risks arising from quasi-fixed rate non-maturity deposits ('NMDs'). 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 their characteristics, and then originating fixed rate receivables or transacting derivatives 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.

4.168 The PRA would expect that any allocation profile of reserves to repricing bands would be agreed by both ALCO and the board. The profile 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 or economic value profile (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, under normal circumstances, be reviewed only as part of the 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.

4.169 As a minimum, 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.

4.170 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).

4.171 Extended approach societies would understand and apply the key principles and components of pricing methodologies 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) – but they would not be expected to implement a full FTP system. 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. An FTP-informed methodology would be a key input to the new product approval process.

Comprehensive approach

4.172 The principal differences between the extended and the comprehensive approaches are 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.

4.173 As with extended approach societies, it is expected that comprehensive approach societies would manage risk using a Board/ALCO/Treasurer reporting structure. The structure of a comprehensive approach society's treasury and treasury risk management activities would exhibit many of the following features:

(a) First line, reporting to a Group Treasurer or Treasury Executive who is a direct report of the CFO, comprising the:

- Front office Deal/ Execution function; and

- Middle Office - Asset and Liability Management ('ALM') function.

(b) First Line, reporting to the Chief Financial Officer ('CFO') or Group Financial Controller ('GFC') who is a direct report of the CFO, comprising:

- Back Office - Administration & Settlement; and
- Financial Control – Payments & Bank Reconciliation function.

This structure segregates the first line Treasury functions. (Note: some societies may choose to place Middle Office under the control of the CFO or GFC).

(c) Second Line, reporting to a Chief Risk Officer operating at (or just below) board level, possibly through a Head of Financial Risk, overseeing the:

- Balance Sheet Risk Management ('BSRM') function;
- Liquidity Risk Management function;
- Treasury Credit Risk Management function; and
- Treasury Policy Compliance function.

(d) Third Line Internal Audit Function, reporting through the Head of Internal Audit to the Chair of the Board Audit Committee, covering third line reviews of:

- treasury management and deal execution risks;
- treasury administration, settlement and payments risks;
- treasury operational risk;
- balance sheet risk management (including liquidity / market / interest rate risks);
- treasury credit risk; and
- treasury governance and policy reviews (including ILAAP & ICAAP).

4.174 Other specialist functions such as debt capital markets, structured financing, collateral management, investor reporting and debt ratings management may be undertaken by comprehensive approach treasuries and may either sit within the above outline structure or as separate discrete teams reporting to the appropriate line manager / executive.

4.175 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 measured and 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 liquidity, funding interest margin and economic value risks over its corporate plan horizon.

4.176 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.

4.177 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 bunching of wholesale refinancing maturities and over reliance on short-term debt). Societies will in any case need to meet any future European Union or PRA policy on the Net Stable Funding Ratio (NSFR)[22] once implemented in the United Kingdom.

4.178 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.).

4.179 A society on the comprehensive approach could fund and hold assets in a range of currencies. However, the proportion of the balance sheet 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.

4.180 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 on the level of basis mismatch that may be carried, both in aggregate, and against different sub-types of interest rate index or base.

4.181 In managing its interest rate risk and structural risk, a comprehensive approach society 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.

4.182 Societies on this approach may employ structural hedging techniques to stabilise earnings on free reserves and non-maturity deposits (NMDs) against the impact of adverse interest rate movements, setting portfolio allocations that represent the board's considered long term view of the duration characteristics of those exposures and its risk appetite for balancing future NII earnings risks against economic value risks. Any such allocations would be regarded as interest rate change neutral ie not taking an interest rate view. The profile of the allocations would not be altered repeatedly or without board approval to adjust tactically for changes in the society's own expectations for short-term changes in interest rates.

4.183 More generally, if the society had developed an interest rate view and wished to position its balance sheet to take advantage of that view, it would do so only within the board risk appetite represented by EVE, NII and any Value-at-Risk (VaR) sensitivity limits and triggers, and having incorporated an assessment of basis risk impacts.

22 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.

4.184 Risk analysis would be based on full balance sheet analysis of both earnings and economic value under a variety of interest rate stresses, 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, present value of a basis point move calculations, VaR or other means to highlight sensitivities to parallel and 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.

4.185 Hedging instruments available for use under agreed board policy could include those for the extended approach plus (as far as permitted by section 9A of the 1986 Act) potentially:

(a) complex interest rate swaps;

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

(c) index-linked derivatives; and

(d) credit derivatives.

4.186 Comprehensive approach societies would be expected to operate a fully-fledged pricing model tailored to its own business model but taking into account the theoretical elements set out in Appendix 6. The model would incorporate all relevant costs including structural costs, liquidity costs, administrative costs, expected credit losses, hedging costs and an appropriate charge for capital. The methodology would be used proactively to influence balance sheet structure as well as volume and pricing of new business flows. Such societies may possibly wish to implement an enterprise-wide FTP solution which delivers business unit profitability and transfers all risks to a specific central unit or hub 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 4 (for financial risk management) 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 Following notification of the proposed change, the PRA will acknowledge the application in writing. The PRA cannot stipulate a standard timescale for its full response, since that will depend on the specific circumstances of the case. The PRA will review the documents and may have questions or observations on the proposal, including potentially requesting additional information before it can 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 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 how will it affect all capital, liquidity, operational and conduct risk drivers). 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 will acknowledge the application in writing and send written feedback as soon as possible. The PRA cannot stipulate a standard timescale for this response, since it will depend on the specific circumstances of the case and its review of any documents requested. The feedback to the society will be based on a review by technical specialists and following discussion at a panel of supervisory managers which will aim 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 three years following the diversification exceeds 10% of projected net interest margin plus other income net of commission paid for that year;

(c) 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.

7 Implementation

7.1 The guidance in this SS takes effect from 1 January 2017.

7.2 The PRA expects that societies will need to review and update their lending and policy statements to take account of this supervisory statement update. Supervisors will review the revised policies as part of their normal supervisory interaction with the society, and will request the relevant documentation as and when they next review either credit risk or liquidity and ALM risk as part of their normal visit cycle. There is no expectation that societies should send in updated policy statements before that time, unless specifically requested by their supervisor in conjunction with a limit extension or change of approach.

Appendices

Note: the indicative limits in the appendices (1-5) apply to a business as usual environment, as opposed to stress scenarios.

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 – eg 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 (eg 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 internal / external valuer AVMs within parameters recorded in policy statement	Undertaken by independent internal / external valuer AVMs within parameters recorded in policy statement	Undertaken by independent internal / external 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 (Note 3)	In total (max 95% LTV) of which	>=80%	In total (max 100% LTV) of which:	>=65%
	<= 80% LTV, or >80% to 95% LTV with external insurance	>=70%	<= 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 (Notes 1 and 4)	In total (max 70% LTV) of which	<=20%	In total (max 80% LTV) of which	<=30%
• <4 mortgaged properties per borrower)	<= 70% LTV	<=20%	<=80%LTV >65% and <=80% LTV	<=30% <=20%
• =>4 mortgaged properties per borrower	<=70%LTV at portfolio level	<=5%	<=75%LTV at portfolio level	<=10%
Impaired credit history (all types)	N/A	0%	LTV <= 70%	<=10%
Shared ownership (Note 3)	<= 90% of share purchased by borrower	<=10%	<= 95% of share purchased by borrower	<=15%
Shared equity (Note 3)		0%	< 25% equity share	<=5%
Social Landlords	<= 80% LTV	<=7.5%	<= 80% LTV	<=15%
Self-build (in construction phase) actual lending plus committed lending (Note 3)	<=80% LTV	<=7.5%	<= 85% LTV	<=15%
Commercial/FSRP/FSOL	FSRP Investment/rented <=70% and/or FSOL Owner occupied <= 50% LTV (max £1m per loan connection)	<=5%	FSRP Investment/rented <=80% and/or other FSRP/FSOL <= 60% LTV	<=10%
Lifetime mortgages: (Note 2) • fixed or variable rate interest, rolled up (with or without no negative equity guarantee)	None	0%	None	0%
Lending in retirement (Notes 2,3,4) • at lifetime fixed rate	None	0%	<= 70% LTV (min age of youngest applicant 60)	<=5%
• at variable or short term fixed rate	<= 70% LTV	<=15%	<= 70% LTV	<=20%
Lending into retirement (Notes 3&4)	<=75%LTV	<=20%	<=80%LTV	<=25%
Non-sterling mortgages	N/A	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.) (see Notes 2 and 3)

In this table: FSRP = fully secured on residential property; FSOL = fully secured on other 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: For details of interest coverage ratio (ICR) calculation and expectations, see SS13/16 paragraphs 2.3-2.7.

Note 2: Lifetime mortgages at fixed rates, with or without interest roll-up, and loans in retirement at lifetime fixed rates are only expected to be undertaken by societies capable of operating on the Comprehensive approach to financial risk management.

Note 3: Self build, shared ownership, shared equity, lending in retirement and lending into retirement can be included as sub-sets of prime owner occupier lending within the overall indicative limit for such lending.

Note 4: It is acknowledged that, on initial implementation, societies may not have a breakdown of the number of mortgaged properties per existing BTL borrower, nor of borrower retirement details for existing loans in/into retirement. Initially, societies therefore may need to adopt their own assumptions for calibrating internal limits for these categories, whilst implementing the data collection necessary to phase in monitoring of the position against the SS expectations in due course. This method also meets expectations for the phased implementation of SS13/16 on BTL underwriting.

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 (eg base rate/SONIA-linked) lending and funding only if with tracking period limited to <=3 years. • Internal limits on volume/stock of variable rate tracker assets and liabilities.	• 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 5 years to reprice date (subject to limits) • Non-administered variable rate (eg base rate/SONIA-linked) lending and funding - max tracking period 5 years. • Internal limits on volume/stock of variable rate tracker assets and liabilities.	• 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 within a period. • Internal limits on volume/stock of variable rate tracker assets and liabilities.	• Internal limits controlling level of administered rate assets and liabilities • Internal limits controlling repricing maturity and volume of new lending/funding at fixed rates • Internal limits controlling reversions to variable rate within a period. • Internal limits controlling volume/stock of variable rate tracker assets and liabilities.
RISK ANALYSIS	• Matching Report + Static Gap analysis (if any fixed rate lending / funding) - (monthly) • Net interest margin analysis and projection	• Matching Report (min monthly) + Static Gap analysis • Net interest margin analysis and projection • Basis risk analysis and projection	• 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	• Run-off B/S Gap or VaR / PV01 Analysis (min weekly) • Dynamic balance sheet simulation modelling of NII (incorporating future business

	ADMINISTERED	MATCHED	EXTENDED	COMPREHENSIVE
	• Basis risk report. • MTM of fixed rate liquid assets (at least monthly) • Forward looking corporate plan (incorporating stress scenario)	• Forward looking corporate plan (incorporating interest rate stress scenario)	assumptions (min quarterly) • Behavioural modelling (prepayment risk) • Basis risk modelling and projected impact (min 2 years) • Forward looking corporate plan (incorporating a range of interest rate stress scenarios)	flows, optionality) under multiple interest rate stress scenarios and yield curves assumptions • Structural basis risk modelling (using projected business flows) • Behavioural modelling (NMDs, prepayments) • 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)
INTEREST RATE 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
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)

	ADMINISTERED	MATCHED	EXTENDED	COMPREHENSIVE
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 as part of strategic review process and amended at other times only with approval of board. No other material position taking in support of an interest rate view	• Earnings / economic value stabilisation on free reserves – duration set by ALCO/Board. Some position taking in support of an interest rate view 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	• Vanilla interest rate swaps • Vanilla interest rate caps/collars/floors (purchase only) • FTSE swaps (receive only)	• 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
PRICING COMPONENTS (see Appendix 6 for a glossary of theoretical pricing components, and an	• Marginal cost of funding • Liquidity cost overlay • Operational costs	• Marginal cost of funding (adjusted for term) • Liquidity costs • Hedging costs • Operational costs	• Cost of core funding (incorporating liquidity, term, optionality, hedging costs)	• Pricing system (incorporating liquidity, term, currency, optionality, hedging costs)

	ADMINISTERED	MATCHED	EXTENDED	COMPREHENSIVE
additional table linking these to the treasury approaches)		• Minimum return on Capital	• Behavioural modelling (prepayment) • Target return on regulatory capital	• Behavioural modelling (prepayment, non-maturity deposits) • Credit EL estimates • Target return on economic capital • FTP system (optional)
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 resource (may be outsourced or co-sourced)	• Specialist Treasury systems and controls Internal Audit resource (may be outsourced or co-sourced).
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 and 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
Non-supranational fixed/floating rate MTNs <5 years	None	None	Max 5% SDL	
UK asset-backed (senior securitised position only)	None	None	RMBS only 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 BUSINESSES/ CORPORATES	Max 10% SDL	Max 15% SDL	Board determined	Board determined
TOTAL WHOLESALE FUNDING FROM FINANCIAL MARKETS (ie excluding central bank funding)	None	Max 15% SDL	Max 25% SDL	Board determined limit, within statutory requirements
AGGREGATE REFINANCING RISK LIMITS (Retail + Business + Wholesale)	Board determined	Board determined	Board determined	Board determined
MATURITY STRUCTURE OF MARKET WHOLESALE FUNDING (excluding pass-through elements of structured funding)	N/A	max 5%SDL maturing in any rolling quarter max 10%SDL maturing in any rolling 12 month period	max 5%SDL maturing in any rolling quarter max 10%SDL maturing in any rolling 12 month period	Board determined
SINGLE NON-RETAIL/ WHOLESALE SOURCE (BY COUNTERPARTY GROUP) (excluding central bank funding)	Max 5% SDL	Max 7.5% SDL	Max 10% SDL	Board determined
ENCUMBRANCE	Bank of England only	Bank of England + Market Repo only	Max 20% TA (excluding central bank encumbrance). Own sub-limits	Board determined limits & sub-limits
FUNDING STABILITY	NSFR*	NSFR*	NSFR*	NSFR*
MARKET FUNDING INSTRUMENTS	Term deposits Loans Overdrafts	Term deposits Loans Overdrafts Repo	Term deposits Loans Overdrafts Repo CDs Fixed /floating rateMTNs 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

Appendix 6 – Glossary of pricing methodology terms

1. Theoretically, assuming a society is wholly retail funded and uses a marginal rather than blended historic cost approach, the potential building blocks of its 'cost of funds' calculation would include, but not necessarily be limited to:

(a) a '**benchmark rate'** that its board believes (based on historical evidence) to be the main driver of changes in its core retail cost of funds (eg bank rate, SONIA);

(b) a '**market spread**' that the society considers it would need to pay above or below (a) to generate core instant access retail funds at the time of pricing eg through its branch network if this represents the source of the majority of its deposits by value. The same spread could be used for all savings products. The society would need to understand how its market spread compares to that of others against which it competes for funding, bearing in mind that the overall price of competitors' products includes their own liquidity, and hedging costs (so their market spread would need to be estimated net of these costs);

(c) a positive or negative adjustment to (b) above based on the society's assumptions and/or **expectations for future widening or tightening of the spread** used in the corporate plan covering the period over which the product is being priced;

(d) for fixed rate products, an adjustment representing the **difference between the benchmark rate and the relevant swap rate**, adjusted for any premium or discount required to offset basis risk mismatch being incurred as a result of offering the product (ie the cost/benefit of changing the society's overall basis mismatch position);

(e) a '**term liquidity premium**' (TLP - Savings) to represent the amount that the society is willing/needs to pay for longer term and/or more stable funding. The TLP may be nil for instant access funding that is transactional, but potentially higher for instant access balances that display longer behavioural maturities (ie where the society would be prepared to pay higher rates to attract instant access balances that are stable - eg some ISA balances - leading potentially to a lower liquidity requirement for these balances). Similarly, for longer term fixed rate funding the board may wish to recognise, in its pricing approach, that liquidity would not need to be held against the liability until the residual contractual period is within its liquidity stress period as defined for its OLAR; and

(f) an estimate of the **different operating costs of various channels** versus the core instant access channel (eg internet and postal channels may be cheaper to operate than the branch channel, justifying an appropriate rate adjustment).

2. The aim of developing such a methodology would be to arrive at a **cost of funding across all products** such that, from a cost perspective alone, the society is indifferent to which product savers actually prefer to take at any given time. Where the adjustments to the core funding cost for all savings products in the range simply reflect the incentives/disincentives to the saver to accept varying product features, the society can use the core funding cost as an input to pricing its mortgage products.

3. However, there are considerations other than price that affect the choice of funding approaches such as liquidity optimisation, NSFR (choosing to target more stable funding than the minimum) and basis risk. The extent to which these can be factored into a pricing model will depend upon the scale and complexity of a society's business.

4. In addition to core funding costs, societies need to consider the impact on **pricing of lending** of other relevant cost elements. Theoretically the key elements of 'loan pricing' are:

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

(b) the '**loan pipeline liquidity cost**': the cost of holding liquidity against anticipated new lending drawdowns;

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

(d) the **operational costs** associated with originating and servicing the new lending and raising and administering core funding;

(e) any **direct statutory or regulatory costs** eg FSCS levy;

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

(g) **hedging costs** associated with managing interest rate risk, basis risk or currency risk arising from the loans (including settlement and clearing house initial and/or variation margin costs); and

(h) the premium needed to achieve the society's **target return on capital**. A society may wish to take into account its target solvency/leverage ratio, its planned growth and the earnings on free reserves in determining its return on capital requirement.

5. Applied to the treasury approaches, the relevant components that societies would model are set out in the following table:

	ADMINISTERED	**MATCHED**	**EXTENDED**	**COMPREHENSIVE**
PRICING COMPONENTS	Cost of funds • Benchmark rate • Market spread • Liquidity term premium (savings) Loan pricing • Cost of core funding • Liquidity holding premium • Fees/incentives costs/revenues • Credit cost • Operating cost • Target return on accounting capital	Cost of funds • Benchmark rate • Market spread • Liquidity term premium (savings) • Hedging spread (savings) Loan pricing • Cost of core funding • Liquidity holding premium • Fees/incentives costs/revenues • Credit cost • Operating cost • Target return on accounting capital • Hedging spread (loans)	Cost of funds • Benchmark rate • Market spread • Liquidity term premium (savings) • Hedging spread (savings) Loan pricing • Cost of core funding • Liquidity holding premium • Fees/incentives costs/revenues • Credit cost • Funding and Lending Variable Operating cost • Target Return on risk adjusted / regulatory capital • Hedging spread (loans) • Statutory/regulatory cost	Cost of funds • Benchmark rate • Market spread (adjusted in line with corporate plan assumptions) • Liquidity term premium (savings), adjusted for deposit behaviour • Hedging spread, adjusted for basis impact Loan pricing • Cost of core funding • Liquidity holding premium • Fees/incentives costs/revenues • Credit EL • Funding and Lending Operating costs (including servicing) • Target return on economic capital • Hedging spread (loans) • Statutory/regulatory cost

Annex: SS20/15 updates

This appendix details changes made to SS20/15 following its initial publication in April 2015.

2020

24 February 2020

This SS was updated following publication of Policy Statement (PS) 3/20 'Responses to Occasional Consultation Paper 25/19 – Chapters 2 and 3'.[23] The changes remove references to the London Interbank Offered Rate (LIBOR) from the SS.

2017

23 January 2017

This SS was updated following its publication on 1 December in Policy Statement 34/16 'Supervising building societies' treasury and lending activities'.[24] The changes are to provide additional clarification and corrections in the following areas:

(i) Paragraph 3.25 has been amended to clarify that the portfolio landlord description is based on 'mortgaged' properties;

(i) Paragraph 3.41 has been amended to clarify that the capital amount can be amortised;

(ii) Paragraph 3.45 has been amended to reflect that longer term lending into retirement, whilst sharing some risk characteristics with interest only lending, is not directly comparable;

(iii) Paragraph 3.67(c) has been amended to delete 'corporate bodies' to clarify that BTL lending to corporate bodies is viewed as commercial lending fully secured on residential property that is let out and held for investment purposes (FSRP investment/let);

(iv) Paragraph 3.84(a) has been amended for the traditional approach to correct a text mismatch between it and Appendix 2. The intention was to align the prime owner-occupied limit with the separate 20% indicative limit for BTL lending, and the inclusion within the prime total of other sub-types of mortgage. The indicative limit for prime owner occupied mortgages has therefore been corrected to 80%;

(v) Paragraph 3.84(b) has been amended to reflect a balance of 20%, including BTL, so as to align with paragraph 3.84(a) above;

(vi) Appendix 2:

- Notes have been renumbered to align fully with the table. Note 4 has been added to clarify expectations where Societies do not have historic data on numbers of BTL properties and retirement ages for borrowers;
- 'Prime owner occupied' indicative limits for the traditional approach have been corrected to read 80% , 70% and 10% to correspond with paragraph 3.84(a);

23 February 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/occasional-consultation-paper-october-2019.

24 December 2016: http://www.bankofengland.co.uk/pra/Pages/publications/ps/2016/ps3416.aspx.

- Prime BTL has been clarified as applying to mortgaged properties only. ICR expectations have been removed (Note 1 has been updated to clarify the read-across to PS28/16 and SS13/16)[25];
- 'Commercial FSOL' has been amended to include FSRP (defined below the table) as well as FSOL, in line with sub para (iv) above. Indicative LTV limits for FSRP investment/let have been clarified in line with those for BTL to individuals;
- The "*" has been removed against the limits for lifetime mortgages and lending in retirement for the limited approach (redundant marker);
- Lending in retirement has been corrected to include short-term fixed rates as well as variable rates;

(vii) Appendix 3, internal audit for extended and comprehensive approaches, has been amended to clarify that the function may be outsourced or co-sourced;

(viii) Appendix 5 has been amended to re-insert the row for funding stability that had been inadvertently deleted from the consultation draft.

2016

1 December 2016

This SS was updated following publication of Policy Statement 34/16 'Supervising building societies' treasury and lending activities'.[26] The changes were consulted on in Consultation Paper 12/16.[27] The SS has been reorganised under seven headings:

(ix) introduction;

(x) overview of PRA expectations;

(xi) lending;

(xii) financial risk management;

(xiii) changes to supervisory approaches;

(xiv) business model diversification; and

(xv) Implementation.

25 Underwriting standards for buy-to-let mortgage contracts, September 2016: www.bankofengland.co.uk/pra/Pages/publications/ps/2016/ps2816.aspx, www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss1316.aspx.
26 December 2016: www.bankofengland.co.uk/pra/Pages/publications/ps/2016/ps3416.aspx.
27 PRA Consultation Paper 12/16 'Supervising building societies' treasury and lending activities', April 2016: www.bankofengland.co.uk/pra/Pages/publications/cp/2016/cp1216.aspx.