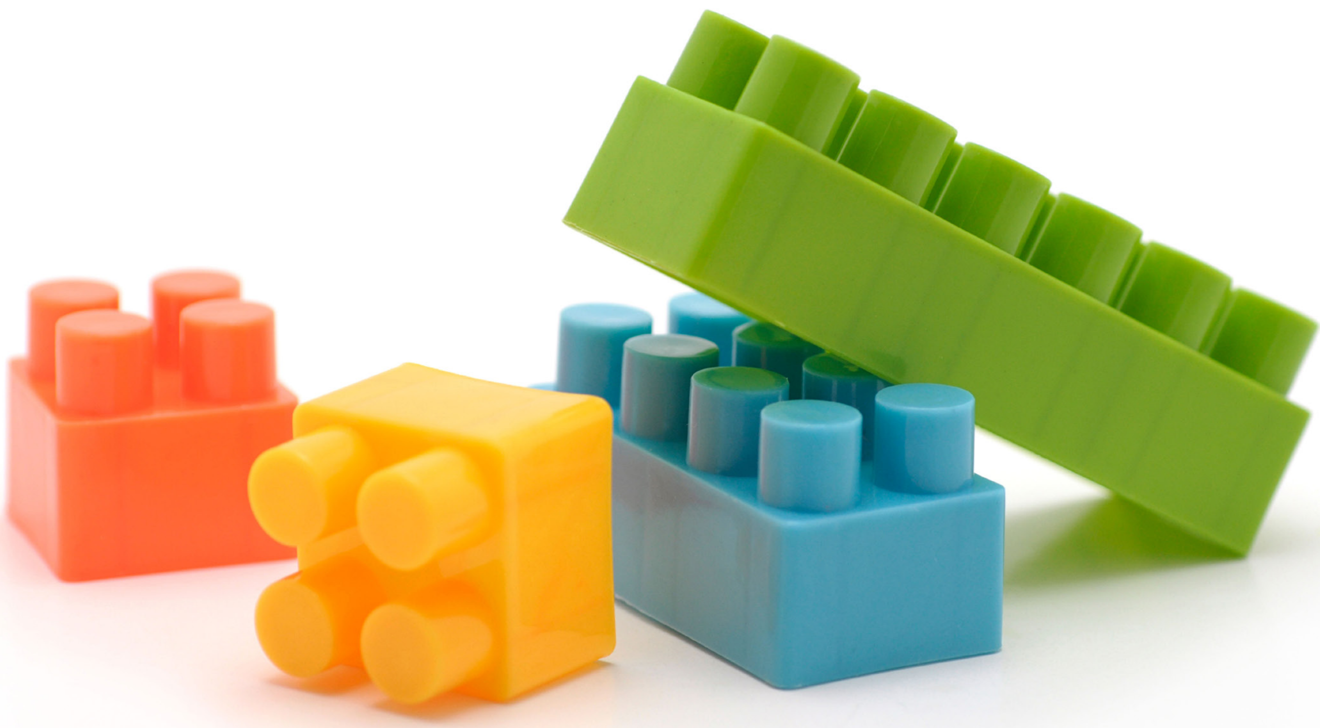
How building societies can manage change in prudential regulation
Piecing it together



EMEA Centre for Regulatory Strategy

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Introduction

The regulatory environment remains challenging for banks and building societies as the introduction of more and tougher prudential standards 'raises the bar' and extends the reach of regulation. There are many moving parts to follow. To gain a complete picture, building societies need to pull together several, sometimes disparate initiatives and understand the inter-linkages between them.

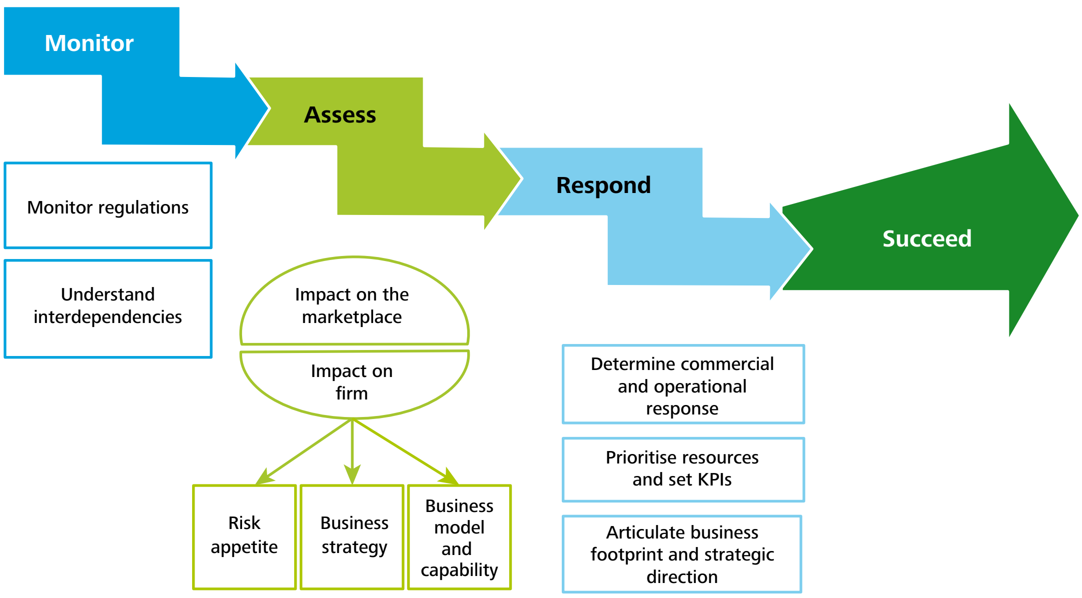
Building societies are in some respects particularly exposed because of their inherently narrower business mix, and because of the higher regulatory cost of their core business – mortgage lending – in the new regime. However, they may find themselves a step ahead of some competitors because features of their existing business model, such as a high dependence on retail deposit funding, are set to become more widespread in future, although increased competition may increase the price of retail deposits, especially following the end of the Funding for Lending scheme, and the impact of 'ring-fencing' requirements.

Monitor, assess, respond

Senior management needs to be on the front foot. This paper sets out a simple framework for managing the changing prudential environment (figure 1):

- **Monitor**: understand the regulatory requirements in play, when they come into force and how they interact.
- **Assess**: the implications for the business model. Consider how risk appetite, business strategy and business model need to adapt.
- **Respond**: develop a strategy to maximise the chance of success in the new regulatory regime and set in train a process to deliver it.

Figure 1. Strategy for success



The simplicity of the framework belies the amount of work that lies ahead. Building societies need to make a significant resource investment in order to tackle this properly. They should not respond to each initiative in isolation. Some initiatives are overlapping; not all initiatives will introduce regulation that is more constraining than that which societies already operate within.

Building societies will be familiar with the risk-weighted capital ratio requirements introduced by CRD IV – the package comprising the European Union (EU) Capital Requirements Regulation and Capital Requirements Directive that implements in the UK the latest international regulatory framework for banks (Basel III). Increased emphasis on Core Tier 1 capital and the extent and variability of higher capital requirements are particularly important to understand, as is the more complex capital buffer structure. But a full understanding of future capital and liquidity requirements, and the cost of meeting them, requires a broader perspective on regulatory requirements. For example, stress testing, the leverage ratio and macroprudential requirements will all have a bearing on capital requirements in future. On top of these factors, the supervisory approach and judgement will be important.

Building societies generally start off in a good position in terms of capital, but given the practical challenge of raising capital other than through retained earnings remains significant, even a small uplift in requirements will need to be carefully managed. In terms of liquidity, societies also start from a good position. But the funding environment is changing across the banking system, for example because of the increased competition for retail deposits. Moreover, the liquidity ratios introduced by CRD IV will introduce additional constraints to balance sheet management.

Five questions for senior management

- What are the key touch points of regulatory change with your current business model?
- What opportunities does re-regulation create for your business?
- What is happening to your competitors?
- How can your regulatory change strategy be flexed to accommodate changes in deadlines?
- Who in your business is managing and coordinating the impact of regulatory change?

The aggregate view of regulatory developments ultimately needs to consider other factors as well, including internal factors such as legacy IT systems and organisational structures, which typically magnify the cost and complexity of implementing required changes, necessitating greater planning and oversight. Changes in external factors, such as the macro economy and disruptive technologies, compound the difficulties of plotting a course through the changes.

Those building societies that succeed will plan carefully, mobilise in good time and be able to commit sufficient, quality resources for the duration of change. The optimal response should be borne out of an integrated strategy, based on an aggregate understanding of regulatory initiatives. It will include an on-going assessment of the aggregate impact of prudential regulatory change, enabling well-informed and timely decision making on the necessary adjustments to the business model and operating platform.

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Monitor: Making sense of a noisy environment

To start tackling regulatory change, senior management needs to form a holistic view of the breadth of initiatives in play. An incremental, piecemeal response to individual initiatives is unlikely to maximise the potential of the business, not least because there are many moving parts and there is so much interplay between them. This view needs to capture key regulatory and supervisory developments, including information such as timelines. Using a portfolio management approach will help to create a more coordinated response, taking into account themes across multiple regulations, other change initiatives and the society's strategic objectives. The process also needs coordination and governance. We turn briefly to those topics later when we consider how societies should organise their response.

CRD IV

The key areas of prudential regulation for building societies to consider are capital and liquidity requirements, where CRD IV is the obvious starting point. New **capital requirements** are characterised by higher quantity and quality of capital, borne out of changes to the definition of capital (and to deductions), increased emphasis on Core Tier 1 capital, and significantly higher risk weights for certain types of assets. New **capital buffers**, including the Capital Conservation Buffer, will also be important. The transition from the current regime to the new capital buffers, and the replacement of the Capital Planning Buffer with the **PRA Buffer**, also require monitoring.

CRD IV will introduce two new liquidity ratios – the **Liquidity Coverage Ratio** (LCR) and the **Net Stable Funding Ratio** (NSFR), alongside qualitative requirements around liquidity risk management. The LCR is intended to improve the short-term (30-day) liquidity risk profile, whilst the NSFR sets a minimum level of stable funding over a longer period, incentivising banks to fund activities with more stable sources of funding. Of course, changes in liquidity regulation are nothing new for building societies. In 2009, the sector moved from semi-quantitative liquidity requirements reflecting the building societies' business model to the Financial Services Authority (now Prudential Regulation Authority (PRA)) Individual Liquidity Adequacy Standards (ILAS). In its current form, the composition of the liquid assets buffer under the LCR is broader than under ILAS, and the stress scenario is less sophisticated. The requirements of the NSFR, however, are new.

The Basel Committee on Banking Supervision (BCBS), the body tasked with developing Basel III, agreed the definition for the new **leverage ratio** earlier this year. The European Commission (EC), which will be responsible for translating the requirements into EU rules, has indicated it intends to follow the Basel III approach as closely as possible. In the UK, however, the Bank of England has just embarked on a review of the role of the leverage ratio in the capital framework. The review will consider the case for a higher threshold than the minimum set by the EU, possibly varying by business model (for example, being higher for ring-fenced banks). It will also consider whether the UK should introduce a **time-varying leverage ratio**, which would be varied by the Financial Policy Committee (FPC) with economic cycles, perhaps in tandem with the new Countercyclical Capital Buffer. Figure 2 sets out the expected timeline for development and implementation of the ratio.

Understanding how the PRA plans to approach supervision and apply the rules is as important as understanding the rules themselves.

Stress testing is also important. It is increasingly the marginal determinant of capital requirements. Currently the new UK regime is focused on the largest banks and building societies, but the Bank of England has signalled its expectation that the requirements will be applied more broadly in future. Even for those institutions to which the requirements are not directly applied, it is likely that the underlying principles will be applied by supervisors.

Digging into the detail

It is not simply a case though of being able to pick up a rule book in order to be able to understand the requirements. Notwithstanding that it is difficult in and of itself to extract the requirements from the complex form of the legislation that establishes them, in many instances the **details necessary to put them into practice are still being developed**. The key player in that process is the European Banking Authority (EBA), which has been tasked by EU legislators to develop over one hundred technical standards. The Bank of England, principally the PRA, also has an important role to play, in particular in respect of setting various elements of the rules in CRD IV that are left to the discretion of national authorities to calibrate. Finally, there is the EC, which has been given the authority to determine the final form of requirements on leverage and liquidity. Building societies will need to monitor the outputs and progress of all these bodies.

Even once the details have been set out, national **supervisory authorities will still retain an influential role in choosing how to apply them**. Understanding how the PRA plans to approach supervision and apply the rules is as important as understanding the rules themselves. In particular, the trend for simplification in regulation will further frame the regulatory landscape, with increasing emphasis placed on "back stop" measures to counteract concern that risk-adjusted measures embed too much subjectivity. For its part, the PRA has over the past year set out the principles it intends to apply to supervision. For CRD IV, they are captured in a number of supervisory statements, as well as the PRA's approach to banking supervision.[1] Societies can also learn from the approach being taken for the largest firms on specific topics, since there is every expectation that the same principles will in future be applied more widely.

1 Bank of England (2013), 'The Prudential Regulation Authority's approach to banking supervision', April, http://www.bankofengland.co.uk/publications/Documents/praapproach/bankingappr1304.pdf

Figure 2. How is the leverage ratio requirement likely to evolve from here?
At the international level, the definition of the leverage ratio has been finalised, although it could still be reviewed by the BCBS before the requirement comes into force. The calibration is nominally set at 3%, but further work is being done to assess its suitability. Some want the ratio to be higher, others want to differentiate the requirement by business model. The EU and UK need to implement the international requirements. They are likely to follow the internationally agreed definition, but may come to a different conclusion on calibration.

		2014	2015	2016	2017	2018
Basel	• A number of changes introduced in the latest version, published in January, addressing some of concerns raised by banks. • Some alterations still possible, although most likely to be limited to clarifications of existing approach. • The issue of calibration is more open.		• Banks start to disclose leverage ratios publicly from 1 January.		• Final adjustments to the definition and calibration made by end-2017.	• Leverage ratio to become a Pillar 1 requirement from 1 January.
EU	• EU definition currently mirrors Basel III leverage ratio from December 2010, but EC intends to align to the latest version when legislative process permits.	• EC to issue a delegated act, amending CRR definition. • EBA to finalise requirements for disclosure.	• EU credit institutions (covered by CRD IV) start to disclose ratio publicly from 1 January.	• EBA/EC report by end-2016. • Possible legislation to introduce leverage as binding requirement.		• Leverage ratio expected to become binding requirement.
UK	• Starting point is for UK to apply EU/Basel rules when they come into force. PRA already has power to set leverage ratio for individual banks and for system as a whole. • FPC is reviewing leverage ratio on direction of Chancellor, in particular power to direct baseline minimum and variation in level over time, as well as leverage standards for ring-fenced banks. • FPC might recommend introducing requirements earlier or with a higher baseline.	• FPC expected to conclude review of leverage ratio by November 2014.	• Public disclosure for UK banks and building societies from 1 January.	• Leverage ratio may become binding requirement sooner than 2018.		

Beyond the familiar components of CRD IV…

After navigating the uncertainty of requirements still under development, and of supervisory judgement in the application of CRD IV, the job is still not quite done. CRD IV does anticipate macroprudential regulation, in particular by establishing new capital buffers. The UK is, however, relatively advanced in the application of **macroprudential policy**. The Bank of England's FPC will be able to influence total capital and liquidity requirements in future by, for example, setting the Countercyclical Capital Buffer or by setting risk-weights for particular types of lending. Although the FPC's power of direction – whereby it can instruct the PRA to take a particular course of action – is limited, its power of recommendation – which does not come with an obligation on the PRA to act – is potentially much broader. As an example, the FPC has a power of direction to set sectoral capital requirements for exposures to specific sectors. It can make recommendations to the PRA in respect of the exercise of any of the PRA's functions.

… and beyond CRD IV

Structural reform, in particular, the **ring-fencing of certain banking activities**, will not apply directly to building societies, but should be considered in terms of the changes it will drive in the competitive environment, including in the availability of funding. For example, ring-fenced banks will place a greater premium on deposit funding. There may also be limitations on the ability of ring-fenced banks to provide funding to other banks. Societies will need to consider the extent to which changes to ring-fenced banks' business models and funding structures will mirror the building society business model and perhaps reduce the distinction in the minds of the consumer.

In the UK, ring-fencing requirements are introduced by the Banking Reform Act. The Act also introduces **bail-in requirements** and gives **insured depositors preference** over other creditors if a building society has to be resolved. Giving preference to insured depositors means that wholesale depositors rank lower and thus the degree of protection of holding wholesale deposits with building societies is reduced. The recently-agreed EU **Deposit Guarantee Scheme Directive** (DGSD) goes further, giving priority in insolvency to all deposits eligible for deposit insurance, although the portion that falls within the limit for insurance ranks highest. The DGSD also introduces risk-based contributions to deposit guarantee schemes.

Building societies will be within scope of the bail-in tool – an option given to the Bank of England as lead resolution authority to reduce or defer liabilities under resolution. The bail-in requirement will influence funding for banking. In future, for example, it will be more likely than is the case today that wholesale creditors look to protect themselves, either by replacing unsecured exposures with secured exposures, or reducing the maturity of deposits to below the threshold from which they are excluded from bail-in (an original maturity of less than seven days). In addition, the largest building societies – those designated as domestic systemically important – will in principle be required to hold a minimum amount of debt that could absorb losses under resolution (referred to as non-capital primary loss absorbing capacity). The Government is consulting on how the bail-in power will be implemented.

Away from banking prudential regulation, there are other initiatives that will have an impact. For example, changes to the Bank of England's Sterling Monetary Framework (SMF) will affect funding markets and access to liquidity insurance. IFRS 9 Financial Instruments, a new accounting standard, sets out the recognition and measurement requirements for financial instruments and certain types of contracts to buy or sell non-financial items. All credit risk assets (mortgages and Treasury) which are reported at amortised costs will be within scope and subject to an impairment provision for IFRS societies. And in the final analysis, building societies will also need to understand any implications of conduct regulation on the new business model, including the Financial Conduct Authority's (FCA) competition objective.

Assess: Understanding the impact

Having built an aggregate view of the relevant drivers of change, societies need to map these developments onto business lines, functions and processes, in order to be able to assess the strategic and operational impacts, including the implications for the building society's business model. Although there are clearly strong commonalities across business models for all building societies, the detail will vary, not least because of differences in risk appetite and existing strategy.

Identifying opportunities

Where does regulatory change create value? How can societies leverage regulations to make their business more profitable? Which of these developments impose the most pressing constraints? Which represent the most significant changes from the status quo? In the medium term, most societies will be capital constrained and so will need to focus on capital management, product pricing and structure of liabilities in order to generate required returns.

The strategic review will be most effective if senior management is prepared to challenge key assumptions in the existing business model. A wider definition of regulatory costs, including the cost of compliance with the current regulatory regimes, and the potential opportunity costs of redirected senior management time and diverted investment from revenue generating activities, is necessary to capture the complete picture.

Building societies face a particular challenge because their relatively narrow business model limits the opportunity to diversify. It cannot be taken for granted that all business models remain viable, even after significant cost-cutting. Senior management needs to be ready to take hard decisions, to the extent that it has not already done so.

Impact on the building society

Assessing the impact of the new regulations is made difficult by a relative paucity of data defined in a way consistent with the final form of the relevant metrics. There have though been several studies that point to the broad direction of impact.

For example, the BCBS has undertaken a regular 'Basel III monitoring exercise'. The latest report[2], published in March 2014 and based on data as of June 2013, included 227 banks, comprising 102 large internationally active banks ('Group 1') and 125 other banks ('Group 2'). The report found that the aggregate shortfall in risk-based capital had continued to decrease for Group 1 banks against the Core Tier 1 capital 7% target (plus the surcharges on Global Systemically Important Banks as appropriate). The aggregate shortfall was €58 billion, compared to €115 billion on 31 December 2012. The aggregate shortfall against the 4.5% minimum requirement had increased (due to an increased shortfall reported at a single bank), as had the shortfall for Group 2 banks against both targets, although the quantities of capital were relatively small. The average Core Tier 1 capital ratio across the sample of banks was over 9%. No assumptions are made about banks' profitability or behavioural responses.

The weighted-average LCR for Group 1 banks was 114%, down from 119% six months earlier. For Group 2 banks, the average had increased from 126% to 132%. Nearly three-quarters of banks in the sample reported an LCR that met or exceeded the 100% minimum requirement.

Analysis by the EBA in its March 2014 'Report on impact of differences in leverage ratio definitions'[3] (based on data for a sample of 173 EU banks as of June 2013) provided an initial insight into the position against the Basel III definition of the leverage ratio finalised earlier this year, although the report had to make a number of simplifying assumptions with the data available. The EBA found that Group 1 banks (based on the same definition as the BCBS report) had an average leverage ratio of 3.3%, whereas Group 2 banks had an average ratio of 3.9%.

Although some UK banks and building societies are included in the BCBS and EBA analysis, the impact of the new regulations in the UK is somewhat difficult to discern from the aggregate numbers reported. Analysis by the Bank of England of the 'major UK banks and building societies' peer group, published in the Bank's June 2013 Financial Stability Report, identified an aggregate capital shortfall of £27.1bn at end-2012 relative to the FPC's enhanced basis for assessing capital, risk weights and valuations.

2 See http://www.bis.org/bcbs/qis/index.htm

3 EBA (2014), 'Report on impact of differences in leverage ratio definitions', 4 March, http://www.eba.europa.eu/documents/10180/534414/EBA+-+Leverage+ratio+analytical+report.pdf

The report noted, however, that around half of this shortfall would be met by actions the banks and building societies in the sample already planned to make over the course of 2013, with capital being raised through retained earnings, disposals and equity issuance. For most of the banks and building societies in the sample, meeting the recommended 7% risk-weighted capital target was sufficient for their leverage ratio to be no less than 3%. However, two of the sample did need to take additional steps.

For building societies, meeting the leverage ratio target is likely to be the principal area of challenge, if any. Building societies start in a relatively strong position against liquidity and risk-weighted capital requirements, but the leverage ratio requirement introduces new constraints. This issue will be more acute if the leverage ratio requirement is set at 4 %, rather than 3%, as some commentators have suggested might be the case.

Moreover, the capacity of building societies to grow capital in future is limited and under pressure. Around 85% of the sector's capital is made up of retained earnings; for most smaller societies, retained earnings account for the entire capital. While the issuance of Core Capital Deferred Shares (CCDS) was an important development for the sector, as a ground-breaking innovation of how to raise additional Core Tier 1 capital, the issuance process was relatively complex and expensive. Perhaps more important in the near-term will be further issuances of Additional Tier 1 capital, which can be used to meet the leverage ratio under the current definition.

The House of Commons Treasury Committee report on 'Competition and Choice in Retail Banking'[4] noted the Office of Fair Trading's (OFT) review of barriers to entry, expansion and exit in retail banking concluded that "the financial crisis has had a major impact on retail banking in the UK". Since April 2008 there have been several mergers in the building societies sector. In the process the sector has become significantly more concentrated: the five largest firms now account for nearly 90% of sector assets, up from almost 75% over the same period according to data from the Building Societies Association.

In terms of liquidity, building societies appear to be in a good position to comply with the incoming LCR requirements. Building societies' business model – lending out mortgages funded by retail deposits – poses fewer challenges in terms of liquidity than business models based on wholesale funding. But they will need to think about how to raise new liquidity given the likely increased demand from ring-fenced banks in future. Competition from challenger banks will also need to be factored in. The NSFR may pose a greater challenge. Societies by their nature have long-maturity assets. All else equal, the NSFR will incentivise building societies to extend the maturity of funding (deposits), which may be difficult to do.

4 House of Commons Treasury Committee (2011), 'Competition and choice in retail banking', Ninth Report of Session 2010-11, Vol. 1, http://www.publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/612/612i.pdf

Respond: Putting plans into action

In this paper we have focused on the analysis required to plan for regulatory change – identifying the key regulatory initiatives and stakeholders that should be considered in forming an aggregate view of regulatory developments. That analytical process needs to be put into practice within a regulatory planning approach.[5] The approach should address the coordination and governance around the monitoring and assessment process. As importantly, it should tackle the 'so what' questions, identifying how regulatory developments flow through to strategy, and how agreed changes will be implemented.

Many firms find resources and senior management attention stretched in these scenarios. The challenge is likely to be particularly acute in many building societies given their size. New capabilities may be required.

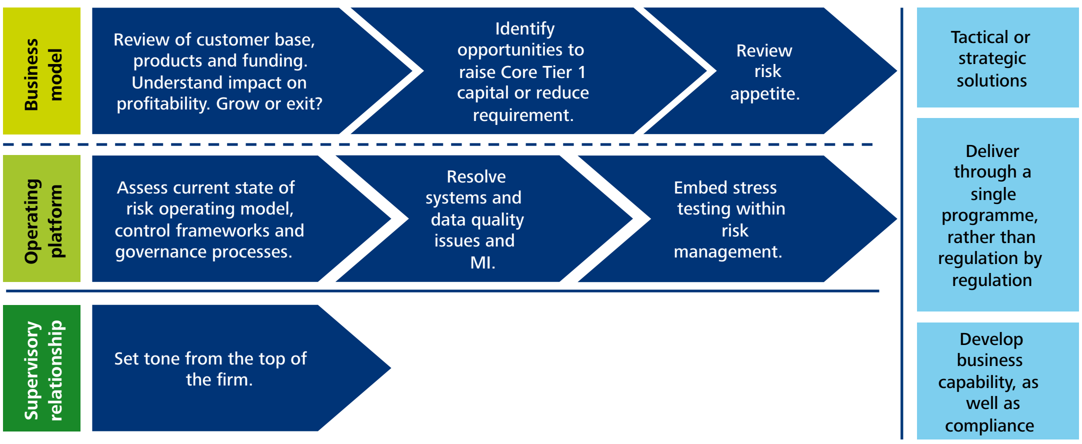
Business as usual operations, and tactical solutions to near-term problems, often have first-call on the resources that are available. It is crucial though that resources are properly prioritised to deliver the strategic solutions. Where the resources do exist, it is important that building societies do not operate in silos, for example, by business line, unable to effectively integrate or coordinate the change initiatives. Key performance indicators (KPIs) should be set and appropriately monitored in order to ensure progress continues.

Increased regulation is a long-term structural trend. Building societies should look at the options for embedding a regulatory decision-making framework as a process – a more strategic way of thinking for all regulatory decision making.

Regulatory decision making: impact assessment, options assessment, action plan

The response needs to begin with a clear view on the strategic direction of the business, including its geographical, digital and service offering footprint and well informed and timely decision-making on the necessary adjustments to the business model and operating platform. The strategic plan needs to be supported by the right supervisory relationship and a well-informed view of supervisory priorities. Not only have the rules been changed, but the PRA has also introduced a new supervisory framework. This framework emphasises the importance of supervisors using judgement, particularly in terms of the forward-looking assessment of adequate capital and liquidity. The risks with judgement are that it is unpredictable (at least, before the PRA has built up a track record) and inconsistent despite the PRA's best efforts.

Figure 3. Responding to regulatory change



What does success look like?

A successful approach will be built on ongoing assessment of the aggregate impact of prudential regulatory change, enabling well-informed and timely decision making on the necessary adjustments to the business model and operating platform. Building societies will have a clear strategy, which the senior management team can articulate to key stakeholders. Progress will be monitored closely and on an ongoing basis, with fit-for-purpose KPIs so that progress can be tracked and problems identified and tackled early. Dedicated lines of responsibility and adequate resources will be allocated so that work can be tackled in a timely manner and with sufficiently good analysis.

5 For illustration, Deloitte's strategic approach to regulatory uncertainty is set out for an insurance case study in: 'Rethinking the response: A strategic approach to regulatory uncertainty in European insurance', Deloitte Insights report, 2013, http://www.deloitte.co.uk/rethinking

Summary

Regulatory change is a practical reality that building societies need to tackle without delay:

- **Monitor**: and be alert to the breadth of factors, including indirect as well as direct.
- **Assess**: think through the interplay with the individual business model; try to quantify; be alert to the risk factors.
- **Respond**: be bold; allocate resources; make it a priority of the board.

The effect will vary by business model and strategic plan, but for all building societies the first step is to form a holistic view of regulatory developments. With that, the operational and strategic implications can be mapped, and a plan to action developed.

Although a significant portion of future requirements has been finalised, much is left to decide. Building societies should build the capacity to keep monitoring developments and to maintain the regulatory change programme.

A successful approach will be built on ongoing assessment of the aggregate impact of prudential regulatory change, enabling well-informed and timely decision making on the necessary adjustments to the business model and operating platform.

Risk factors to success

There are a number of risk factors that building societies need to bear in mind:

- **Judgement led supervision**: could be as significant as the rules themselves. Identifying supervisory 'straws in the wind' is key.
- **Making plans operational**: challenges remain.
- **Profitability**: it cannot be taken for granted that all business models remain viable even after significant cost cutting.
- **Time**: plan carefully and mobilise in good time, to maximise chances of success.
- **Conduct agenda**: take account of any constraints imposed, including the FCA's competition objective.

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