Policy Statement

10/5

Financial Services Authority

A specialist sourcebook for building societies:

Enhanced supervisory guidance on financial and credit risk management

Feedback to CP09/17

March 2010

Financial Services Authority

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Appendix 1: Handbook rules and guidance

This Policy Statement introduces guidance (consulted on in Consultation Paper 09/17) on how building societies might choose to comply with high level rules (principally in SYSC, GENPRU and BIPRU) in the areas of treasury and credit risk management. It introduces a new specialist sourcebook, the Building Society sourcebook (BSOCS) and deletes the existing Interim Prudential Sourcebook for Building Societies (IPRU(BSOC)).

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1 Overview

Introduction

1.1 In this Policy Statement (PS), we respond to the comments received on Consultation Paper (CP) 09/17 *'A Specialist Sourcebook for Building Societies: Enhanced supervisory guidance on Financial and Credit Risk Management'* which we published in June 2009, accompanied by draft Handbook text.

1.2 This sourcebook contains guidance explaining how we expect building societies might (given the statutory constraints placed upon them by the Building Societies Act 1986) comply with rules located largely within SYSC,[1] GENPRU [2] and BIPRU.[3] It does not introduce new requirements, but illustrates how societies may apply the provisions.

1.3 The consultation closed on 5 September 2009. We received 37 written responses - two from trade associations (the Building Societies Association (BSA) and the Council of Mortgage Lenders (CML)), 30 from individual building societies (representing over 75% of the sector as measured by assets held) and five from other respondents. See Annex 1 for a list of all non-confidential respondents. We also received useful comments during a widely attended seminar organised by the BSA, from further informal technical discussions with societies and the BSA and from the Smaller Business Practitioner Panel.

1.4 In Chapters 2 and 3, we provide feedback on specific policy proposals in the same order as CP09/17. However, we have split feedback on treasury proposals and lending proposals between the two chapters to improve clarity. Chapter 4 provides feedback on our cost-benefit analysis and compatibility statement, and addresses concerns raised regarding societies' ability to compete with banks under the proposed regime.

1.5 Each chapter summarises comments received on our questions, our responses and describes any significant changes we have made to the draft Handbook text included in CP09/17. We have also made minor amendments to the Handbook text to improve clarity.

1.6 Many respondents addressed several questions together, particularly answering questions on cost-benefit or compatibility when responding to other questions.

1 SYSC = Senior Management Arrangements, Systems and Controls Sourcebook
2 GENPRU = General Prudential sourcebook
3 BIPRU = Prudential sourcebook for Banks, Building Societies and Investment Firms

Where several points were raised at once we have covered them in the most appropriate chapter rather than repeat the same discussion several times.

1.7 The timeline in Annex 2 shows when societies will be subject to the Building Societies sourcebook's (BSOCS) different provisions, and how this coordinates with the new liquidity regime timelines (published in PS09/16). Appendix 1 contains our final Handbook rules and guidance.

1.8 This chapter gives our feedback on concerns respondents raised regarding:

- our general approach to rules and guidance;
- flexibility within the risk management models; and
- when our proposals will be implemented.

1.9 One commentator argued that as BSOCS represents a separate prudential regime for building societies, this can be seen as a precedent, and that mutuals in a different sector of the financial marketplace should also have a special regime. This is a mis-understanding of the role of BSOCS. Building societies are subject to the same capital and liquidity regime as other deposit takers, BSOCS does not change this.

Our general approach to rules and guidance

1.10 In CP09/17 we proposed expanding the existing treasury risk management approaches and introducing three new credit risk management approaches. Each society will be asked to:

- assign themselves a financial and a credit risk management approach;
- compare their business models to those we expect for societies on their chosen risk management approaches;
- discuss any mismatches with their supervisors; and
- identify whether alternative risk management processes are in place, or discuss and develop a plan for taking any steps needed to align the society's business model with its risk management capabilities.

1.11 Although CP09/17 clearly states our proposals are only guidance, many respondents expressed concern that supervisors would treat the guidance as obligatory. This was reflected both in direct comments and the fact that many societies in their responses interpreted figures presented in tabular form as absolute limits.

1.12 Chapter 6 of our *Reader's Guide: an introduction to the FSA Handbook* explains that Handbook guidance is not binding on those to whom the Financial Services and Markets Act (FSMA) and the rules made under it apply. It need not be followed to achieve compliance with the relevant rule or other requirements. So, a society cannot incur disciplinary liability because it has not followed the guidance in BSOCS. There is no presumption that departing from guidance indicates a breach of the relevant rule. Guidance is generally designed to throw light on a particular aspect of regulatory requirements, rather than to give an exhaustive description of firms' obligations.

1.13 We do not believe it is useful to repeat this explanation in BSOCS. However, for ease of reference, we have included an electronic link to the Reader's Guide in the sourcebook text. We have also reiterated in the paragraph immediately before each table that tabular guidance does not contain absolute limits. Instead, it aims to draw management and supervisory attention to areas where a society's risk management and business model differs from expectations, and which therefore is likely to form the basis for supervisory dialogue.

1.14 As the Reader's Guide indicates, BSOCS's guidance describes one way, but not the only way, that societies can comply with our high-level organisational systems and controls rules - particularly SYSC 4.1.1R and SYSC 7.1.2R. Societies may use other risk management models as long as they can show these effectively manage their business model's risks.

Flexibility within the risk management model

1.15 Some respondents questioned how flexible our proposals are when a building society's business model is at the 'top end' of a particular approach (either the treasury or lending approaches). We were asked if a society would have to set up all controls expected for the next approach 'level' if it wanted to operate marginally outside our treasury or lending parameters. Our provisions are the starting point from where the match between a society's business model and risk management capabilities can be discussed. We would therefore consider the individual circumstances of any society which does not fully fit these expectations. However, if a society has assigned itself to the most appropriate lending and treasury risk management approaches, we think it is unlikely that it will identify more than a small number of areas for detailed supervisory discussion.

1.16 Some respondents commented that our proposals may prevent societies from supplying products that customers were demanding, such as fixed rate mortgages or high loan to value mortgages for first-time buyers. We confirm that societies are free to select any business model, and offer any mortgage products that their senior management choose;[4] as long as they implement appropriate risk management processes to manage the associated credit, interest rate, basis and treasury risks in accordance with SYSC 7.1.2R.

Implementing our proposals

1.17 Many respondents questioned the timing of our proposals, citing in particular the current changes to the liquidity regime for BIPRU firms and the wider mortgage market review (MMR) which is considering the UK mortgage market's future structure. Respondents were concerned that our proposals were not consistent with the liquidity regime or that our proposals would be introduced and then need to be amended after the MMR outcomes were known. We do not believe that there are inconsistencies between these policy proposals, as set out below.

4 Subject to the statutory limits of the Building Societies Act 1986.

Transitional arrangements and the new liquidity regime

1.18 Our proposals have taken into account the timeline for the new liquidity regime's transitional arrangements, published in CP08/22. Many respondents did not appear to view the two as separate initiatives and commented on that regime when responding to CP09/17. The consultation on the new liquidity regime, now finalised and published as PS09/16,[5] was a separate consultation process.

1.19 The new PS09/16 regime applies to all deposit takers and investment firms, including UK banks, UK branches of foreign banks and building societies. As such it will require the disapplication of that part of IPRU(BSOC)[6] which contains the previous building society eight day liquidity regime. Although we could have deleted the remainder of IPRU(BSOC) and introduced BSOCS without referring to liquidity regime timelines, we believe this would be confusing for societies, so we have scheduled the changes to occur at the same time.

1.20 So, BSOCS will come into effect on 1 April 2010, but transitional arrangements will mean that only those provisions in 1.15.1G and 2.4.1G to 2.4.11G will apply until either 31 May 2010 (for societies adopting standardised ILAS)[7] or 30 September 2010 (for societies adopting simplified ILAS).

1.21 From 1 April to 30 September 2010, societies should self assess their financial and credit risk management capabilities, identify possible mismatches between risk management and business model and agree with their supervisor what if any actions are needed to address these and their timescales. However, the current provisions in IPRU(BSOC) will still apply in all other respects until 31 May or 30 September 2010 depending on the liquidity regime that applies to the society. On 1 October 2010, IPRU(BSOC) will no longer apply. It will be removed from the Handbook, but will still be available for reference using the 'time travel' feature on our website.

1.22 To help societies understand the transition of the new BSOCS regime, we have included a timeline in Annex 2, which sets out how this is coordinated with the liquidity regime timeline.

1.23 Rather than require societies to unwind treasury positions or dispose of loan portfolios at a time when they would suffer a loss on disposal, we expect supervisors to agree that any such transactions can be managed by allowing positions or exposures to run-off naturally. As a result, societies may need to establish further risk control mechanisms to manage their risks during this run-off period; supervisors and societies will agree on this during the review process.

The Mortgage Market Review

1.24 Some stakeholders questioned whether implementing BSOCS should be delayed until we know the outcome of the MMR consultation process. They were particularly concerned about whether our approach regarding high loan to value (LTV) mortgages were consistent as between BSOCS and the MMR. Paragraphs 4.8 to 4.20 of DP09/03

5 This Policy Statement reports on the main issues arising from the liquidity risk Consultation Papers 08/22, 09/13 and 09/14 and publishes final rules.

6 IPRU(BSOC) = the Interim Prudential Sourcebook for Building Societies

7 ILAS = individual liquidity adequacy standards

suggest that the correlation between high LTV loans and defaults is not automatic, and that further analysis is needed before reaching final views on the extent to which such a correlation exists.

1.25 The guidance in BSOCS is targeted at lenders' prudential stability. Although the link between high LTV and likelihood of default may not be automatic, once the consumer has defaulted, a high LTV is likely to be strongly correlated with the size of loss the lender will incur. On this basis, a society's risk management policies and procedures should take the increased risk of loss given default associated with a higher LTV into account, and this is reflected in BSOCS.

1.26 The MMR is primarily focused on retail lending. It does not give a view on commercial mortgages or treasury risk management - those areas of CP09/17 which generated the most responses from societies. Therefore, we do not plan to delay the implementation of BSOCS. However, we will consider whether amending BSOCS is necessary after the MMR outcomes are finalised.

Who should read this PS?

1.27 This PS is primarily of interest to building societies, although smaller mortgage banks may also find it useful.

CONSUMERS

We did not receive comments on our proposals from consumers or consumer bodies. No issues of significant relevance to consumers have arisen since we published CP09/17.

2 Extending the supervisory approaches to treasury risk management

Introduction

2.1 In Chapters 2 and 3 of CP09/17 we explained our proposal to reorder and move financial risk management guidance in IPRU(BSOC) and expand the five models, or supervisory approaches, to financial risk management within it. We also described how we planned to introduce new guidance on three lending approaches, driven by different levels of sophistication of credit risk management control.

2.2 Respondents broadly supported our proposals to reorder the text and clarify our expectations, but challenged some of the suggested thresholds in the tables. They especially questioned the relationship between our proposals and the new liquidity regime – now published as PS09/16 – and whether the longer-dated wholesale funding which we were encouraging is available.

2.3 We have set out below the questions we asked in CP09/17, together with our response to answers given.

> Q1: Do you agree that it is desirable to structure these provisions as guidance to allow sufficient flexibility for them to be tailored to the individual circumstances of individual societies?
>
> Q9: Do you agree that it makes sense to restructure this material in this way and move it to a specialist sourcebook? If not, please explain your concerns.

2.4 Everyone who responded agreed with our proposal to restructure and move the IPRU(BSOC) material. With one exception, respondents agreed that the provisions should be guidance and not rules. Many respondents were concerned about the status of guidance within the Handbook.

Our response: We confirm that we will restructure and move the IPRU(BSOCS) material, and that our BSOCS proposals will be guidance and not rules. As explained in Chapter 1 we have reiterated the difference between the status of rules and guidance, and made that explanation easily accessible to sourcebook users.

Expanded treasury management approaches

Q2: Are there any details within the three treasury management tables which are inconsistent, either within a particular table or between tables? If so, please explain.

Q3: Are there any suggested limits within the three treasury management tables which you believe have been set at the wrong level? If so, please explain.

Treasury investments and liquidity

2.5 One respondent suggested that we rebase the investment metrics in terms of SDL[8] rather than TI,[9] so that the underlying bases of all the treasury management tables will be consistent.

Our response: We agree this would make the guidance more internally consistent and therefore improve the final regime. We have recalculated the tables in terms of SDL using savings, deposits, loans and treasury data as at August 2009 (which we believe is typical for the sector), and have rounded the result upwards to the next multiple of 5%. Since we have consistently rounded up to a higher figure, the final parameters are marginally more liberal than those consulted on in CP09/17. As such, this change will not increase societies' costs, and may slightly lower them – although data available suggests this will be minimal and will not detract from our intended policy outcome.

2.6 Several societies were unclear whether the treasury investment balances included or excluded the investments needed to comply with the new BIPRU 12 liquidity regime's buffer requirements.

2.7 Other respondents questioned the need for guidance on an overnight liquidity balance in addition to the buffer requirements included within our new liquidity regime. We also received several responses that challenged whether the parameters were set at an appropriate level.

Our response: We have amended the treasury investment table to clarify that it relates to all treasury investments, whether held to comply with BIPRU 12 or for other purposes.

We have also added guidance to the text explaining why societies need to consider both their three month liquidity buffer and their intra-day liquidity needs, removed reference to parameters on overnight funding within the treasury investment table and cross-referred societies to the relevant rules and guidance now contained within BIPRU 12.3 which requires societies to actively manage their intra-day liquidity and related risks, and provides guidance on how they might do so. This ensures consistency between BSOCS and the liquidity regime in BIPRU 12.

2.8 In respect of the treasury investments listed for each treasury approach we were asked:

a) why we expected those on the extended approach to consider holding bank FRNs[10] (within limits) but not fixed rate bonds, MTNs[11] or supranational bonds;

8 SDL = share and deposit liabilities
9 TI = treasury investments
10 FRNs = floating rate notes
11 MTNs = medium term notes

Our response: We expect that societies on the extended treasury management approach may choose to invest in fixed rate bonds, MTNs or supranational bonds with maturities of less than five years and have added them to the treasury investment table accordingly.

b) why no maximum term was suggested for FRNs even though a maximum term was suggested for gilts;

Our response: We agree with respondents who commented that the longer the term of a financial instrument, the harder it is for societies to assess its associated counterparty and market risk. We have made our expectation clearer that societies on the extended treasury management approach who choose to hold FRNs will limit their investments to those with maturities of less than five years (which is the typical term of such instruments).

We believe the more sophisticated treasury management systems and controls of comprehensive approach societies are sufficient to manage the risk of longer duration investments, if management chooses to invest in them.

c) whether our expectation regarding societies who hold bank FRNs included building society FRNs;

Our response: We expect societies on the extended, comprehensive or trading treasury risk management approaches may wish to hold both bank and building society FRNs. Again we have amended the treasury investment table to reflect this.

d) why we did not expect societies on the administered and matched approaches to invest in FRNs, which gave a higher yield than deposit accounts;

Our response: Recent experience has suggested that FRNs are not necessarily liquid in a stressed market. They also represent a longer term instrument than is normal for a term deposit (typically five years compared to a few months). This represents greater risk for the investor, and is why returns are greater. Societies on administered or matched approaches have less sophisticated treasury management capabilities. Therefore, we confirm we do not expect these societies to have appropriate risk management capabilities to manage FRNs' inherent risks.

e) whether our expectations regarding term deposit limits at banks are related purely to deposit accounts or include other treasury instruments.

Our response: We have amended the text to clarify that when we refer to our expectation regarding term deposits we intend to include CDs.[12]

MTNs, FRNs and fixed rate bond holdings for societies on the extended approach are covered separately in the table. We do not expect societies on administered or matched approaches to hold MTNs, FRNs or fixed rate bonds.

2.9 One society asked why we had set a higher expectation for term deposits at building societies than for those at local authorities.

Our response: We accept that there is no more risk associated when depositing funds with local authorities than there is for inter-society deposits. Consequently, we have amended the parameters on local authority deposits upwards to match that for inter-society deposits.

12 CDs = certificates of deposit

2.10 We were asked by several societies and one trade association to clarify whether the CP09/17 proposals, together with the liquidity policy published in PS09/16, would result in the eight day liquidity regime being replaced.

Our response: We confirm that the new BIPRU 12 liquidity regime, as set out in PS09/16, will replace the current building society eight day liquidity regime.

Under the current eight day liquidity regime IPRU(BSOC) 5.2.4E provides an evidential provision, the breach of which would tend to establish contravention of GENPRU 1.2.26R. As explained in Annex B to CP09/17, IPRU(BSOC) 5.2.4E will be deleted as a result of introducing the new liquidity regime.

Wholesale funding

2.11 During meetings with larger societies we were asked to clarify how we intended to reconcile the expected maturity structure, wholesale funding metrics and sectoral limits within the wholesale funding table with the ILAS process for societies with standard ILAS requirements.

Our response: We agree that societies with standard ILAS requirements would consider these elements of their funding profile as part of the ILAS process. It is therefore unnecessary to include expectations for such societies within the BSOCS regime. We have removed the relevant details for societies on the standard ILAS regime.

2.12 Several societies questioned why we had set our expectation for wholesale funding with less than three months duration at a lower level than our expectation for total wholesale funding. They argued that most (or in some cases all) of the wholesale funding available to them was of three months duration or less; and that in practice our true expectation for wholesale funding was the lower figure.

Our response: Since we have now removed references to funding profiles for societies on the standardised ILAS approach (see above), these comments now only concern funding of societies on the simplified approach to ILAS.

Following the publication of CP09/17, the BIPRU liquidity regime was finalised and published. Once fully implemented, BIPRU will require societies on the simplified ILAS approach to always hold a liquidity buffer of eligible assets greater than or equal to the sum of:

- the wholesale net cash outflow component over the next three month period;
- the retail deposit component; and
- the credit pipeline component.[13]

So, a society on the simplified approach which raises wholesale funding of less than three months must increase their liquidity buffer assets by an equal and opposite amount. As a result, such funding cannot be used to fund lending activities. Because of this we believe societies on the simplified approach will either seek to identify new sources of longer term wholesale funding from which to fund lending or to restrict themselves to retail funding sources. However, this behavioural change is a consequence of the new BIPRU 12 liquidity regime, rather than CP09/17.

13 For full details see BIPRU 12.6.9R to BIPRU 12.6.10R

Because of these expected changes in behaviour, we have not amended the wholesale funding limit for societies on the simplified approach. However, to make BSOCS consistent with the BIPRU 12 liquidity regime, we have made it clear that the limits refer to wholesale net cash outflow (so, for example, societies who hold maturing treasury investments which match a maturing wholesale liability should net these off when looking at the tables).

2.13 Some societies were unclear whether the reference to the term of funding in this guidance referred to original or remaining term. Different societies made different assumptions when responding to the CP. We were also asked to clarify whether the expected limits was confined to wholesale funds from the financial markets, or included all wholesale funds (such as monies deposited in solicitors' client accounts).

Our response: We have now clarified that we intended:

- The maturity profile to refer to the remaining term of funding, not the original term (so, for example, we would expect a society on the administered treasury risk management approach, who wished to raise wholesale funding of 10% SDL to be repaid within 12 months, to adopt a forward looking approach to structuring its wholesale funding, e.g. by splitting such funding into two or more graduated segments with maturity dates more than three months apart, to ensure that, at any given time, a maximum 5% SDL has a maturity of less than three months); and
- the wholesale maturity ladder in BSOCS 4.5G refers only to wholesale funding from the financial markets.

2.14 We were asked why we did not expect societies on any of our five treasury approaches to use fixed rate bonds as funding instruments, why we expected issuance of commercial paper to be confined to societies on the comprehensive or trading approaches and why we thought only societies on the trading approach were likely to repo.

Our response: We have reconsidered this and agree that all societies on the extended, comprehensive or trading approaches might be expected to issue fixed rate bonds or commercial paper.

We would expect societies on the extended treasury risk management approach or above to have appropriate risk management capabilities to manage repo transactions. We also believe that some, but not all societies on a matched approach may have appropriate risk management in place. We have amended the wholesale funding table to indicate that societies on the matched approach should discuss plans with us before undertaking repos. We expect societies on more sophisticated treasury risk management approaches to enter into such transactions without previous supervisory discussion if they wish.

2.15 One society commented that it obtained material amounts of wholesale funding from non-financial sector sources such as universities, pension funds and local businesses. It queried how this would be treated in future.

Our response: Our expectation in this area was driven by the need for societies to avoid systemic risk, where funding from many participants from a particular sector might be withdrawn at the same time. We have amended our guidance to show that we would expect societies to set wholesale funding sub-limits for any source of wholesale funding, whether other building societies, local authorities or other sources of funding.

Financial risk management

2.16 Several responses referred to the current strong consumer preference for fixed rate lending, explaining that this was driven by the long-term trend for variable rates to move upwards in the medium term. They argued that in this climate societies who were unable to offer fixed rate products and would lose market share. Societies also argued that the lack of demand for administered rate lending, together with the current disinclination of customers on fixed or base-rate tracking mortgages to convert to administered rate mortgages, made it impossible for them to adjust their mortgage books to comply with our guidance in the current market.

Our response: Many smaller building societies have operated a very successful business model based on offering administered rate mortgages. Also, our policy proposal only aims at aligning the risk management capability and business models. As such we are not preventing societies from undertaking fixed or tracker lending. Instead, we are expressing an expectation that if they do so, they should have appropriate controls in place to manage the associated basis risk. If a society's business model exposes it to a significant amount of basis risk, we would expect it to develop treasury modelling and structural hedging capabilities to manage that risk, and to develop an interest rate view to enable it to develop and incorporate expectations of future interest rates into their risk management processes.

However, we accept that the basis risk (although present) is lower where fixed or tracker lending will shortly revert to an administered rate than where the reversion date is further away. As a result, we have amended our parameters, setting a lower expectation for the proportion of lending which is on administered rate for societies on the matched or extended approaches, but setting additional parameters for the proportion of their loan book which is 'either on administered rate or due to revert within the next twelve months'.

We recognise that if societies choose to change their business model and increase the extent of administered rate lending which they undertake (rather than choosing to develop their risk management capabilities) then it may take some time for them to adjust their overall mortgage book. We would expect any such societies to control the basis risk they are exposed to during this adjustment period appropriately.

Other

2.17 When CP09/17 was published, consultation on the new liquidity proposals suggested that the simplified buffer ratio would only be available to societies that met various criteria including 'the firm has no foreign currency exposure in assets or liabilities'.[14] Our guidance reflected our expectation that societies with an extended approach to treasury risk management which were on simplified buffer requirements should restrict their activities to sterling, whilst we expected those on the standard ILAS approach to restrict their business model to sterling, euros or United States dollars.

2.18 The liquidity rules in BIPRU 12.6.8 have widened the permissible assets somewhat, requiring simplified buffer ratio firms to have no less than 99.5% of the firm's total assets and no less than 99.5% of its total liabilities to be denominated in sterling, euros or United States dollars.

14 Quoting from paragraph 5.9 of Consultation Paper 08/22.

Our response: To remain consistent with BIPRU 12.6.8, we have increased the range of currencies to which we expect societies on the extended treasury risk management approach might choose to be exposed. Key changes are:

- societies on the extended approach to treasury management who apply the simplified buffer requirements may hold assets denominated in euros or United States dollars; and
- any societies on the extended approach to treasury management may choose to hold a small proportion of assets and/or liabilities denominated in currencies other than in sterling, euros or United States dollars.

Our expectation concerning societies on the administered and matched treasury risk management approaches, given their less sophisticated financial risk management, remains they will only fund in sterling.

2.19 In October 2009 the Bank of England announced that all firms required to report Eligible Liabilities to the Bank would be eligible to sign up for a Reserves Account and the other Sterling Monetary Framework facilities. Firms that are not required to place cash ratio deposits with the Bank will be required to pay a fee of £10,000 per annum if granted access to any SMF facility.

Our response: This extension applies to all building societies and we expect them to take advantage of this. We have accordingly amended the list of expected treasury instruments in the liquidity table.

3 Introducing supervisory approaches to credit risk management

Introduction

3.1 Chapter 2 of CP09/17 not only explained our proposal to extend the five models to financial risk management but also described proposals:

- to introduce new guidance on three lending approaches driven by different levels of sophistication of credit risk management control; and
- to require notification of other diversification.

3.2 In general, respondents accepted that a society should have systems and controls that matched their lending patterns, but questioned our lending categories. Several argued the proposals would severely restrict their business model and would cause lending profitability to substantially deteriorate. Societies were particularly concerned we were proposing one single threshold which covered all commercial lending, and argued the definition encompassed lending on many different types of property, with different risk profiles.

The new lending management proposals

Q4: Do you agree that it will be useful to building societies for us to extend our published guidance on how they might comply with SYSC 4.1.1 R and SYSC 7.1.2 R to cover control of the lending book?

Q5: Do the three models provide sufficient granularity of controls over the mortgage book? If not, please explain what further gradation could be introduced.

Q6: Are there any particular aspects of our proposed guidance which you believe risk placing building societies at a competitive disadvantage when compared to other financial institutions? If so, please describe what they are and which institutions you believe will be advantaged by this.

Granularity of lending guidance

3.3 Respondents had strong opinions on whether our lending guidance had sufficient granularity, but their views were not consistent. Many argued we were proposing a multitude of cross-cutting limits and sub-limits which threatened societies' underwriting flexibility. Others argued that many more sub-limits were needed, such as splitting commercial loan limits into professional premises, development finance, small shops, large factories etc. We also received comments that some commercial property, in particular guest houses, could easily be changed back into residential property and had a risk profile closer to residential lending.

Our response: We accept respondents' observations that commercial loans exhibited a variety of different types of risk profile. After further consideration we concluded that to set separate metrics for each sub-type of commercial lending was likely to prove confusing and may have unintended consequences. We therefore rejected this option. However, we have added text explaining our belief that there are broadly three types of commercial lending:

- owner occupied: e.g. an architect's office owned and occupied by a professional firm, or a retail shop with living premises owned and occupied by the retailer;
- development: e.g. a builder develops an estate of domestic properties for sale; and
- investment: commercial property held as a long term investment for a rental income stream.

We have expanded our guidance to explain which of these sub-categories we would expect societies on each of the three levels of credit risk management sophistication to be able to manage.

Segregation of duties guidance

3.4 Several societies asked us to clarify segregation of duties guidance.

Our response: We have clarified our guidance by describing the outcome we aim to achieve:

- segregation of the underwriting and mortgage sales function; and
- segregation of the underwriting function and the function(s) which check compliance with policy and legislation and which assess lending/underwriting quality.

Individual societies must then decide how they will allocate tasks, given their specific organisational structure.

Automated valuation models (AVMs)

3.5 Several respondents questioned our proposal regarding AVMs,[15] claiming it was unduly simplistic or not sufficiently clear on when such models might be appropriate.

Our response: After considering all comments, we have amended our guidance on using AVMs, and have provided more detail on when we believe these can be appropriate. We have also added a reference to the CRD[16] requirements on using AVMs to obtain valuations for input into capital calculations.

15 AVMs = automatic valuation models
16 CRD = Capital Requirements Directive

Mortgage Indemnity Guarantees (MIG) and other risk mitigation tools

3.6 Several respondents argued that MIG insurance was not readily available to smaller societies and that our proposals might therefore prevent societies lending at less than 80% loan to value (LTV). They argued that since these mortgages tend to be granted to first-time buyers, our proposals would disproportionately limit mortgage availability to this sector of the market.

3.7 One respondent argued that where MIG insurance was in place, the credit risk had been transferred from the building society to insurer. As such, high LTV mortgages with MIG in place should be considered within the same category as lower LTV mortgages. Other responses argued that obtaining alternative collateral was another means of mitigating the credit risk associated with high LTV.

3.8 We were also asked to clarify whether we expected societies to apply all the risk mitigation tools listed in the table 2.5.2G, or whether this was a range from which we expected societies to select some or all tools.

3.9 One respondent suggested that 'seasoned' high LTV mortgages, which borrowers had demonstrated they could afford over several years, should be reallocated to the lower risk category.

Our response: Our enquiries suggest that MIG is both available and being used by a variety of building societies of all sizes. We accept that where societies write very few high LTV mortgages the associated costs may be high, but we understand that several smaller societies have formed consortia to achieve the economies of scale necessary to make MIG practical.

We do not believe that requiring societies with less sophisticated credit risk management to obtain MIG for high LTV lending distorts the market to the detriment of first-time buyers. Any high LTV lending should price-in the associated risk. Whether a lender chooses to pass on that risk to a MIG provider or to retain it should be a secondary decision. Where societies do not have the risk capabilities to self-insure, we guide them to pass on the risk – but we do not believe the cost of doing this is substantially different from the true cost of self-insuring. Therefore, our proposals should support properly risk-priced lending.

We agree that obtaining MIG cover or alternative collateral are mitigants to the risk of loss-given-default risk associated with high LTV lending. Mortgages with MIG or alternative collateral should therefore be considered alongside mortgages of lower LTV lending, when considering loan book structure. We have amended the lending tables to reflect this. We have also amended our guidance to reflect the fact that societies may wish to undertake a small amount of higher LTV lending without MIG or alternative collateral.

We can also confirm that the different risk mitigants listed in 2.5.2G are a range of techniques from which we would expect societies to select some or all of them as they see fit.

We do not believe that seasoned high LTV lending becomes less risky for a society as the borrower proves they can afford the mortgage, since, as discussed in paragraphs 1.23-1.25 above, the risk is primarily associated with 'loss given default' rather than 'probability of default'. We do, however, agree that it would be reasonable for seasoned sub-prime lending to be re-categorised as prime after a number of years (if affordability has been demonstrated) since in the case of such lending it is affordability rather than loss given default which is the main risk factor. This has been reflected in the Handbook text, suggesting that societies may reclassify sub-prime lending as prime once it has been performing for five years.

Specialist underwriting skills

3.10 Many respondents stressed that the key to managing credit risk was to ensure that underwriting quality was strong. In particular, several respondents argued that they had developed specialist knowledge in a niche market (defined variously by location or product) which allows them to manage a loan book with a portfolio structure outside the range suggested by their lending approach.

Our response: The provisions of BSOCS offer guidance to the sector in general and describe one way, but not the only way, to comply with the high level requirements of SYSC. If societies believe they can demonstrate appropriate controls and expertise to manage the risks associated with an alternative business model, they are free to include this within their supervisory discussions.

Potential unintended consequences

3.11 Several respondents believed lending guidance could lead societies to take on more risk since, when they had 'filled up' their allowance of one lending sub-type (e.g. buy to let), they would feel they had to move on to another (e.g. commercial) regardless of whether they had knowledge of the associated risks.

Our response: These comments misunderstand what the guidance in paragraph 2.6.3G is trying to convey. It is not a model lending profile.

For each lending sub-type, the table indicates the point where we expect the society and supervisor to consider if risk management is appropriate for the lending activity and portfolio. We believe we addressed this when we clarified the status of guidance (see paragraphs 1.9-1.13 above).

Societies should not undertake lending in any sub-categories unless they have the appropriate risk management in place to ensure that the lending conforms to the risk appetite, risk controls and business strategy articulated by their senior management.

Social landlords and shared ownership lending

3.12 We were asked to explain why we expected societies with less sophisticated credit risk management capabilities to limit the amount of lending they advanced in these areas.

Our response: We have expanded our guidance to explain why the risk characteristics of lending to social landlords are more akin to commercial lending than to residential lending.

We have also provided some examples of ways in which shared ownership lending is administratively complex. Societies undertaking such lending should note that the Homes and Communities Agency will introduce revised wording for all new leases on shared ownership properties sold after 1st April 2010, designed to clarify and enhance the protection offered to lenders by the Mortgage Protection Clause.[17]

Other diversification

Q7: Do you agree with our proposal to ask societies to pre-notify the FSA of material diversification into other areas, and supply the requisite risk information and ICAAP?[18] If not, please explain why not.

Q8: Are there any additional instances where you believe societies should pre-notify the FSA?

3.13 Although respondents agreed with the principle behind our proposals about pre-notifying us of material diversifying into other areas, some questioned how this would work in practice.

3.14 We were asked to clarify whether our proposals applied to all diversification, or whether activities such as estate agency were excluded, as this is closely related to property sale and therefore has similar business cycles. We were also asked to define what we meant by 'investment' in regard to diversification; the timeframe during which the profit projection should be considered; and whether exit costs should be included in the calculation.

Our response: Societies should consider diversification as a move into any activity other than the sub-types of mortgage lending included in BSOCS 2.6.3G. As such, the proposed acquisition of an estate agency chain would be pre-notifiable, as would entry into any new type of mortgage lending not covered in BSOCS which may be developed by the mortgage industry at some time in the future.

Ideally, investment should be calculated as the discounted cash flow of budgeted costs associated with setting up the diversified operation, including losses expected until the break-even point is reached. However, we recognise that societies use different methodologies to appraise potential developments, and therefore we believe it is impractical to be prescriptive here. If societies are unsure whether a diversification falls within our guidance or not, we expect them to discuss it with their supervisor.

We do not normally expect costs to exit an area to be included in the discounted cash flow, since societies do not usually enter a market and withdraw soon after. However, if a society was planning to diversify into a new venture for a limited and predefined period then it would be appropriate to include exit costs in their calculation.

We expect societies to consider a three year horizon when projecting future profits, and have amended the text to reflect this.

3.15 Recently many societies have experienced low profitability or in some cases reported losses. Respondents questioned the practicality of using a 10% projected pre-tax profits criteria for notification in a low profitability environment.

17 For details of the new model lease, guidance and background societies should refer to:
http://cfg.homesandcommunities.co.uk/model-leases-for-housing-association-use-from-april-2010.htm
http://www.cml.org.uk/cml/policy/issues/166

18 ICAAP = Internal Capital Adequacy Assessment

Our response: We accept that the definition we included in the CP draft text would not reflect our policy intention where societies were projecting a particularly low profit or a loss. We have amended the definition to address this, by defining expected post implementation income in terms of 'net interest margin plus other income net of commission paid'. This figure is more stable through the economic cycle (since it excludes a variety of non-core and one-off costs, such as impairment charges and investment losses which can cause a society's profitability to vary considerably from year to year) and therefore represents a better basis from which to identify which diversification should be pre notified.

3.16 Several societies questioned whether the need to pre-notify might place them at a competitive disadvantage compared to other larger businesses, for example where a business opportunity to diversify arose (perhaps from the sale of a local business as a going concern). The building society would have to pre-notify us that it was considering entering that market, whilst other potential purchasers would not, thus giving them the advantage of being able to complete the transaction faster.

Our response: We recognise that due to their size there may be occasions where a potential diversification may be material to a building society and not material to, for example, a bank with which it is competing. Building societies may also face competition in some areas of diversification from entities which the FSA does not regulate. We will seek to be sensitive to commercial situations faced by societies, and are mindful of the need to minimise the adverse effects on competition. We believe, however, that there will be few occasions where material transactions are undertaken with such constrained timescales. Section 92A of the Building Societies Act 1986 may, in any event, impact the timescale for acquisition or establishment of a business by a building society. We believe that the guidance in chapter 6 of BSOCS is proportionate to benefits of pre-notification of material diversification at the earliest opportunity.

4 Feedback on cost benefit analysis and compatibility statement

Introduction

4.1 We published a cost benefit analysis (CBA) in Chapter 4 of CP09/17, which provided an assessment of the costs and benefits of the proposals, measured using our current rules and guidance as a baseline. We also published a compatibility statement in Chapter 5 of that CP, setting out our views on how the proposals were compatible with our objectives and the principles of good regulation.

4.2 This chapter provides feedback on comments received concerning those chapters, except where comments related to specific policy topics, in which case we have covered the points in Chapters 1 to 3.

4.3 We asked for responses to five questions in respect of our CBA and one in respect of our compatibility statement:

> Q10: Do you agree with our assumptions [that where controls and business model are not aligned, societies will generally choose to respond by changing their business model]? If not, please identify those areas where you believe societies will rather strengthen their control systems, and explain why you think they will make this choice.
>
> Q11: Do you agree that data is available and IT costs will be minimal? If not, please identify the major changes which might be necessary, and an estimate of the associated costs.
>
> Q12: Are there any other material general overhead costs which you would face as a result of our proposals? Please detail both what would cause the costs and an estimate of their value.
>
> Q13: Do you agree with [our cost benefit] analysis? If not, please explain why you believe we have under estimated the costs or over estimated the benefits.
>
> Q14: Are there any other material costs (actual or opportunity) which you believe will result from our proposals? Please identify what they are and the magnitude of cost that will result.

Q15: Do you agree that our proposed enhanced supervisory guidance on financial and credit risk management for building societies is compatible with our statutory objectives and principles of good regulation?

4.4 Very few respondents who provided feedback on our CBA answered these questions individually. Most provided a general paragraph discussing several points regarding costs. We have therefore arranged the rest of this chapter in terms of the main response themes, rather than the questions as originally posed.

4.5 Nine responses included detailed cost data regarding our proposals. Several others stated that they believed there would be substantial additional costs but were not able to quantify them, or were unable to separate them from the costs of other FSA policy initiatives – particularly the new liquidity regime in PS09/16.

4.6 We considered each of the quantitative responses in detail, in some cases asking societies to provide further detail of how they calculated their figures. We were therefore able to identify that in several instances the additional costs quoted were not the impact of the BSOCS proposals, but either related to the new liquidity regime or to unrelated managerial decisions within the respective society. We have not included such costs in our CBA considerations here but have, where appropriate, passed them to the relevant policy area for consideration.

4.7 We have made no changes that would increase costs subsequent to the CP. The main changes we have made which may lower costs for societies but will not increase them, are to:

- remove guidance on wholesale funding for standardised ILAS societies, where this duplicated supervisory conversations mandated under BIPRU 12;
- widen the range of treasury assets included in the extended approach;
- widen the range of funding instruments included in the more sophisticated treasury risk management approaches;
- give guidance that extended societies on the simplified may hold assets and liabilities denominated in United States dollars and euros as well as sterling;
- amend our criteria for notifying diversification, to ensure the guidance captures our policy intention in a low profitability environment; and
- clarify that MIG and other recognised collateral are acceptable mitigants to manage credit risks on high LTV and slightly relax our parameters regarding high LTV lending without MIG.

Assumptions made in the CBA

4.8 Several societies disagreed with our assumption that, in the event of a mismatch, societies would choose to change their product offering rather than strengthen credit risk management. They argued that since larger mortgage lenders have a price competitive advantage, societies had to compete on service or product differentiation. Therefore they would choose to strengthen risk management capabilities rather than change business model.

4.9 However, the only quantitative data we received on our lending proposals was based on the assumption that a society will withdraw from lending in the niche market they are currently active in. It did not consider the cost of strengthening credit controls to allow it to continue in its chosen niche.

Our response: We believe it is plausible that societies may choose to retain their niche markets and upgrade systems and controls to manage the associated risks, rather than adjust their business model. However, since societies are already operating their chosen business model they may already have controls to manage the associated credit risks in place. We are open to discussing this with societies as part of the self-assessment process.

We accept that if societies do not currently have appropriate mitigating controls in place to manage the credit risks associated with their business model, they will incur costs upgrading their capabilities. If they choose to do this instead of changing their business model this may suggest they are not complying with the current rules underpinning this guidance.

4.10 As explained above, some additional costs which respondents suggested would arise from our policy proposals, proved on further investigation to:

- result from other policy initiatives, published in PS09/16; or
- management decisions unconnected with our proposals.

Other costs fell into two main categories:

- one off costs to upgrade treasury technology capabilities and to complete the initial gap analysis process; and
- ongoing costs associated with increasing staffing levels to increase compliance and monitoring capabilities or to strengthen segregation of duties.

Our response: Using the societies' responses, we estimate that implementing our proposals might cost the sector £1m more in one-off costs than we originally estimated in our CBA. These additional costs primarily relate to buying new Treasury systems and other IT-related costs.

Societies also indicated they will face some new IT costs and will need to increase staffing resources. We estimate additional ongoing costs for the sector will be about £130,000 each year on IT infrastructure and £455,000 on additional staffing.

Costs and benefits of lending proposals

4.11 We received very few comments on the costs of our lending proposals although one society provided information on the lower interest rates it would earn if it ceased to lend in its chosen niche and reverted solely to prime lending.

Our response: As we have indicated, these proposals are guidance and not rules. We accept that societies may have developed a niche speciality which is not fully reflected in the approaches set out in the lending table. As long as a society demonstrates it has appropriate risk management systems and controls over that niche speciality, it is free to continue using its selected business model. Therefore, the costs that would result from a change in lending model do not result from the proposed BSOCS guidance.

Compatibility statement

4.12 Many respondents argued that these proposals would restrict building societies' abilities to compete with banks, and they were therefore incompatible with our objectives and the principles of good regulation. In particular, respondents commented that the same restrictions on lending did not apply to banks, which would leave building societies at a disadvantage in the mortgage market.

Our response: We consider that our proposals are consistent with the principles of good regulation.

As explained above, we do not intend to prevent building societies from undertaking any lending activity (subject to statutory constraints) as long as they have the appropriate credit risk management processes in place. The relevant high level rule in SYSC 4.1.1 R, which requires firms to have effective processes to identify, manage, monitor and report the risks it is or might be exposed to, applies equally to banks, building societies and all other mortgage providers. Similarly, the rule in SYSC 7.1.2 R requires a common platform firm to establish, implement and maintain adequate risk management policies and procedures applies to banks and building societies alike. Our BSOCS guidance is aimed at making transparent our expectations of how societies (who are subject to specific restrictions relating to their establishment, constitution and powers under the Building Societies Act 1986 and are, therefore, a relatively homogeneous group of entities) might apply the rules within their businesses.

As other deposit-taking mortgage lenders' ('non-banks') business models are dissimilar, we do not believe it is possible to develop similar sector-wide guidance for them. Instead, firms' compliance with SYSC will be assessed on an individual basis as part of the regulatory process. Since the requirement for mortgage providers to have effective processes to manage credit risk applies to all lenders operating in the mortgage sector, we do not believe building societies are disadvantaged by the increased transparency we offer them.

At present most non-banks have left the market and are not competing with building societies. However, as with banks, they must comply with the high level rules in SYSC. Although such compliance would currently be assessed on an individual basis, as part of the regulatory process we are currently considering a range of future regulatory levers for this type of lender. This includes imposing asset limits (see paragraph 3.54 to 3.55 of DP09/3: *The Mortgage Market Review*).

List of non-confidential respondents to CP09/17

Acadametrics

Beverley Building Society

The Building Societies Association

Cambridge Building Society

Chesham Building Society

Chorley Building Society

The Council of Mortgage Lenders

Coventry Building Society

Cumberland Building Society

Darlington Building Society

Dudley Building Society

Earl Shilton Building Society

Ecology Building Society

Furness Building Society

Genworthy Financial

Hanley Economic Building Society

Holmesdale Building Society

Ipswich Building Society

King & Shaxson

Leeds Building Society

Leek Building Society

Manchester Building Society

Market Harborough Building Society

Marsden Building Society

National Counties Building Society

Nationwide Building Society

Newbury Building Society

Nottingham Building Society

Philip Santo & Co

Principality Building Society

Saffron Building Society

Shepshed Building Society

Stroud & Swindon Building Society

Scottish Building Society

Sterling Consultants

Teachers Building Society

Timeline diagrams for applying the Sourcebook

	2010											
Simplified ILAS building societies	**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**
BIPRU systems and controls requirement (BIPRU 12.3 & 12.4)	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
BSOCS 6 month self assessment period (BSOCS 1.15.1G & 2.4.1G to 2.4.10G)				Y	Y	Y	Y	Y	Y			
IPRU(BSOC) provisions including 8-day liquidity	Y	Y	Y	Y	Y	Y	Y	Y	Y			
Other BIPRU 12 and reporting										Y	Y	Y
All other BSOCS provisions										Y	Y	Y
Full ILAS building societies												
BIPRU systems and controls requirement (BIPRU 12.3 & 12.4)	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
BSOCS 6 month self assessment period (BSOCS 1.15.1G & 2.4.1G to 2.4.10G)				Y	Y	Y	Y	Y	Y			
IPRU(BSOC) provisions including 8-day liquidity	Y	Y	Y	Y	Y							
Other BIPRU 12 and reporting						Y	Y	Y	Y	Y	Y	Y
All other BSOCS provisions						Y	Y	Y	Y	Y	Y	Y

Destination table for previous IPRU(BSOC) provisions

The provisions of the Interim Prudential sourcebook for Building Societies (IPRU(BSOC)) will either:

- move into the new Building Societies sourcebook (BSOCS);
- move into the existing Building Societies Regulatory Guide (BSOG);
- be deleted by FSA 2010/11 Building Societies Sourcebook instrument (BSOCS); or
- be deleted by FSA 2009/68 Prudential Sourcebook for Banks, Building Societies and Investment Firms (Liquidity) Consequential Amendments Instrument (the liquidity consequential).

The following table shows the intended destination of previous IPRU(BSOC) provisions (which have in some cases been modified; please see the Handbook text in Appendix 1 for full details).

IPRU BSOC ref	Deleted	Transferred to	
		BSOCS	BSOG
X.2.1R		1.1.1	
4.1.1		5.1.1	
4.1.1A		5.1.2	
4.1.2		1.1.2	
4.1.3		5.1.3	
4.1.4		5.1.4	
4.2.1		5.2.1	
4.2.2		5.2.2	
4.2.3		5.2.3	
4.2.4	Already deleted		
4.2.5		5.2.4	
4.2.6	Already deleted		
4.2.7	Already deleted		
4.2.8		5.2.5	
4.2.9		5.2.6	
4.3.1		4.1.1	

IPRU BSOC ref	Deleted	Transferred to	
		BSOCS	BSOG
4.3.2		4.1.2	
4.3.3		4.1.3	
4.3.4	Deleted by BSOCS		
4.3.5		5.3.1	
4.3.6		5.4.1	
4.3.7		5.4.2	
4.3.8 (1)		5.4.3 (1)	
4.3.8 (2)		5.4.3 (2)	
4.3.8 (3)	Already deleted		
4.3.8 (4)		5.4.3 (3)	
4.3.8 (5)	Already deleted		
4.4.1			1.2.3A
4.4.2-7			1.2.7 to 1.2.12
4.5.1		4.3.1	
4.5.2		4.3.2	
4.5.3		1.2.1	
4.5.4		1.2.2	
4.5.5		1.2.3	
4.5.6		1.4.1	
4.5.7		1.4.2	
4.5.8		1.4.3	
4.6	Already deleted		
4.7.1		5.5.1	
4.7.2		5.5.2	
4.7.3		5.5.3	
4.7.4		5.5.4	
4.7.5		5.5.5	
4.7.6		5.5.6	
4.7.7		5.5.7	
4.7.8		5.5.8	
4.8.1		5.6.1	
4.8.2		5.6.2	
4.8.3		5.6.3	
4.8.4		5.6.4	
4.8.5		5.6.5	
4.8.5A		5.6.6	
4.8.6		5.6.7	
4.8.7		5.6.8	
4.8.8		5.6.9 and 5.6.10	
4.9 1-6	Already deleted		
4.9.7		5.4.4	
4.10.1		5.7.1	
4.10.2		5.7.2	
4.10.3	Already deleted		
4A1.1		1.5.1	
4A2.1		1.6.1	
4A2.2	Deleted by BSOCS		

IPRU BSOC ref	Deleted	Transferred to	
		BSOCS	BSOG
4A2.3	Deleted by BSOCS		
4A 3.1		1.7.1	
4A 3.2	Deleted by BSOCS		
4A 3.3		1.7.2	
4A 3.4		1.7.3	
4A 3.5		1.7.4	
4A 4.1		1.8.1	
4A 4.2		1.8.4	
4A 4.3		1.8.5	
4A 4.4		1.8.6	
4A 4.5		1.8.7	
4A 4.6		1.8.8	
4A 4.7	Deleted by BSOCS		
4A 4.8	Deleted by BSOCS		
4A 5.1		1.9.1	
4A 5.2		1.9.2	
4A 5.3		1.9.3	
4A 5.4		1.9.4	
4A 5.5		1.9.5	
4A 6.1		1.10.1	
4A 6.2		1.10.2	
4A 6.3	Already deleted		
4A7	Deleted by BSOCS		
5.1.1	Liquidity consequential to delete		
5.1.1A	Liquidity consequential to delete		
5.1.2	Liquidity consequential to delete		
5.2.1 to 5.2.3	Already deleted		
5.2.4	Liquidity consequential to delete		
5.2.5	Liquidity consequential to delete		
5.2.6	Liquidity consequential to delete		
5.2.7	Liquidity consequential to delete		
5.2.8	Liquidity consequential to delete		
5.2.9	Already deleted		
5.3.1		3.2.2	
5.3.2	Deleted by BSOCS		
5.3.3	Liquidity consequential to delete		
5.3.4	Liquidity consequential to delete		
5.3.5	Deleted by BSOCS		
5.4.1	Liquidity consequential to delete		
5.4.2	Liquidity consequential to delete		
5.4.3	Liquidity consequential to delete		
5.4.4	Liquidity consequential to delete		
5.4.5	Liquidity consequential to delete		
5.4.6	Liquidity consequential to delete		
5.4.7	Liquidity consequential to delete		
5.5.1	Liquidity consequential to delete		
5.5.2	Liquidity consequential to delete		

IPRU BSOC ref	Deleted	Transferred to	
		BSOCS	BSOG
5.6.1		3.2.1	
5.6.2		3.2.4	
5.6.3		3.2.5	
5.6.4		3.2.6	
5.6.5		3.2.7	
5.6.6 to 8	Already deleted		
5.7.1	Liquidity consequential to delete		
5.8.1	Already deleted		
5.8.2		3.2.8	
5A	Deleted by BSOCS		
5B1.1		3.3.1	
5B2.1		3.3.2	
5B2.2		3.3.3	
5B2.3		3.3.4	
5B2.4		3.3.5	
5B2.5		3.3.6	
5B2.6		3.3.7	
5B2.7		3.3.8	
5B2.8		3.3.9	
5B2.9		3.3.10	
5C.1	Liquidity consequential to delete		
5C.2	Liquidity consequential to delete		
5C.3	Liquidity consequential to delete		
5C.4	Liquidity consequential to delete		
5C.5	Liquidity consequential to delete		

Handbook rules and guidance

BUILDING SOCIETIES SOURCEBOOK INSTRUMENT 2010

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 138 (General rule-making power);
(2) section 156 (General supplementary powers); and
(3) section 157(1) (Guidance).

B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force as follows:

(1) Annex B comes into force on 1 June 2010;
(2) the remainder of this instrument comes into force on 1 April 2010.

Amendments to the Handbook

D. The Glossary of definitions is amended in accordance with Annex A to this instrument.

E. The Interim Prudential sourcebook for Building Societies (IPRU(BSOC)) is amended in accordance with Annex B to this instrument.

Making the Building Societies sourcebook (BSOCS)

F. The Financial Services Authority makes the rules and gives the guidance in Annex C to this instrument.

Revocation of Interim Prudential sourcebook for Building Societies (IPRU(BSOC))

G. The provisions of the Interim Prudential sourcebook for Building Societies (IPRU(BSOC)) are revoked with effect from 1 October 2010.

Amendments to material outside the Handbook

H. The Building Societies Regulatory Guide (BSOG) is amended in accordance with Annex D to this instrument.

Citation

I. This instrument may be cited as the Building Societies Sourcebook Instrument 2010.

J. The sourcebook in Annex C to this instrument may be cited as the Building Societies sourcebook (or BSOCS).

By order of the Board
25 March 2010

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

Insert the following new definitions in the appropriate alphabetical position. The text is not underlined.

BSOCS	the Building Societies sourcebook.
SDL	(in *BSOCS*) the total of share and deposit liabilities, excluding amounts that qualify as *own funds* but including accrued interest not yet payable.
society	(in *BSOCS*) a *building society*.
1986 Act	(in *BSOCS*) the Building Societies Act 1986.

Amend the following definitions as shown.

contingency funding plan	(1)	…
	(2)	(in *BIPRU* 12 and *BSOCS*) a plan for dealing with liquidity crises as required by *BIPRU* 12.4.10R.
designated money market fund	(in *BIPRU* 12 and *BSOCS*) a *collective investment scheme* authorised under the *UCITS Directive* or which is subject to supervision and, if applicable, authorised by an authority under the national law of an *EEA State*, and which satisfies the following conditions: …	
early repayment charge	(in *MCOB* and *BSOCS*) a charge levied by the *mortgage lender* on the *customer* in the event that the amount of the loan is repaid in full or in part before a date specified in the contract.	
PD	(1)	…
	(2)	(in *GENPRU*, ~~and~~ *BIPRU* and *BSOCS*) *probability of default*.
qualifying money market fund	(1)	(in *COLL*, ~~and~~ *CASS* 7 and *BSOCS*) a *collective investment scheme* authorised under the *UCITS Directive* or which is subject to supervision and, if applicable, authorised by an

		authority under the national law of an *EEA State*, and which satisfies the following conditions:
		…
	…	
Society	(1)	(except in *BSOCS*) the society incorporated by Lloyd's Act 1871 by the name of Lloyd's.
	(2)	(in *BSOCS*) a *building society*.
subsidiary undertaking	…	
	(3)	(in *LR* and *BSOCS*) as defined in section 1162 of the Companies Act 2006.
trading book	(1)	…
	(2)	(in *BIPRU*, ~~and~~ *GENPRU* and *BSOCS* and in relation to a *BIPRU firm*) has the meaning in *BIPRU* 1.2 (Definition of the trading book) which is in summary, all that *firm's positions* in *CRD financial instruments* and *commodities* held either with trading intent or in order to hedge other elements of the *trading book*, and which are either free of any restrictive covenants on their tradability or able to be hedged.
	…	

Annex B

Amendments to the Interim Prudential sourcebook for Building Societies (IPRU(BSOC))

In this Annex, the following sections and provisions of IPRU(BSOC) are deleted. The text of the deleted sections and provisions is not shown.

Comes into force: 1 June 2010

IPRU(BSOC) ref

X.2 Application

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4.1 Introduction

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4.2 General

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4.3 Financial risks

Funding risks

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Structural risks

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Operational risks

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Key risk categories

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4.4 Statutory restrictions

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4.5 Supervisory approach

Funding limits

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4.7 Risk management systems

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4.9 Operational risk

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4.10 Independent review and controls

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4A.1 Supervisory approach categories

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4A.2 "Administered" approach

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4A.3 "Matched" approach

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4A.4 "Extended" approach

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4A.5 "Comprehensive" approach

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4A 5.4 G [deleted]

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4A.6 "Trading" approach

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4A7 G Summary of the five approaches [deleted]

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5.3 The Prudential Regime for Liquidity

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5.6 Board and Management Responsibilities

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5.8 Brokers' Advice

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Annex 5A

Prudential Liquidity

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Annex 5B

Policy Statement on Liquidity

5B.1 Overview

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5B.2 Policy Statement Contents

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Annex C

Building Societies sourcebook (BSOCS)

Insert the following new sourcebook before the Collective Investment Schemes sourcebook (COLL) in the block of the Handbook titled "Specialist Sourcebooks". The text is all new and is not underlined.

1 Introduction

1.1 Application and overview

Application

1.1.1 R The Building Societies sourcebook (*BSOCS*) applies to all *building societies*.

Purpose

1.1.2 G This chapter describes the key financial and lending risks to which *societies* are exposed and sets out the framework within which the *FSA* will supervise the treasury activities of *societies*. It includes details of the five treasury "approach" categories ("Administered", "Matched", "Extended", "Comprehensive" and "Trading") applied, as well as details of the three approaches to lending activities ("Traditional", "Limited" and "Mitigated"). The chapter emphasises the respective responsibilities of boards and management for monitoring and controlling financial risks and lending.

Other applicable provisions

1.1.3 G *Societies* should note that they must also comply with the applicable prudential *rules* in *GENPRU* and *BIPRU*. *Societies* should refer to *GENPRU* and *BIPRU* for full details of these *rules*.

1.1.4 G Unless otherwise stated, references in this sourcebook to "*society*" (except those that relate to *BIPRU* 12) are to "*society"* groups, consolidated to include all *subsidiary undertakings*. For the avoidance of doubt, any *undertakings* in the *society's* group that are subject to the requirements of *BIPRU* 12 must comply with those requirements on a solo basis.

1.2 Supervisory standards for treasury activities

Setting risk limits

1.2.1 G Under section 5 of the *1986 Act*, a *society's* principal purpose is that of making loans which are secured on residential property and are funded substantially by its members, not undertaking, and trading in, financial risk for profit. *Societies* should therefore 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* ("boards") should set risk limits which either:

(1) ensure that, as far as possible, exposures to changes in interest rates are minimised; or

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

1.2.2 G *Societies* should aim to eliminate, as far as is practicable, all exposures to risk arising from movements in currency exchange rates.

1.2.3 G (1) As explained in *BSOCS* 5.2.1G, a *society's* system for financial risk management should be adequate. The policy statement envisaged in *BSOCS* 5.2.4G should be appropriate for the *society's* business needs and the complexity of its existing and proposed treasury activities.

(2) The *FSA* has devised five models for financial risk management and treasury operations, described as supervisory treasury approaches, of increasing sophistication, to assist *societies*. The approaches are described as "Administered", "Matched", "Extended", "Comprehensive" and "Trading". A *society* that conducts its treasury activities in accordance with the most suitable (for it) of these five models, can readily demonstrate that it complies with the requirements of *SYSC* 4.1.1R, *SYSC* 7.1.2R and *SYSC* 7.1.4R in the context of financial risk management. But these models are neither mandatory nor exhaustive. Guidance on the characteristics of each approach is set out in *BSOCS* 1.5.

1.3 Supervisory standards for managing risks in the lending book

1.3.1 G Under section 6 of the *1986 Act*, *societies* are required to ensure that a minimum of 75% of their commercial assets is fully secured on residential property. Since residential 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.

1.3.2 G Accordingly, *societies* should 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 setting out the key underwriting policies and controls. As with financial risk limits, boards should aim to:

(1) ensure that, as far as possible, credit risks arising from lending are aligned with management risk appetite through careful underwriting; and

(2) ensure that any additional risk taken is appropriately priced and managed so that loss levels under stressed conditions would not compromise the current or future viability of their *societies*.

1.3.3 G The policy statement envisaged in *BSOCS* 1.3.2G should be appropriate for the *society's* business needs and the complexity of its existing and proposed lending activities. The *FSA* has devised three models for lending book management, described as supervisory lending approaches, of increasing sophistication, to assist *societies*. The approaches are described as "Traditional", "Limited" and "Mitigated". A *society* that conducts its lending activities in accordance with the most suitable (for it) of these three models can readily demonstrate that it complies with the requirements of *SYSC* 4.1.1R and *SYSC* 7.1.2R, in the context of loan book management. But these models are neither mandatory nor exhaustive. Guidance on the characteristics of each approach is set out in *BSOCS* 2.

1.4 Supervisory discussions on change of "approach"

1.4.1 G With regard to any of the five approaches to treasury risk and financial risk management, or the three approaches to managing the lending book, the *FSA* anticipates that *societies* will wish to develop further their expertise, and that a change of "approach" may be necessary. In this respect, the "approach" categories should 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. *Societies* should develop their risk management and systems to the level appropriate to support the scale and nature of their business and the *FSA* will be encouraging *societies* to enhance these capabilities where this is considered to be necessary.

1.4.2 G Whilst the "approach" benchmarks are not binding and are guidance only, the process of moving between approaches provides a useful opportunity for the *FSA* to review a *society's* progress, and to satisfy itself that policies, limits and systems are appropriate for the activities planned.

1.4.3 G Any *society* which wishes to move between the five approaches to treasury risk and financial risk management, or the three approaches to managing the lending book, should contact the *FSA* at an early stage. The *FSA* will wish to be satisfied that the *society* has the requisite expertise, management information systems, accounting systems and controls before any significant change in the *society's* treasury activities or lending policy is implemented.

1.5 Supervisory approaches to treasury management

1.5.1 G *BSOCS* 1.5 to 1.10 provide *guidance* on the five models, or supervisory approaches, to treasury management described in *BSOCS* 1.2.3G. Where *societies* have treasury operations in *subsidiary undertakings*, these should adopt the same approach category as that of the parent *society*. An outline description of each approach is set out in *BSOCS* 1.6 to 1.10, and tables at the end of each of Chapters 3 to 5 summarise the key features.

1.6 "Administered" approach

1.6.1 G *Societies* in the "Administered" approach category should have balance sheets where loan assets and funding liabilities are entirely in Sterling and predominantly (>95%) subject to administered rates. In general, it is anticipated that the "Administered" approach will tend to suit small or very small *societies* where balance sheet management is typically undertaken by the Chief Executive in conjunction with the board.

1.6.2 G S*ocieties* in this category should not hold any treasury investments, or issue any funding instruments, which contain complex structured optionality, whether this optionality relates to interest payable or receivable, instrument term or any other variable.

1.6.3 G It is likely to be appropriate for a *society* that falls into this category to apply for a *simplified ILAS waiver*.

1.7 "Matched" approach

1.7.1 G (1) *Societies* adopting the "Matched" approach should have balance sheets where assets and liabilities are entirely in Sterling and use hedging contracts (or internal matching of assets and liabilities with similar interest rate and maturity features) to neutralise the risk arising from loans or funding other than at administered rates, on a tranche by tranche, product by product basis.

(2) This approach is characteristic of small to medium sized *societies*, with limited treasury skills or resources. Typically the Chief Executive of such *societies* will be supported by a Finance Director or Finance Manager, and report direct to the board on treasury matters (or through an appropriate committee).

1.7.2 G The policies of such *societies* can allow use of standard hedging products for transactions permitted by section 9A of the *1986 Act*, for example:

(1) interest rate *swaps*; and

(2) plain vanilla *over the counter* ("OTC") options such as swaptions, caps, collars and floors (options purchased only);

for the purpose only of matching individual products and within the exemptions permitted by section 9A. Structural hedging of the whole balance sheet should not be permitted.

1.7.3 G Risk management for such *societies* should be achieved internally through:

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

(2) gap analysis; for gapping purposes, reserves will need to be treated as having no fixed repricing date, and gap limits should be set at the minimum level required to give flexibility in timing the hedges for individual mortgage and investment products, with some allowance for residual risks (those too small to be economic to hedge) and for holdings of fixed rate liquid assets. *Basis risk* should be minimised by setting cautious limits for fixed rate, bank base rate and any other market rate assets and liabilities.

1.7.4 G Gap monitoring reports should be updated and considered by the board at least monthly. By implication, *societies* adopting this approach should not be taking an interest rate view for the purposes of determining a hedging strategy.

1.7.5 G *Societies* in this category should not hold any treasury investments, or issue any funding instruments, which contain complex structured optionality, whether this optionality relates to interest payable or receivable, instrument term or any other variable.

1.7.6 G It is likely to be appropriate for a *society* that falls into this category to apply for a *simplified ILAS waiver*.

1.8 "Extended" approach

1.8.1 G The principal difference between the "Matched" and the "Extended" approaches lies in the capability to measure and hedge structural risk across the whole balance sheet, including reserves, rather than just hedging individual transactions. The approach will thus allow a *society* to allocate reserves to specific repricing bands representing a considered view of the characteristics of those reserves, and/or the assets deemed to "represent" them, or to manage interest rate gaps as part of a strategy for hedging the endowment effect of interest free reserves against adverse interest rate movements. Risk analysis should also enable it to position its balance sheet to take advantage of a particular interest view.

1.8.2 G The *FSA* expects that some *societies* on the extended approach will, subject to being able to satisfy the relevant conditions, elect to apply for a *simplified ILAS waiver* whilst others may choose to remain as *standard ILAS BIPRU firms*. For a *society* that is a s*tandard ILAS BIPRU firm*, the FSA will discuss with the *society* the maximum level of wholesale funding that the society should hold. A *society* that wishes to operate the *simplified ILAS* approach will need to satisfy the relevant conditions in *BIPRU* 12.6, including those relating to the minimum percentage of total liabilities accounted for by retail *deposits*.

1.8.3 G A *society* on the extended approach can potentially fund and hold assets denominated in Sterling, Euros or US dollars, whether it is a *simplified ILAS BIPRU firm* or a *standard ILAS BIPRU firm*.

1.8.4 G A *society* adopting the extended approach should:

(1) adopt policies and systems to enable it to undertake the hedging of individual transactions within the context of an overall strategy for structural hedging, based on detailed analysis of its balance sheet; and

(2) use the output of that analysis to enable it to position its balance sheet to take advantage of a particular interest view.

1.8.5 G Management of interest risk for such *societies* will typically be controlled by the board acting through an Assets and Liabilities Committee ("ALCO") or equivalent sub-committee, which will normally be responsible for agreeing any interest rate view. Reporting to the ALCO, there will typically be a Treasurer running a small treasury department with appropriate segregation between dealing and settlement activities.

1.8.6 G Hedging instruments available to be authorised by the board will be the same as for the "Matched" approach, with the addition of (as far as permitted by section 9A):

(1) *FRAs*/*futures*; and

(2) foreign exchange *swaps*/*forward* contracts/*options* (purchase only).

1.8.7 G Risk management systems should be based on full balance sheet gap analysis, possibly supplemented by static simulation.

1.8.8 G Gap limits could allow leeway for risk positions, to be controlled by sensitivity limits covering potential changes in both earnings and economic value.

1.9 "Comprehensive" approach

1.9.1 G The principal differences between the "Extended" and the "Comprehensive" approaches lie in:

(1) the depth and quality of the risk management systems put in place to monitor and control structural risk;

(2) the frequency of analysis undertaken; and

(3) the currencies in which treasury operations would be undertaken.

1.9.2 G Like the extended approach *societies*, comprehensive approach *societies* will manage risk using a board/ALCO/Treasurer reporting structure, but the latter will typically subdivide the treasury department further with a separate "middle office" risk management function, segregated from "front office" (dealing) and "back office" (settlement/accounting).

1.9.3 G Hedging instruments available for use under agreed board policy will include those for the extended approach plus (as far as permitted by section 9A):

(1) complex interest rate *swaps*;

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

(3) House Price Index *derivatives*; and

(4) credit *derivatives*.

1.9.4 G Risk analysis should extend beyond static gap/static sensitivity analysis to (for example):

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

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

(3) *value at risk*, using correlation/historic simulation and/or Monte Carlo simulation;

the impact on both earnings and economic value being assessed internally on a very regular basis.

1.9.5 G Risk positions could reflect an interest view, subject to sensitivity limits set by the board/ALCO and incorporating *basis risk* assessment/control. Foreign exchange mismatch (i.e. exchange rate exposure) should be subject to appropriate risk management over foreign exchange movements.

1.9.6 G It is likely to be appropriate for a *society* on the comprehensive approach to be a *standard ILAS BIPRU firm*.

1.10 "Trading" approach

1.10.1 G The "Trading" approach is a category for those *societies* which wish to take advantage of the ability to trade in securities. Essentially, those *societies* will adopt the comprehensive approach for the purpose of managing interest risk arising in their banking book, but with additional policies, financial instruments, systems and expertise for managing the *market risks* inherent in running a separate *trading book*.

1.10.2 G Such a *society* should control the additional *market risks* through a Market Risk Committee of the board and risk management systems should include complex portfolio management, option pricing and *value at risk* models.

1.10.3 G It is likely to be appropriate for a *society* on the trading approach to be a *standard ILAS BIPRU firm*.

1.11 Supervisory approach to managing the lending book

1.11.1 G *BSOCS* 1.12 to 1.14 provides *guidance* on the three models, or supervisory approaches, to managing the lending book described in *BSOCS* 1.3.3G. An outline description of each approach is set out at *BSOCS* 1.12 to 1.14 and the Tables at the end of *BSOCS* 2 summarise the key features.

1.12 "Traditional" lending approach

1.12.1 G *Societies* in the "Traditional" lending approach category should restrict their lending activities mainly to prime quality residential mortgages for owner-occupiers. The traditional approach should suit small or very 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.

1.12.2 G *Societies* adopting this approach should have board-approved lending policies that:

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

(2) limit other types of lending within the maximum 15% balance to prime owner-occupied >80% to <90% LTV without external insurance, prime buy to let, shared ownership, social landlords and secured commercial lending (including fully secured on land) only;

(3) require the use of approved independent valuers (in this context, independent valuer has the same meaning as in *BIPRU* 3.4.66R(2));

(4) 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

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

1.13 "Limited" lending approach

1.13.1 G The "Limited" lending approach is suitable for *societies* that have a slightly higher appetite for credit risk than those on the traditional approach. *Societies* adopting this approach should control the amount of risk assumed through a comprehensive system of policy limits. These limits will prevent the *society* from becoming over-exposed to non-traditional lending, and will take account of the differing risks associated with the type of lending and the type of security held. In general it is anticipated that the limited approach will tend to suit medium-sized and larger *societies* where:

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

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

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

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

1.13.2 G *Societies* adopting this approach should have board-approved lending policies that:

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

(2) set sub-limits, both in terms of total loan book and lending in a twelve-month period, for other types of lending within the maximum 35% balance; and

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

1.14 "Mitigated" lending approach

1.14.1 G The "Mitigated" lending approach is suitable for *societies* that undertake a diverse range of lending. *Societies* adopting this approach should mitigate their risk through sophisticated credit risk management systems that control the amount of risk assumed, both through a comprehensive system of policy limits and through the operation of stochastic risk models. In general it is anticipated that the mitigated approach will tend to suit only the largest *societies* where:

(1) there is a segregated and independent risk function reporting directly to the board (or a board-level committee);

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

(3) underwriting is independent of mortgage sales function;

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

(5) 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.

1.14.2 G *Societies* adopting this approach:

(1) should have board-approved lending policies that set appropriate limits, both in terms of total loan book and lending in a twelve-month period, for each type of lending; and

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

1.15 Review of financial risk management approach and assessment of lending approach

1.15.1 G *Societies* should perform an initial review of their current financial risk management approach in the light of the guidance in *BSOCS* and undertake a self-assessment of controls over their lending book in the light of the *BSOCS* lending criteria. Having done so, the *society* should inform its supervisor at the *FSA* in writing of the approaches that it considers are the ones most suited to its systems and controls for managing financial and lending risks, provide details of any features of its systems, controls or activities that fall outside the parameters of those approaches, and discuss with its supervisor what, if any, actions are needed on the part of the *society* to address these. This should be completed by 1 October 2010.

1.15.2 G The *FSA* recognises that, where the need to make changes to funding profile, treasury investments or lending profile to achieve compliance with *SYSC* is identified, it is likely that the move to achieve this will be gradual. The *FSA* will discuss with each *society* an appropriate period of time over which any realignment should be undertaken.

1.15.3 G Subsequent to this initial review, *societies* should continue to review the suitability of their allocated approaches as appropriate and speak to their supervisor at the earliest opportunity if they anticipate that their systems, controls or activities will fall outside the parameters of those approaches.

1.16 Interpretation

1.16.1 G In this sourcebook "administered rate" is defined as a rate of interest (which may be applied to lending or funding) which is, to the extent compatible with regulatory requirements and the general law, set from time to time at the discretion of the *society* and is not geared automatically to changes in an external reference rate, subject to the following:

(1) a *society* operating under the administered or matched approaches to financial risk management that chooses to set a contractual floor or cap should set nothing other than a floor (minimum rate receivable) on a rate charged on mortgages and/or a cap (maximum rate payable) on a rate payable to retail savers; these are the only limitations that may be applied to administered rate products allocated against the minimum policy limit; and

(2) a *society* not operating on either of the approaches in (1) may choose to include any guarantee in combination with an administered rate; it would however be expected to set appropriate sub-limits to control the level of basis and re-pricing risk taken, and to be able to evidence that it has assessed the cumulative impact of all such guarantees on its ability to vary rates generally as part of its regular stress and scenario testing programme.

1.16.2 G In this sourcebook "total loan book" is defined as total outstanding lending whether secured on property or unsecured.

1.16.3 G For the purposes of *BSOCS* 2.6.3G, loans to companies or partnerships secured on buy-to-let property should always be considered commercial.

1.16.4 G In this sourcebook reference to the term of any funding or treasury investment (including those held to comply with *BIPRU* 12) should in all cases be taken to mean the residual date to maturity.

1.16.5 G The status of the provisions in *BSOCS* is indicated by icons containing the letters R or G. Please refer to chapter six of the Reader's Guide for further explanation about the significance of these icons. The Reader's Guide can be found at

http://fsahandbook.info/FSA/pdf/rguide.pdf

2 Lending

2.1 Introduction

2.1.1 G (1) This chapter sets out *FSA guidance* on the management by *societies* of their lending, using the three approaches to lending set out in *BSOCS* 1, in order to enable them to comply with the requirements in *SYSC* 4 to *SYSC* 7. The chapter outlines factors the *FSA* will consider when assessing whether a *society* meets these requirements in relation to lending risk management.

(2) A list of the types of lending suitable for *societies* managing risk according to each of the three levels of lending risk management, together with appropriate controls, is set out in the tables at *BSOCS* 2.5.2G and 2.6.3G.

2.2 Risks of mortgage lending

Affordability

2.2.1 G The primary risk associated with mortgage lending is that the borrower will be unable or unwilling to service the loan. In this respect, some types of mortgage will present greater risks than others. In particular, risks are likely to be increased for lenders (and in some cases also for consumers):

(1) where repayment commitments represent an unusually high percentage of disposable income; or

(2) where an unusually large proportion of the borrower's income is variable; or

(3) where the borrower has an impaired credit history.

2.2.2 G *Societies* should ensure that they consider the risk profile of the different types of lending that they undertake, put sub-limits and other mitigating controls in place where they consider it appropriate and price their lending to reflect the perceived residual risks.

2.2.3 G (1) *Societies* should also consider when product features such as fixed mortgage rates expire and whether to set a maturity profile. If large numbers of mortgage loans revert to, for example, another base rate or a standard variable rate (SVR) simultaneously the *society* may experience operational strain dealing with the associated administration and customer queries.

(2) Also, if interest rates have changed significantly, *societies* may need to respond to a significant number of customers experiencing payment shock at the same time. In such a situation a *society* may experience a

profitability strain resulting from abnormally high redemption levels.

2.2.4 G Whilst non-sterling mortgages expose a *society* to foreign exchange risks (covered further within *BSOCS* 3 to 5) as well as all other risks which normally attach to mortgage lending, it may also expose the borrower to exchange rate risk which, if it crystallises, impacts on their ability to afford the loan. *Societies* (other than those with the most sophisticated lending risk management controls) should therefore set very conservative limits for such business, and confine such loans to borrowers with income denominated in the relevant currency.

2.2.5 G *Societies* must also comply with the general law and other regulatory requirements, including those in *MCOB* and the *Principles* for Businesses, relating to affordability and other aspects of granting a mortgage.

Valuation of security

2.2.6 G If a mortgage fails to perform, a *society* ultimately relies upon the value of its security to safeguard its interests, so the reliability of the value is important. The integrity, competence and expertise of the valuer are important, particularly where experience in more complex valuation areas (for example, related to commercial lending) is needed.

2.2.7 G 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 have an increased risk if local price drivers are not fully appreciated. S*ocieties* should consider this in setting their lending policy, balancing the potential risks against the advantages of lowering the concentration risk to which they might be exposed.

Automatic valuation models (AVMs)

2.2.8 G If a *society* proposes to use an automatic valuation model (AVM), either as part of its loan origination process or subsequent revaluation for credit decision purposes, it should do so within the terms of clear and well-considered policies. In doing so it should note that, in the calculation of the *credit risk capital component*, in relation to risk weights assigned to exposures secured by mortgages on residential property, *BIPRU* 3.4.77R requires that the "property shall be valued by an independent valuer at or less than market value" and that an independent valuer is defined in *BIPRU* 3.4.66R as a "person who possesses the necessary qualifications, ability and experience to execute a valuation and who is independent from the credit decision process." This means that, for those purposes, the use of AVM output must always fall within a process leading to a valuation that can be ascribed to an independent valuer.

2.2.9 G The *society* should also consider the limitations of AVMs before making a decision regarding whether an AVM is appropriate, particularly when the valuation plays an important role in the calculation of capital requirements. In determining a reasonable approach to AVMs a *society* should consider that:

(1) all AVMs have estimation errors;

(2) there are strengths and weaknesses of various AVMs. For example, many AVMs could be well suited to urban areas with many similar properties, but most will find it difficult accurately to value a property with little in common to those close by, for example in rural areas;

(3) AVMs should not be used to value non-domestic properties.

2.2.10 G The higher the LTV, the greater the risk that an over-valuation of the property could result in the *CRD* risk weighting being mis-stated. *Societies* should be particularly careful in those situations.

2.2.11 G If a *society* chooses to use AVMs, its lending policy should set out clearly when it intends to do so. For example, it may set a maximum LTV or loan amount. A *society* should also have procedures for reviewing its use of AVMs based on experience and market developments.

2.2.12 G Statistical methods, such as house price indices or AVMs, can also be used to monitor the value of a property, identify property that needs revaluation and amend valuations assigned to a property. The detailed rules concerning monitoring of property values for the purposes of calculating the *credit risk capital component* are contained in *BIPRU* 3.4.66R to *BIPRU* 3.4.71G. If AVMs are used in this way, the principles of AVM use are the same as for loan origination and *societies* should consider the appropriateness of AVMs to obtain a prudent value.

Non-traditional lending

2.2.13 G (1) Non-traditional lending can present additional risks, when compared with the more conventional prime owner-occupied lending model. *Societies* should recognise this within their risk assessment and management processes, procedures and lending policy.

(2) *BSOCS* 2.2.14G to 2.2.21G describe factors that *societies* should take into account in managing the risks associated with non-traditional lending; these are not exhaustive and not all points will be relevant to all *societies*.

Sub-prime lending

2.2.14 G Whilst the risk of default on sub-prime owner-occupied lending is initially greater than that for prime (all other things being equal) the *FSA* recognises that sub-prime borrowers may demonstrate affordability over time. In these circumstances, the *FSA* is content for *societies* to reclassify seasoned sub-prime lending as prime after five years (at the LTV at origination), if they wish to do so.

Buy-to-let

2.2.15 G (1) Whilst buy-to-let (BTL) lending is secured on residential property and therefore falls within the Building Societies Act nature limit (the statutory requirement that 75% of lending should be secured on residential property), it presents different risks to those of conventional residential mortgages to owner-occupiers.

(2) The *FSA* expects Boards and Management to recognise that existing experience and skills in residential mortgage lending do not simply transfer to buy-to-let and that the potentially significant differences in risk profile mean that different post-completion administration arrangements will be appropriate.

2.2.16 G A *society* undertaking BTL lending should, when determining its risk appetite, have regard to the underlying commercial nature of this type of business. Relevant factors which *societies* should consider and address within their lending policy include:

(1) the degree to which the investor borrower is dependent on the cashflow performance of the investment property to service the loan;

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

(3) what tenancy basis and kinds of BTL are acceptable;

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

(5) 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

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

(a) monitoring of exposures on a scheduled basis (e.g. annual review);

(b) 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.

Equity release: Lifetime Mortgages and Home Reversion Plans

2.2.17 G (1) *Lifetime mortgages* create a residential mortgage exposure (and fall within the nature limit) and also carry a morbidity risk associated with the potential deterioration of health of the borrower. In addition, those with interest roll-up features carry a mortality risk associated with the longevity of the loan, so their risks differ from conventional lending risks. Because of these risk characteristics the *FSA* would not expect limited approach *societies* to offer such products where any applicant is under 65, nor to extend loans greater than 25% LTV for borrowers of 65. If they wish to offer larger LTV advances to older borrowers they should ensure that they have appropriate actuarial expertise to enable them to assess the associated risks.

(2) *Home reversion plans* are likely to carry even more complex risks, since they not only have an actuarial risk but also expose lenders directly to variations in the market value of the property with which the individual plan is associated. As such, *societies* should enter those markets only if they have more sophisticated lending management control structures. In these circumstances, *societies* should set very conservative limits on the amount of such business that can be done.

Commercial lending

2.2.18 G (1) Commercial property may require different valuation skills to domestic property, and historically has a higher default rate than conventional owner-occupied lending. It may or may not fall within the nature limits, depending on whether the business of the commercial enterprise is to provide residential property.

(2) Commercial lending can be divided into three broad types, owner occupied, commercial developments and investments. Each of these broad types typically has different associated risk profiles and is likely to require different risk management capabilities.

(3) *Societies* on different lending approaches are likely to have different risk management capabilities with respect to the three types. S*ocieties* on the traditional approach should restrict themselves to owner-occupied commercial lending. The *FSA* would expect that *societies* on the limited approach might have the risk management capabilities to undertake small scale residential development (ten properties or less) or small scale commercial investments.

(4) Commercial lending may be "lumpy" in character, particularly that falling into the commercial investments category. When considering the risks associated with any commercial lending, *societies* should be mindful of the absolute size of individual loans, their absolute total exposure to commercial lending and the extent to which they are exposed to concentration risk, whether geographic concentration, concentration to particular counterparties or particular sectors of the economy.

(5) *Societies* should also 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. S*ocieties* on either the traditional or limited approach should not undertake any syndicated lending.

(6) *Societies* should also ensure that when undertaking commercial lending they establish that a realistic alternative use exists for the

property, in case they later have to enforce the security.

Social landlords (including Registered Social Landlords)

2.2.19 G (1) Lending to housing associations can be difficult to evaluate and for smaller *societies* these can represent significant sized loans. Whilst loans may be low LTV, the saleability of underlying properties varies and would usually not be with vacant possession. As such, *societies* considering such lending should consider not only the portfolio valuation but also the financial management record of the landlord, including arrears management and losses through voids. 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.

(2) As such, *societies* should 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.

Shared ownership lending

2.2.20 G Shared ownership lending can be more complex than mainstream mortgage lending. *Societies* will need to assess the borrower's ability to afford the loan, which may be more complicated than for traditional lending. In addition, 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. 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* should consider include (but are not necessarily restricted to) the following.

(1) 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.

(2) Security is held over the leasehold on the owned portion of the property, not the freehold. If the borrower fails to pay rent to the social landlord, the lease may be terminated by the landlord; if terminated then security for the loan would be lost. Whilst 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) *societies* should consider how they will manage such risk situations and decide as a matter of policy which if any costs they will consider paying.

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

2.3 Board and management responsibilities

2.3.1 G To comply with *SYSC* 4.1.1R and *SYSC* 7.1.2R, *societies* should have a lending policy. This should be agreed and formally approved by the board and be consistent with the *society's* strategic plan and its financial risk management policy statement.

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

2.3.3 G To comply with *SYSC* 4.1.10R (Regular monitoring), *societies* should check, on a regular basis, that staff are complying with this lending policy.

2.4 Lending policy

2.4.1 G This section provides guidance on the issues which should 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.

Contents of policy

2.4.2 G The introduction section should include:

(1) 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;

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

(3) arrangements for, and frequency of, review (which should be conducted at least on an annual basis).

2.4.3 G The objectives of the policy should cross-refer to the *society's* general statement of risk appetite (as set out in its *ICAAP* for Pillar 2 capital adequacy purposes), and should set out the *society's* general philosophical approach to lending.

2.4.4 G The policy should set out the *society's* business and operational characteristics, including:

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

(2) high level framework for ensuring compliance with *MCOB* and other regulatory requirements;

(3) delegation process and authorities;

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

(5) marketing and administration controls; and

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

2.4.5 G The risk management section should include a description of:

(1) the risk management structure and reporting lines;

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

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

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

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

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

(7) exposure limits for individual portfolios, including BTL portfolios;

(8) concentration risk exposure limits by product type, borrower type, security type, introducer and geographical area (expressed both in terms of the overall lending book and as a proportion of new lending in a given period);

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

(10) 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

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

2.4.6 G The lending permitted section should include details of the lending which the *society* intends to undertake by borrower and property/security type and origination source, including (as applicable):

(1) prime residential mortgage lending to individuals;

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

(3) buy-to-let mortgage lending to individuals and corporate bodies;

(4) shared-ownership residential lending to individuals;

(5) second-charge residential lending to individuals;

(6) *lifetime mortgage* lending to individuals;

(7) *home reversion plans* for individuals;

(8) commercial mortgages for owner-occupiers;

(9) commercial mortgages for investors (both individuals and corporate bodies);

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

(11) lending to registered social landlords; and

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

2.4.7 G The policy should also set out the acceptable types of security, including:

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

(2) the maximum original loan to value ratio permitted for each lending type;

(3) requirements for additional security such as guarantees, charges over other assets, life cover, accident/sickness/unemployment cover or for additional credit insurance (mortgage indemnity guarantee or similar) (including procedures for checking that such cover can be relied upon and is effective and checking the credit worthiness of the provider);

(4) requirements for buildings insurance cover; and

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

2.4.8 G The underwriting requirements for each type of loan should be specified in the policy, including:

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

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

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

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

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

(6) any requirements for third party references.

2.4.9 G The policy should set out the basis for pricing new lending, including:

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

(2) requirements for adjusting pricing to reflect risk;

(3) the approach to setting fees, routine charges and *early repayment charges*, etc; and

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

2.4.10 G The policy should be consistent with the provisions relating to conduct of business that apply to the *society* under the *Handbook* and the general law, including those in *MCOB* and the *Unfair Terms Regulations*.

Lending approach

2.4.11 G Having developed its lending policy statement, each *society* will be able to classify itself against one of the approaches set out in the table in *BSOCS* 2.5.1G and assess its lending types and lending limits against the guidance in *BSOCS* 2.6.1G.

2.5 Lending risk management structures

2.5.1 G The table in *BSOCS* 2.5.2G describes the type of controls that the management of *societies* should put in place (and where appropriate clearly document within their lending policy documentation) in each of the three lending models to manage lending risk.

2.5.2 G This table belongs to *BSOCS* 2.5.1G. It sets out guidance on credit risk management processes and procedures in accordance with the three lending approaches referred to in *BSOCS* 1.1.2G and dealt with in detail at *BSOCS* 1.11 to 1.14. It shows the criteria which *societies* should use in assessing the controls over their lending book, as detailed in *BSOCS* 1.15. It is designed to draw management and supervisory attention to areas of a *society's* credit risk management which are different from the *FSA's* general expectation for *societies* on their respective lending approach. *Societies* should expect their supervisors to focus in greater detail on those areas of difference, to identify whether business risks and controls are aligned and if not to develop plans to address the mis-alignment. As such, these expectations should not be interpreted as hard limits but as input into establishing appropriate policies and the basis for supervisory dialogue

	Traditional	**Limited**	**Mitigated**
Asset characteristics – high level	Mainly restricted to high quality lending to individuals, secured on residential property for owner-occupation purposes: • LTV <= 80% or with external insurance cover on higher LTV exposures or other recognised collateral • Fully underwritten • Restricted affordability criteria	A minimum of 50% of total loan assets to comprise high quality lending to individuals, secured on residential property for owner-occupation purposes: • LTV <= 80% or with external insurance cover on higher LTV exposures or other recognised collateral • Fully underwritten • Restricted affordability criteria Other lending controlled through structure of board-approved limits set at levels comfortably within statutory maxima.	Exposures to non-traditional lending allowed up to statutory maxima but controlled through: • Structure of board-approved limits (subject to *FSA* agreement) • Credit risk mitigation
Lending policy statement	Approved by board and reviewed at least annually		
Pricing model	Board to set clear hurdle return on new lending and articulate this through key operational plans Clear delegated responsibility for monitoring actual return achieved v hurdle on regular periodic basis		Board or appropriate committee to set clear hurdle return required on loan book as minimum approach – use of economic capital and risk-based return modelling encouraged
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 quarterly	Approved by board or credit risk committee (or similar) at least annually Reviewed to consider continued applicability at least quarterly
Risk management structure	If no dedicated risk management function, CEO/FD will fulfil this role	Risk management function (fully independent of lending and sales functions) reporting direct to CEO	Head of Risk function (senior executive) supported by risk management team, reporting to credit risk committee (or similar)
Loan exposure restrictions	Lending policy restricts exposure to connected counterparties to <= 10% of *capital resources*	Lending policy restricts exposure to connected counterparties absolutely to <= 15% of *capital resources*	Lending policy does not restrict exposures within statutory or regulatory limits
Underwriting	Cases fully underwritten on an individual basis	Independent underwriting function	Independent underwriting function

	Limited delegation under mandates Board to approve all loans where aggregate exposure to borrower and/or connected clients => 2.5% of *capital resources*	Cases underwritten individually or systematically credit scored Hierarchy of fully delegated mandates (with exception reporting to senior management) Appropriate specialist expertise for all categories of non-residential lending May use specialist anti-fraud systems	Cases systematically credit scored (with manual over-ride where appropriate) Hierarchy of fully delegated mandates *PD*/*LGD* modelling Portfolio underwriting Appropriate specialist expertise for all categories of non-residential lending Use specialist anti-fraud systems
Risk mitigation	Risks mitigated by combination of: • conservative LTV or external insurance on exposures > 80% LTV • other recognised collateral • restricted affordability criteria	Risks mitigated by combination of: • conservative LTV or external insurance on exposures > 80% LTV • other recognised collateral • stop-loss/excess of loss insurance	Risks mitigated by combination of: • external insurance (where used) • other recognised collateral • stop-loss/excess of loss insurance (or similar) at pool or portfolio level • credit default swaps • loan book sales
Valuations	Undertaken by independent valuer AVMs within parameters recorded in policy statement	Undertaken by external or staff valuer AVMs within parameters recorded in policy statement	Undertaken by external or staff valuer AVMs within parameters recorded in policy statement
Segregation of duty between:			
Underwriting function and mortgage sales function (providing "four-eyes" check over lending)	Segregation at executive manager level	Segregation at an operational level	Full segregation
Underwriting function and the lending review/audit/ compliance functions which check (1) compliance with underwriting and fraud policy and legislation; and (2) lending/ underwriting quality (by review of MI, live fraud cases, bad debt cases	Segregation at executive manager level	Segregation at an operational level	Full segregation

etc).			
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	

2.6 Lending types and lending limits

2.6.1 G Given the lending risk management controls and processes set out in the table at *BSOCS* 2.5.2G, the lending limits which *societies* following one of the three lending models have in their lending policy should resemble the table in *BSOCS* 2.6.3G.

2.6.2 G If a *society* plans to become exposed to mortgages of sub-types not covered in the table in *BSOCS* 2.6.3G, they should speak to their supervisor before entering the market, and again if their exposure reaches an agreed threshold to be set by the supervisor based on the perceived risk characteristics of the sub-type.

2.6.3 G This table belongs to *BSOCS* 2.6.1G. It sets out the criteria which *societies* should use in assessing the controls over their lending book, as detailed in *BSOCS* 1.15. It is designed to draw management and supervisory attention to areas of a *society's* business model which are different from the *FSA's* general expectation for societies on their lending approach. *Societies* should expect their supervisors to focus in greater detail on those areas of difference, to identify whether business risks and controls are aligned and if not to develop plans to address the mis-alignment. As such, these expectations should not be interpreted as hard limits but as input into establishing appropriate policies and the basis for supervisory dialogue.

	Lending types	**Normal loan to value at origination and other limits applying**	**Asset limits**	
			as % total loan book	as lending in rolling 12 month period
Traditional	Prime owner-occupier	<= 80% LTV, or >80% to 95% LTV with external insurance	Min 85%	Min 80%
		> 80% to <= 90% LTV without external insurance	Max 7.5%	Max 10%
	Prime Buy to Let	<= 70% LTV (min rental cover 130%, calculated assuming no void periods)	Max 15%	Max 20%
	Shared ownership	<= 90% of share purchased by borrower	Max 10%	Max 15%
	Social Landlords	<=80%	Max 7.5%	Max 7.5%
	Commercial/FSOL	<= 50%	Max 5%	Max 10%
Limited	Prime owner-occupier	In total	Min 65%	Min 55%

		of which:		
		<= 80% LTV, or >80% to 100% LTV with external insurance	Min 55%	Min 40%
		> 80% to <= 95% LTV without external insurance	Max 10%	Max 15%
	Prime Buy-to-Let	In total (min rental cover 125%, calculated assuming no void periods) Of which no lending > 80% LTV and	Max 25%	
		LTV between 60% and 80%	Max 20%	Max 20%
	Impaired credit history (all types)	<= 70%	Max 10%	Max 10%
	Lifetime mortgages	<= 25% (min age of youngest applicant => 65)	Max 10%	Max 15%
	Shared ownership	<= 95% of share purchased by borrower	Max 15%	Max 20%
	Social Landlords	<= 80%	Max 15%	Max 15%
	Commercial/FSOL	<= 60%	Max 10%	Max 15%
	Non-sterling mortgages	Only permitted where borrower also has income in relevant currency	Max 5%	Max 5%
Mitigated	Any lending permitted subject to statutory constrains and to lending policy set by management.			

In this table:

FSOL = fully secured on land

Shared ownership = part-owned by the occupier and part by a social housing provider. This does not include shared equity arrangements where the *society* takes part of the equity interest.

LTV is based at loan to value at origination and should be calculated after taking into account any alternative recognised collateral.

3 Treasury investments and liquidity risk management

3.1 Introduction

3.1.1 G (1) This chapter sets out the *FSA's* guidance specific to *societies* on management of their treasury investments, using the five approaches to financial risk management set out in *BSOCS* 1, in order to enable them to comply with *BIPRU* 12, *GENPRU* 1.2 and *SYSC* 4 to *SYSC* 7.

(2) The chapter outlines factors the *FSA* will consider when assessing the adequacy of a *society's* treasury investment risk management. A list of the types of asset suitable for inclusion as treasury investments for *societies* on each of the five levels of financial risk management capability is set out in the table at *BSOCS* 3.3.12G.

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

(1) assets held for inclusion in a *society's* liquid assets buffer as required by *BIPRU* 12.7;

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

(3) assets which management have decided to hold in order to generate income.

3.1.3 G The *guidance* in this sourcebook relating to treasury investments applies to all treasury investments, regardless of the reason for which they are held.

3.2 Board and management responsibilities over treasury activities

Degree of risk

3.2.1 G *BSOCS* 5 (Financial risk management) refers to the potential risks to *societies* of treasury activities. In particular, the size and complexity of some transactions can make them vulnerable to losses, and the impact of losses on individual transactions in the treasury area can be significant and immediate. 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.

3.2.2 G A *society* specialises in long-term mortgage lending which is financed mainly by liabilities which are contractually short-term. This feature of *societies*' business creates maturity mismatches which can give rise to cash flow imbalances. To ensure that it can meet its obligations as they fall due, a *society* is required to hold an adequate liquid assets buffer of the kind described in *BIPRU* 12.7.

3.2.3 G In addition to cash flow mismatches which occur over time, *societies* can face intra-day mismatches, as outflows may precede inflows. *Societies* should ensure that they manage this risk in full compliance with the intra-day liquidity management provisions of *BIPRU* 12.3.17R to 12.3.21E.

Liquidity policy statements

3.2.4 G (1) S*ocieties* should have a liquidity policy statement, which, among other things, includes the strategies, policies, processes and systems to manage *liquidity risk*, and the *liquidity risk* tolerance, required by *BIPRU*. *Rules* and *guidance* in relation to the responsibilities placed on a *society's governing body* to approve these strategies, policies, processes and systems and to establish and document a *liquidity risk* tolerance are set out in *BIPRU* 12.3.8R to 12.3.13G. The liquidity policy should be approved by the *society's* board and be consistent with the *society's* strategic plan and its financial risk management policy statement. *Societies* should also have regard to the *rules* and *guidance* in *GENPRU* 1.2, and *SYSC* 4 to *SYSC* 7.

(2) Where a *society* chooses to hold treasury investments other than for the purposes of its *BIPRU* 12 liquid assets buffer, then the *society's*

liquidity policy statement should include all such investments.

3.2.5 G Liquidity policy statements should set out the board's objectives for *liquidity risk* management, the limits within which liquidity should be maintained, the range of treasury investments in which the *society* can invest and conditions under which authority is exercised. The document should establish the framework for operating limits and high level controls, and should set out the board's policy on credit assessment, ratings and exposure limits. Further *guidance* on the content of liquidity policy statements is set out in *BSOCS* 3.3.

3.2.6 G A liquidity policy statement should be a working document and personnel in the treasury and settlement areas should be familiar with its contents, as should members of ALCO and/or the Finance Committee. When aspects of the policy or limits change, the policy document should be amended as frequently as necessary. The board should agree all substantive changes.

3.2.7 G Boards should establish the objectives for *liquidity risk* management, including meeting obligations as they fall due (including any unexpected adverse cash flow), smoothing out the effect of maturity mismatches and the maintenance of public confidence. The need to earn a return on treasury investments may also be recognised as an objective, although this should be secondary to the security of the assets. *Societies* should also have regard to the *rules* and *guidance* in *BIPRU* 12.

3.2.8 G If a *society* enters into a formal arrangement with a broker where securities are delivered to and from the broker and a customer agreement between the broker and the *society* is completed, the *society* should differentiate between advice and discretionary fund management. If the *society* has entered into an agreement involving the provision of advice, it should ensure that no transaction is undertaken without its prior consent. As with discretionary fund management, *societies* should make certain that all transactions are within the terms of its liquidity policy statement.

3.2.9 G *Guidance* on the content of a liquidity policy statement is set out in *BSOCS* 3.3. *Societies* may, for convenience, wish to combine their liquidity policy statement with documentation required to satisfy the provisions of BIPRU 12.4 relating to *contingency funding plan*s. If they do so, *societies* need to be clear how any combined document meets the separate requirements.

3.3 Liquidity policy statement

3.3.1 G This section provides *guidance* on the issues which should be addressed in a liquidity policy statement. The list of issues is not exhaustive and not all points will be relevant to all *societies*.

3.3.2 G The introduction section should include:

(1) background to the *society's* approach to *liquidity risk* management;

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

(3) arrangements for, and frequency of, review (which should be conducted at least on an annual basis).

3.3.3 G The objectives section should set out whether the *FSA* has granted the society a *simplified ILAS waiver* of the kind described in *BIPRU* 12.6. A *simplified ILAS BIPRU firm* should still have a full liquidity policy statement.

3.3.4 G The operational characteristics section should set out the *society's* business and operational characteristics, which impact on the amount and composition of liquidity and treasury investments, and the intended range for liquidity and liquidity net of mortgage commitments as a percentage of *SDL*.

3.3.5 G The risk management section should include:

(1) exposure policies, including controls and limits as appropriate, for countries, sectors and counterparties, including exposure to brokers;

(2) the policy adopted for the use of credit ratings, stating the minimum quality acceptable and procedures for ensuring credit ratings are up to date, together with other information such as market intelligence which should also be reviewed when considering how to make treasury investments;

(3) the policy of assessment to be adopted towards sectors that are non-rated;

(4) operational and settlement risk, including: framework of board authorisation, delegations and operating limits (including, inter alia, dealer limits, transaction and day limits); deal authorisation, confirmation checking, segregation of duties;

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

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

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

3.3.6 G The maturity structure section should include the policy for maturity mismatch and a "maturity ladder" of treasury investments. This should give a clear view of the maturity pattern of treasury investments to be followed, showing the maximum proportions to mature within each time band. In relation to a *society* which is a *simplified ILAS BIPRU firm*, there should be a clear policy with regard to managing the peak cumulative wholesale net cash outflow over the next 3 months in order that an adequate liquid assets buffer is maintained.

3.3.7 G The categories of assets and activities section should set out the *society's* policy for the following:

(1) assets held in the liquid assets buffer;

(2) inter-*society* and local authority deposits;

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

(4) *stock lending*;

(5) mortgage backed securities (including, where applicable, US) mortgage backed securities and *covered bonds*;

(6) foreign currency securities and the handling of foreign currency exposures (for those on the extended, comprehensive or trading approaches);

(7) commercial paper;

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

(9) collateral eligible for use in the Bank of England's open market operations and discount window facility.

3.3.8 G The *society's* policy for membership and use of any clearing system or depository should be set out clearly, including a section dealing with authorisation and operational controls.

3.3.9 G Liquidity implications and the role of standby facilities should be included in the policy statement.

3.3.10 G The role of external professional advisers should be clearly stated, where applicable.

3.3.11 G *Custody* arrangements should be clearly set out. If the arrangement is to use services provided by a broker then a *society* should ensure that it retains legal ownership of the investments.

3.3.12 G This table belongs to *BSOCS* 3.1.1G and sets out the criteria which *societies* should use in developing the review of financial risk management, as detailed in *BSOCS* 1.15. It is designed to draw management and supervisory attention to areas of a *society's* business model which are different from the *FSA's* general expectation for *societies* on their respective treasury management approach. *Societies* should expect their supervisors to focus in greater detail on those areas of difference, to identify whether business risks and controls are aligned and if not to develop plans to address the mis-alignment. As such, these expectations should not be interpreted as hard limits but as input into establishing appropriate policies and the basis for supervisory dialogue.

TREASURY INVESTMENTS

ADMINISTERED APPROACH		
TREASURY INVESTMENTS	Bank of England reserve account	No max
	Call deposits: bank	No max
	Term deposits: bank (includes CDs)	Max 15% *SDL*
	Term deposits: *societies*	Max 10% *SDL*
	Term deposits: Local Authorities/Regional Gvt	Max 10% *SDL*
	Gilts <3 years	No max
	Treasury bills	No max
	Designated money market funds	No max
	Qualifying money market funds	No max
Bank of England CAPACITY	Reserve account Standing deposit facility (if eligible)	
MINIMUM LIQUIDITY LIMITS	*Simplified buffer requirement*	
CURRENCY	Sterling only	

MATCHED APPROACH		
TREASURY INVESTMENTS	Bank of England Reserve account	No max
	Call deposits: bank	No max
	Term deposits: bank (includes CDs)	Max 15% *SDL*
	Term deposits: *societies*	Max 10% *SDL*
	Term deposits: Local Authorities/Regional Gvt	Max 10% *SDL*
	Gilts <5 years	No max
	Treasury bills	No max
	Designated money market funds	No max
	Qualifying money market funds	No max
	Reverse *repo* (Gilts only, after agreement with supervisor)	Up to limits above
Bank of England CAPACITY	Reserve account Standing deposit facility (if eligible)	
MINIMUM LIQUIDITY LIMITS	*Simplified buffer requirement*	
CURRENCY	Sterling only	

EXTENDED APPROACH		
TREASURY INVESTMENTS	Bank of England Reserve account	No max
	Call deposits: banks	No max
	Term deposits: banks (includes CDs)	Max 15% *SDL*
	Term deposits: *societies*	Max 10% *SDL*
	Term deposits: Local Authorities/Regional Gvt	Max 10% *SDL*
	Gilts <5 years	No max
	Gilts >5 years	Max 5% *SDL*
	Supranational Bonds <5 years	Max 5% *SDL*
	Treasury bills	No max
	FRNs, MTNs or fixed rate bonds <5 years	Max 5% *SDL*
	UK RMBS (senior securitised position only)	Max 5% *SDL*
	UK *covered bonds* (*CRD* compliant only)	Max 5% *SDL*
	Designated money market funds	No max
	Qualifying money market funds	No max
	Reverse *repo*	Up to limits above
Bank of England CAPACITY	Reserve account Standing deposit facility OMO counterparty (optional, subject to BoE acceptance)	

MINIMUM LIQUIDITY LIMITS	*Simplified buffer requirement* or *individual liquidity guidance* if a *standard ILAS BIPRU firm*
CURRENCY	No less than 99.5% of total balance sheet assets and liabilities denominated in Sterling, US$ or € (whether on *simplified buffer requirement* or *individual liquidity guidance* if a *standard ILAS BIPRU firm*)

COMPREHENSIVE and TRADING APPROACHES		
TREASURY INVESTMENTS	Self-defined list based on market depth and marketability (subject to satisfying the requirements of *BIPRU* 12)	Own defined limits
Bank of England CAPACITY	Reserve account Standing deposit facility OMO counterparty (subject to BoE acceptance)	
MINIMUM LIQUIDITY LIMITS	*individual liquidity guidance*	
CURRENCY	Any traded currency	

In this table:

CDs = certificates of deposit
FRN = floating rate note issued by bank or *building society*
ILAS = individual liquidity adequacy standards
MTNs = medium term notes
OMO = open market operations
RMBS = residential mortgage backed securities
Treasury Investments – all treasury investments including those held within the liquid assets buffer as required by BIPRU 12.7

In relation to minimum liquidity limits, a *society* that is a *simplified ILAS BIPRU firm* should note that the *simplified ILAS* approach does not relieve a *simplified ILAS BIPRU firm* from the obligation to hold liquidity resources which are adequate for the purpose of meeting the *overall liquidity adequacy rule* or from the obligation in *BIPRU* 12.3.4R to assess and maintain on an ongoing basis the adequacy of its liquidity resources.

4 Funding

4.1 Funding risks

4.1.1 G *Societies*' core business, financing long-term residential mortgages with short-term personal savings, necessarily involves a high degree of maturity transformation, and this constitutes a major financial risk that all *societies* need to manage.

4.1.2 G Wholesale markets may provide funding at a more definitive maturity than deposit funding, but may concentrate the refinancing risks *societies* face. Exposure to re-financing risk needs careful management, and an awareness of the risk of over-reliance on an assumption of continued access to the wholesale market.

4.1.3 G The particular constitution of *societies* means that the scale of deposit funding has a significant impact on the position of investor members. The public perceives *society* share accounts to be as secure as (or even more secure than) bank deposits although they hold a subordinated creditor rank. A *society* which gears itself up significantly with wholesale funds thereby dilutes the security of its members, whilst at the same time increasing its refinancing and *liquidity risks*.

4.1.4 G To access the wholesale markets some *societies* have been credit-rated by external agencies. Obtaining such a rating exposes the *society* to the danger of a change in market view of the sector or the *society*, and the process of obtaining and continuing management of the rating needs careful consideration and monitoring. The *FSA* would not expect *societies* on the Administered or Matched approaches to have external ratings, and would expect *societies* on the extended approach, if they have external ratings at all, to confine them to *covered bond* issues only.

4.2 Wholesale maturity structure for a society which is a simplified ILAS BIPRU firm

4.2.1 G For *simplified ILAS BIPRU firms BIPRU* 12.6.10R sets out how they should calculate the wholesale net cash outflow component of their *simplified buffer requirement*.

4.2.2 G Whilst a *society* which is a *simplified ILAS BIPRU firm* may choose to fund lending activities with wholesale funding of duration greater than three months, such funding will still influence the peak cumulative wholesale cash outflow position (and thus the *simplified buffer requirement*) when it is within three months from maturity. *Societies* using wholesale funding should therefore manage their wholesale maturity profile so that it does not cause excessive volatility to their liquid assets buffer.

4.2.3 G To achieve this, a *society* which is a *simplified ILAS BIPRU firm* should ensure that its maturity profile of wholesale funding, net of any maturing treasury assets held to redeem the funding, resembles the respective profiles in *BSOCS* 4.5.1G.

4.3 Funding limits

4.3.1 G (1) Whilst the section 7 funding limit is expressed as a minimum of 50% share account funding, *societies* should, for prudential monitoring purposes, draw up a funding policy which incorporates an internal policy limit based on a maximum level of funds raised by means other than the issue of shares (i.e. an inversion of the "nature limit"). In order to avoid any possibility of an inadvertent breach of the *1986 Act*, these internal policy limits should be set at levels below the 50% statutory maximum.

(2) Similarly, one of the conditions in *BIPRU* 12.6 to be satisfied by a *firm* for it to be eligible for a *simplified ILAS waiver* is that a minimum percentage of the *firm's* total liabilities are accounted for by retail *deposits*. The funding policy drawn up by a *simplified ILAS BIPRU firm* should include an internal policy limit referring to a maximum percentage of the *firm's* total liabilities accounted for by liabilities other than retail *deposits* (i.e. an inversion of the condition in *BIPRU* 12.6). This maximum percentage should be set at a level below that necessary to satisfy the conditions in *BIPRU* 12.6.

4.3.2 G (1) In setting funding limits, the board should consider all funding requirements over the period of their *society's* current corporate plan, and avoid setting limits at levels where usage is either unplanned or highly unlikely.

(2) Wholesale funding can be divided into three broad types originating from different sources: offshore/overseas retail deposits up-streamed to the *society*, deposits from non-financial / non-individuals and wholesale funding from the financial markets.

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

4.4 Repurchase (repo) transactions (including reverse repo)

4.4.1 G The *FSA* would expect that *societies* adopting the extended, comprehensive or trading approaches to treasury management are likely to have the systems and capabilities to transact *repo* business. The *FSA* would expect that their boards would obtain full legal advice before agreeing counterparty documentation.

4.4.2 G Whilst *societies* on the matched treasury risk management approach may have appropriate treasury risk management controls and procedures to undertake *repo* transactions, they should discuss any such plans with their supervisor before undertaking those transactions.

4.5 Funding risk management table

4.5.1 G This table sets out guidance for wholesale funding in accordance with the five approaches (see *BSOCS* 1.1.2G). It shows the criteria which *societies* should use in developing the review of financial risk management, as detailed in *BSOCS* 1.15. It is designed to draw management and supervisory attention to areas of a *society's* business model which are different from the *FSA's* general expectation for *societies* on their respective treasury management approach. *Societies* should expect their supervisors to focus in greater detail on those areas of difference, to identify whether business risks and controls are aligned and if not to develop plans to address the mis-alignment. As such, these expectations should not be interpreted as hard limits but as input into establishing appropriate policies and the basis for supervisory dialogue.

WHOLESALE FUNDING FROM FINANCIAL MARKETS

ADMINISTERED APPROACH		
WHOLESALE FUNDING FROM FINANCIAL MARKETS - OVERALL & SECTORAL LIMITS	Total Wholesale	Max 10% *SDL*
	Any single sector source	Max 5% *SDL*
MATURITY STRUCTURE OF WHOLESALE NET CASH OUTFLOW FROM FINANCIAL MARKETS	< 3 mths	Max 5% *SDL*
	< 12 mths	Max 10% *SDL*
FUNDING INSTRUMENTS	Term deposits and facilities	
EXTERNAL RATINGS	No	
Bank of England CAPACITY	Standing lending facility (if eligible) Discount window (if eligible)	
CURRENCY	Sterling only	

MATCHED APPROACH		
WHOLESALE FUNDING FROM FINANCIAL MARKETS – OVERALL & SECTORAL LIMITS	Total Wholesale	Max 15% *SDL*
	Any single sector source	Max 7.5% *SDL*
MATURITY STRUCTURE OF WHOLESALE NET CASH OUTFLOW FROM FINANCIAL MARKETS	< 3 mths	Max 5% *SDL*
	< 12 mths	Max 10% *SDL*
FUNDING INSTRUMENTS	Term deposits and facilities *Repo* (after agreement with supervisor)	
EXTERNAL RATINGS	No	
Bank of England CAPACITY	Standing lending facility (if eligible) Discount window facility (if eligible) OMO counterparty (optional, subject to BoE acceptance)	
CURRENCY	Sterling only	

EXTENDED APPROACH		
WHOLESALE FUNDING FROM FINANCIAL MARKETS - OVERALL & SECTORAL LIMITS		
For *societies* wishing to operate the *simplified ILAS* approach	Total Wholesale	See conditions in *BIPRU* 12.6
	Any single sector source	Max 7.5% *SDL*
For *standard ILAS BIPRU firms*	Total wholesale and sector limits as agreed individually	
MATURITY STRUCTURE OF WHOLESALE NET CASH OUTFLOW FROM FINANCIAL MARKETS		
For *societies* wishing to operate the *simplified ILAS* approach	< 3 mths	Max 5% *SDL*
	< 12 mths	Max 15% *SDL*

	< 2 years	Max 20% *SDL*
For *standard ILAS BIPRU firms*	As agreed individually	
FUNDING INSTRUMENTS	Term deposits and facilities CDs FRNs Fixed rate bonds *Covered bonds* Securitisations CP *Repo*	
EXTERNAL RATINGS	*Covered bonds* only	
Bank of England CAPACITY	Standing lending facility Discount window facility OMO counterparty (optional, subject to BoE acceptance)	
CURRENCY	No less than 99.5% of total balance sheet assets and liabilities denominated in Sterling, US$ or €	

COMPREHENSIVE APPROACH	
W/SALE FUNDING FROM FINANCIAL MARKETS - OVERALL & SECTORAL LIMITS	Total wholesale and sector limits as agreed individually
MATURITY STRUCTURE OF WHOLESALE NET CASH OUTFLOW FROM FINANCIAL MARKETS	As agreed individually
FUNDING INSTRUMENTS	Term deposits and facilities CDs FRNs Fixed rate bonds *Covered bonds* Securitisations CP *Repo*
EXTERNAL RATINGS	Yes
Bank of England CAPACITY	Standing lending facility Discount window facility OMO counterparty (subject to BoE acceptance)
CURRENCY	Any traded currency

TRADING APPROACH	
WHOLESALE FUNDING FROM FINANCIAL MARKETS - OVERALL & SECTORAL LIMITS	Total wholesale and sector limits as agreed individually
MATURITY STRUCTURE OF WHOLESALE NET CASH OUTFLOW FROM FINANCIAL MARKETS	As agreed individually
FUNDING INSTRUMENTS	Bank loans B Soc loans LA loans CDs FRNs Fixed rate bonds *Covered bonds* Securitisations CP *Repo*
EXTERNAL RATINGS	Yes

Bank of England CAPACITY	Standing lending facility Discount window facility OMO counterparty (subject to BoE acceptance)
CURRENCY	Any traded currency

In this and subsequent tables: **CDs = certificates of deposit** **CPs = commercial paper** **FRNs = floating rate notes** **ILAS = individual liquidity adequacy standards** **LA loans = local authority loans**

5 Financial risk management

5.1 Introduction

5.1.1 G This chapter contains guidance for *societies* on financial risk management which supplements the high level requirement in *SYSC*.

5.1.2 G As part of the implementation of the *Capital Adequacy Directive* (*CAD*), the *Banking Consolidation Directive* (*BCD*) and the Markets in Financial Instruments Directive (*MiFID*), provisions relating to a *society's* organisational and risk systems and controls have been introduced in *SYSC* 4 to *SYSC* 7. The guidance in this chapter generally explains the application of the high level requirements in *SYSC* 4 to *SYSC* 7 (even if there may not be a specific cross reference) in the context of financial risk management.

5.1.3 G *Rules* and *guidance* on interest rate risk in the banking book are contained in *BIPRU* 2.3. Under these requirements a *society* should evaluate the effect of a standard interest rate shock specified by the *FSA* in that chapter. The result should be taken account of in the *ICAAP*.

5.1.4 G *Societies* with a *trading book* will also be subject to a market risk capital requirement calculated in accordance with *BIPRU* 7. This is unlikely to be applicable to any *societies* apart from those on the "Trading" approach: see *BSOCS* 1.10. A *society* with foreign currency exposures will however be subject to the foreign exchange capital requirements in *BIPRU* 7 whether or not it has a *trading book*.

5.2 General

Systems for controlling and managing financial risks

5.2.1 G In meeting the requirements of *SYSC* 4.1.1R and *SYSC* 7.1.2R 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.

Systems for controlling index-related risks

5.2.2 G The arrangements, processes, and mechanisms required in *SYSC* 7.1.3R should include systems and procedures for identifying, monitoring and controlling all material maturity mismatch, interest rate, base rate, foreign exchange and similar (e.g. index-related) risks, and for reporting exposures to senior management and the board of the *society* on a regular, and timely, basis. *Societies* should also have interest margin management systems in place to estimate the expected profitability of new mortgage and savings products, and to project forward the cumulative effect of mortgage incentives and loyalty schemes.

Credit limits for counterparties

5.2.3 G *Societies* should have credit limits in place for all counterparties both for making treasury investments and for transacting *derivative* contracts (further *guidance* also in *GENPRU* 1.2 and *BIPRU* 12.4: stress testing and scenario analysis, and *contingency funding plans*).

Policy statement on financial risk management

5.2.4 G In meeting the requirements in *SYSC* 7.1.4R in the context of financial risk management, the board of a *society* should approve and periodically review a policy statement on financial risk management.

5.2.5 G The policy statement establishes guidelines for the *society's* senior managers on the control of financial risks, including: *operational risk*; structural risk; funding risk; and *counterparty credit risk* (including settlement). These documents should be consistent with the type of business undertaken by the *society* and compliant with sections 7 and 9A of the *1986 Act*.

Policy statements on strategic framework for treasury operations

5.2.6 G Policy statements should set out the strategic framework for treasury operations, recording the rationale for that framework, i.e. why and how treasury activities are expected to support the *society's* core business, and the "approach" category being followed, derived, where possible, from the results of a financial risk review (either by the *society's* internal audit function or using external resources). They should clearly state the conditions under which authority is delegated to a board sub-committee, or to management, and should establish the operating limits and high level controls that will maintain exposures within levels consistent with the policy, and the procedures/controls on the introduction of new products or activities. Copies of the policy statements should be made available to, and read by, all personnel involved in treasury operations.

5.3 Structural risks

5.3.1 G Most *societies* are susceptible to interest rate exposure arising not only as a result of changes (or potential changes) in the general level of interest rates or the relationship between short term and long term rates, but also from divergence of rates for different balance sheet elements (*basis risk*), for example, the risk that it may not be possible to decrease administered savings rates in line with decreases in money market (LIBOR) rates, resulting in a margin squeeze where lending is LIBOR-based. In this chapter, risks which arise from the different interest rate or currency characteristics of assets and liabilities, and from transactions based on other financial reference rates or indices, are referred to as "structural" risks.

5.4 Operational risks

5.4.1 G The extension of *society* activities into more complex forms of funding, liquidity and off balance sheet instruments has dramatically increased the *operational risks* involved. The documentation, accounting treatment and settlement procedures for such instruments can be highly complex, with significant costs and penalties arising from operational mistakes. *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, and that deal recording and settlement systems are effective (with appropriate contingency arrangements in place).

Key risk categories

5.4.2 G The key financial risks which, as envisaged in *BSOCS* 5.2.1G, *societies* should manage and control, are:

(1) maturity mismatch, including the risks:

(a) that the *society* may be unable to refinance term wholesale borrowings on a rollover date due to general market conditions (which may or may not be related to the position of the *society* itself);

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

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

(d) arising from the prepayment (early repayment) profile of mortgages, and those inherent in the early withdrawal characteristics of retail savings products (i.e. behavioural as opposed to contractual maturity risks);

(2) interest rate risk to a *society's* earnings (most significantly, to its interest margin) and to its economic value (the present value of future

cashflows) arising from:

(a) repricing mismatches, e.g. 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 with interest rate movements (e.g. gilts), and unhedged fixed rate retail products (e.g. unhedged fixed rate mortgages funded by variable rate liabilities would yield less margin should the cost of the liabilities increase due to changes in market rates);

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

(c) interest basis mismatches, arising from the imperfect correlation of rates on instruments with similar repricing characteristics, e.g. between LIBOR rates and mortgage rates (both of which are variable but are subject to different market forces), or between LIBOR and reference gilt rates, or between 3 and 12 month LIBOR rates etc. Risk can also arise where the underlying market rate is the same for matching assets and liabilities, but the margin paid relative to the offer rate diverges from the margin received relative to the bid rate;

(d) balance sheet composition, where an increase in the proportion of assets and liabilities repricing at fixed or variable wholesale market rates implies a reduced administered rate element in the balance sheet, which will nevertheless have to bear (at least in the short term) the full brunt of any rate changes required in order for a *society* to widen its margins, if necessary for business or profitability reasons (e.g. in the event of a significant credit deterioration leading to rising provision levels);

(e) optionality (i.e. 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 embedded/implied options included within products, such as early withdrawal or redemption entitlements), magnifying the effect of other interest rate risks: in particular, *societies* may be subject to implied optionality in respect of retail savings rates (for which a minimum rate payable - a “floor” - above 0% may need to be assumed), and from prepayment of mortgages/pre-withdrawal of deposits (where the *customer* may effectively have an “option” which may not be adequately “hedged” by way of *early repayment charges*); and

(f) product pricing, arising particularly where products are not immediately profitable and where longer term payback is dependent upon the achievement of specific cost and/or pricing assumptions;

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

(4) index-related risk, arising from the effects of movements in an index of financial assets (e.g. the FTSE 100), or similar reference rate, on unmatched assets or liabilities paying or receiving a return based on that index/rate.

5.4.3 G *Societies*' financial risk management policies should also cover:

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

(2) counterparty risk: associated with settlement risk, where a counterparty cannot or will not complete a transaction; and

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

IT security

5.4.4 G Reliance on computerised dealing, information, treasury management and risk assessment systems renders *societies* particularly vulnerable to software or hardware failure. Boards of *societies* should:

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

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

(3) involve internal audit in reviewing the development or modification of treasury IT systems.

5.5 Risk management systems

5.5.1 G The *guidance* in this section amplifies *SYSC* 7.1.2R and *SYSC* 7.1.3R specifically in the context of treasury management. A *society* should have in place information systems that are capable of:

(1) measuring the level of maturity mismatch and structural risk inherent in its balance sheet;

(2) assessing the potential impact of interest rate (and, if applicable, currency exchange rate) changes on its earnings and its economic value (including the effect of any standard interest rate shock as specified by the *FSA* in *BIPRU* 2.3);

(3) reporting accurately, and promptly, on risk positions (to management, to the board and, if requested, to the *FSA*) including generating the information necessary to carry out its *ICAAP* and reporting the results of stress testing for interest rate risk in the banking book;

(4) recording accurately, and on a timely basis, all new transactions and/or cashflows which will affect calculations of structural risk exposures;

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

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

5.5.2 G The scale and scope of the risk measurement system employed should reflect the sophistication of a *society's* treasury operations, those *societies* wishing to adopt more sophisticated approaches requiring more complex techniques to capture different facets of risk.

Control limits

5.5.3 G Control limits confine structural risk positions within levels considered by board and management to be prudent, given the size, complexity and capital needs of the *society's* business. Where applicable, limits should also be applied to individual instrument types, asset/liability portfolios, and to separate business activities or *subsidiary undertakings*. Limits should also cover both the quantum and term/run-off of positions and should take due account of the extent to which margins are constrained, limiting business flexibility.

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

5.5.5 G The number and type of limits which should be applied will depend upon the relative sophistication of a *society's* treasury operations, and further *guidance* on the *FSA's* expectations for each policy approach is set out in *BSOCS* 1.6 to 1.10.

5.5.6 G Where limits are set as part of the overall board policy, these should be treated as absolute. Therefore any limit exceptions should be reported immediately to executive managers, and the policy should make clear what action is expected of management in those circumstances (including arrangements for informing the board and the *FSA* of the breach). Limits set by management should similarly be subject to clear guidelines covering the circumstances and periods for which breaches may be permitted (if at all) and the arrangements for notification of exceptions.

Stress testing

5.5.7 G (1) The risk measurement systems put in place should evaluate the impact, on income or economic value as appropriate, of abnormal market conditions. The amount and type of the stress testing required will depend upon the sophistication of treasury operations undertaken, and the level of risk taken, but where required should be regular and systematic. 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 should, periodically, review the extent of that stress testing to ensure that any "worst case" scenarios remain valid. Contingency plans should be in place to deal with the consequences should those scenarios become reality.

(2) *Rules* and *guidance* on stress testing and scenario analysis are in *GENPRU* 1.2 and *BIPRU* 2.2. Material on this subject specifically relating to *liquidity risk*, including liquidity *contingency funding plans*, is in *BIPRU* 12.4. Requirements for stress testing for interest rate risk in the banking book are set out in *BIPRU* 2.3.

Board information reporting

5.5.8 G The *FSA* 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 should include regular and systematic stress testing, as described above, which should be taken into account when policies and limits are established or reviewed.

5.6 Counterparty risk

5.6.1 G Counterparty limits should cover:

(1) full risk exposures (e.g. deposits or marketable instruments);

(2) *market risk* exposures (e.g. mark to market positive value of *swaps*, plus appropriate addition for potential future exposure increases arising from changes in market rates); and

(3) settlement risk exposures (e.g. currency deals where amounts are paid out before funds are received).

5.6.2 G Boards should determine the extent to which authority to set counterparty limits is delegated to management, but delegation to a single individual should not 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 a pre-approved limit.

5.6.3 G Limits should be established on the basis of a robust methodology, which should be fully documented and reviewed regularly. For *societies* with more active treasury operations, a separate credit risk committee with responsibility for preparing a credit policy statement and counterparty list may be appropriate; less active *societies* may incorporate a section on credit risk within their liquidity policy statements, with appropriate cross-references to other policy and procedures statements. In all cases, the counterparty list and individual limits should be subject to formal credit review at least annually, with interim arrangements in place to add, amend or remove limits as appropriate.

5.6.4 G (1) If reliance is placed on sources of information or opinion external to both the *society* and the counterparty (e.g. rating agencies), the nature of the source, and arrangements for ensuring that the information relied upon is kept up to date, should be made explicit in the credit risk policy document and in procedures manuals.

(2) Where ratings are reduced (or put on "watch" with "negative implications"), or where a *society* becomes aware of information on a counterparty which might affect its perceived creditworthiness (whether or not this results in a rate change), it should have systems for reviewing individual counterparty limits and, possibly, suspending or removing individual names from authorised lists in an expeditious manner.

(3) Arrangements for obtaining information on counterparties where this is in the public domain should also be included in procedures manuals.

5.6.5 G Exposures to counterparties should 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 should be monitored continuously against agreed limits.

5.6.6 G The guidance in this section complements the high level rules and guidance on credit and counterparty risk in *SYSC* 7.1.9R to *SYSC* 7.1.11R.

Large shareholdings and deposits

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

5.6.8 G A small *society* is relatively more exposed to this type of risk, and should consider the implications of concentration on individual shareholders or depositors when assessing its liquidity levels and need for committed facilities. In the management of large retail investment accounts, a *society* should normally avoid:

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

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

Committed facilities

5.6.9 G A *society* with high levels of maturing funding, or vulnerability to withdrawal of individual deposits, may consider arranging committed facilities (or maintain higher than average levels of liquidity). In arranging committed facilities, a *society* should consider:

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

(2) the documented basis of the commitment (i.e. is it an unconditional commitment or a "best endeavours" arrangement); and

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

5.6.10 G 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, and face the legal consequences (if any) rather than lend money to a *society* in difficulties. *Societies* should not, therefore, become over reliant on committed facilities to plug short term cashflow difficulties and should be cautious on how any such facilities should be treated in stress testing.

5.7 Independent review and controls

Internal audit

5.7.1 G The *guidance* in this section amplifies *SYSC* 6.2.1R in the context of treasury management. Each board should ensure that its *society's* internal audit department (if it has one) has the skills and resources available to undertake an audit of the treasury function. Internal audit should 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 should assess the effectiveness of treasury management procedures.

5.7.2 G *Societies* with complex treasuries or lacking internal auditors with treasury expertise may outsource treasury audit to an audit firm with the appropriate expertise and experience. The work of outsourced internal audit should be fully integrated into the *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 the *society's* own external auditors, even if the function were to be performed by a completely different branch of the audit firm.

5.7.3 G This table sets out guidance on financial risk management processes and procedures in accordance with the five approaches (see *BSOCS* 1.1.2G). It shows the criteria which *societies* should use in developing the review of financial risk management, as detailed in *BSOCS* 1.15. It is designed to draw management and supervisory attention to areas of a *society's* treasury risk management which are different from the *FSA's* general expectation for *societies* on their respective treasury management approach. *Societies* should expect their supervisors to focus in greater detail on those areas of difference, to identify whether business risks and controls are aligned and if not to develop plans to address the mis-alignment. As such, these expectations should not be interpreted as hard limits but as input into establishing appropriate policies and the basis for supervisory dialogue.

FINANCIAL RISK MANAGEMENT

ADMINISTERED APPROACH	
RISK MANAGEMENT	CEO (+FD/FM) & Board Dealing / settlement segregation (4 eyes)
RISK ANALYSIS	None (but MTM fixed rate liquid assets at least monthly)
FIXED RATE LENDING/FUNDING	Commercial assets: Minimum 95% on administered rates Liabilities: Minimum 95% *SDL* on administered rates No fixed rate lending > 1 year
COUNTERPARTY LIMITS	Single name/connected group limits UK Counterparties only Instrument type and maturity limits
HEDGING INSTRUMENTS	None
TREASURY SYSTEMS/CONTROLS	Management accounting system Internal Audit

MATCHED APPROACH	
RISK MANAGEMENT	CEO + FD (or FM) & Board Dealing / settlement segregation (4 eyes)
RISK ANALYSIS	Matching Report + (min mthly) Gap Analysis Minimal gap/NPV limits (to cover residuals, prepayment and pipeline only) No structural hedging (incl reserves) No interest rate view *Basis risk* report
FIXED RATE LENDING/FUNDING	Commercial assets: A minimum of 65% either on administered rates or due to revert to administered rates in the next 12 months, and of that a minimum 50% already on administered rates. Liabilities: Minimum 65% *SDL* on administered rates Fixed rate lending/funding max 5 yrs to reprice date (subject to limits). Max stock fixed rate (> 1 yr) 20% commercial assets + 20%SDL Max fixed rate lending/funding 25% loans advanced/retail funding p.a.
COUNTERPARTY LIMITS	Single name/connected group limits Country limits Instrument type and maturity limits

HEDGING INSTRUMENTS	Match funding Vanilla interest rate *swaps* Vanilla interest rate caps/collars/floors (purchase only) FTSE *swaps* (receive only)
TREASURY SYSTEMS/CONTROLS	Management accounting system Simple treasury matching system Internal Audit

EXTENDED APPROACH	
RISK MANAGEMENT	(CEO)/FD + Treasurer ALCO Front Office + Back Office
RISK ANALYSIS	Monthly (min.) static gap (+ static simulation modelling) Gap limits Sensitivity limits (NPV & NII) Structural hedging Reserves hedging (strategic) Interest rate view No FX mismatch *Basis risk* modelling
FIXED RATE LENDING/FUNDING	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 30% already on administered rates. Liabilities: Minimum 45% *SDL* on administered rates
COUNTERPARTY LIMITS	Single name/connected group limits Country limits Sector limits Instrument type limits Currency limits
HEDGING INSTRUMENTS	Match funding Vanilla interest rate *swaps* (purchase only) 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)
TREASURY SYSTEMS/CONTROLS	Treasury IT system capable of modelling optionality in static balance sheet. Specialist IT and Treasury Internal Audit

COMPREHENSIVE APPROACH	
RISK MANAGEMENT	FD + Treasurer (+Risk Director) ALCO + Daily Treasury Committee Front + Middle + Back Office
RISK ANALYSIS	Very frequent dynamic balance sheet modelling (future flows) Multiple scenario & yield curve simulation modelling with sensitivity limits (NPV & NII) *Basis risk* modelling Internal transfer pricing systems Structural hedging Reserves hedging (strategic) Interest view FX mismatch < 2% *own funds*

FIXED RATE LENDING/FUNDING	Commercial assets: Minimum 30% on administered rates Liabilities: Minimum 30% *SDL* on administered rates
COUNTERPARTY LIMITS	Comprehensive limit structure
HEDGING INSTRUMENTS	Match funding Complex interest rate *swaps* Complex interest rate caps/collars/floors (purchase only) Swaptions (purchase only) HPI *derivatives* (purchase only) Credit *derivatives* (purchase only) *FRAs*/*Futures* (purchase only) FTSE *swaps* (receive only) FX *swaps*/*forward* contracts (purchase only) FX *options* (purchase only)
TREASURY SYSTEMS/CONTROLS	Treasury IT system capable of projecting forward balance sheet and simulating different interest rate environments, plus measuring embedded optionality, *basis risk* etc. Specialist IT and Treasury Audit

TRADING APPROACH	
RISK MANAGEMENT	FD + Treasurer (+Risk Director) ALCO + Daily Treasury Ctee Front + Middle + Back Office Banking + *Trading books*
RISK ANALYSIS	Banking book: daily (min) duration / simulation analysis. Multiple yield curves and interest rate basis. Structural & reserve hedging Interest rate view. *Trading book*: Valuation at risk and equivalent measures. Daily P&L (MTM). Product, currency, counterparty limits. Dealing position limits etc.
FIXED RATE LENDING/FUNDING	No limits
COUNTERPARTY LIMITS	Comprehensive limit structure, including cross banking and *trading book* limits
HEDGING INSTRUMENTS	Any available (subject to *the 1986 Act* s9A restrictions on use)
TREASURY SYSTEMS/CONTROLS	Treasury IT system capable of projecting forward balance sheet and simulating different interest rate environments, plus measuring embedded optionality, *basis risk* etc. *Trading book* systems Specialist IT and Treasury Audit

In this table:

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

6 Business model diversification

6.1 Pre-notification of business model diversification

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

(1) which is not covered by the *BSOCS* tables; and

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

should pre-notify the *FSA* and provide a board-approved best/worst case analysis of the risks and potential exit costs, together with a revised *ICAAP* for supervisory review and evaluation before proceeding, whether the proposed diversification is by acquisition or by investment to enter an area or facilitate organic growth.

6.1.2 G *Societies* should also note the provisions of section 92A of the *1986 Act* in relation to acquisition or establishment of a business.

BSOCS TP - Transitional provisions

(1)	(2)	(3)	(4)	(5)	(6)
	Material to which the transitional provision relates		**Transitional provision**	**Transitional provisions: dates in force**	**Handbook provisions: coming into force**
1.1	*BSOCS* (other than *BSOCS* 1.15.1G and *BSOCS* 2.4.1G to 2.4.11G)	R	In relation to a *society* which as at 30 November 2009 was subject to *IPRU(BSOC)*, the *rules* and *guidance* listed in column (2) do not apply until 1 June 2010.	1 April 2010 to 31 May 2010	1 April 2010
1.2	*BSOCS* (other than *BSOCS* 1.15.1G and	R	In relation to a *society* which as at 30 November 2009 was subject to *IPRU(BSOC)* and which as at 31 May 2010 is a *simplified ILAS*	1 June 2010 to 30 September	1 April 2010

	BSOCS 2.4.1G to 2.4.11G)		*BIPRU firm*, the *rules* and *guidance* listed in column (2) do not apply until 1 October 2010.	2010	
1.3	The changes to *IPRU(BSOC)* set out in Annex B to the Building Societies Sourcebook Instrument 2010	R	In relation to a *society* which as at 30 November 2009 was subject to *IPRU(BSOC)* and which as at 31 May 2010 is a *simplified ILAS BIPRU firm*, the changes effected by the Annex listed in column (2) do not apply.	1 June 2010 to 30 September 2010	1 June 2010

Schedule 1 Record keeping requirements

Sch 1.1 G There are no record-keeping requirements in *BSOCS*.

Schedule 2 Notification requirements

Sch 2.1 G There are no notification requirements in *BSOCS*.

Schedule 3 Fees and other required payments

Sch 3.1 G There are no requirements for fees in *BSOCS*.

Schedule 4 Powers Exercised

Sch 4.1 G

The following powers and related provisions in or under the *Act* have been exercised by the *FSA* to make the *rules* in *BSOCS*:	
	section 138 (General rule-making power)
	section 156 (General supplementary powers)

Sch 4.2 G

The following powers in the *Act* have been exercised by the *FSA* to give the *guidance* in *BSOCS*:	
	section 157(1) (Guidance)

Schedule 5		**Rights of action for damages**
Sch 5.1	G	There are no rules in *BSOCS* which give rights of action for damages.

Schedule 6		**Rules that can be waived**
Sch 6.1	G	There are no rules in *BSOCS* that can be waived.

Annex D

Amendments to the Building Societies Regulatory Guide (BSOG)

After BSOG 1.2.3G insert the following new text. The text is not underlined.

1.2.3A	G	Section 7 of the 1986 Act provides that at least 50% of the funds (excluding those qualifying as own funds) of a society (or, if appropriate, of the society's group) must be raised in the form of shares held by individual members of the society (excluding share accounts held by individuals as bare trustees for corporate bodies).

After BSOG 1.2.6G insert the following new text. The text is not underlined.

Structural risk management restrictions

1.2.7 G Section 9A prohibits a society or its subsidiary undertakings (subject to certain defined exemptions) from:

(1) acting as a market maker in securities, commodities, or currencies;

(2) trading in commodities or currencies; or

(3) entering into any transactions involving derivative investments.

1.2.8 G Section 9A contains definitions of the above terms, and societies are directed particularly to section 9A(9) for the purposes of compliance monitoring.

1.2.9 G Section 9A also includes a "purpose" test for entering into derivatives contracts and a "safe harbour" clause for society counterparties stating that any transaction in contravention of the section 9A prohibitions is not, however, thereby invalid and may be enforced against the society.

1.2.10 G The exemptions in section 9A fall into two broad categories:

(1) those which allow a society or subsidiary undertaking to provide certain retail services to its customers, including:

(a) acting as market maker in currency or securities transactions of less than £100,000;

(b) trading in currencies (but not commodities) up to a value of £100,000 per transaction;

(c) entering into "contracts for differences" in respect of customers who wish to hedge exposures arising from their own loans or deposits with the society or a connected undertaking; or

(d) acting as market maker or entering into derivative investments in its capacity as manager of a collective investment scheme; and

(2) those which allow a society or subsidiary undertaking to use derivative investments in order to limit the extent to which it, or a connected undertaking, will be affected by changes in interest rates, exchange rates, any index of retail prices, any index of residential property prices, any index of the prices of securities, or the creditworthiness of any borrower(s).

1.2.11 G The Treasury may, by negative resolution order, amend the £100,000 transaction limit and may add factors to, or remove factors from, the list in *BSOG* 1.2.10G(2). The factor relating to credit worthiness was added to the original list in section 9A(4)(b) by the Building Societies (Restricted Transactions) Order 2001 (SI 2001/1826). The Treasury may, by affirmative resolution order, make more significant amendments to section 9A.

1.2.12 G Boards should have procedures and controls to ensure that use of section 9A exemptions by their society (and subsidiary undertakings, if any) is within the law. The exemptions permitting transactions of up to £100,000 (as market-maker in currency or securities transactions, or trading currencies) may not be abused by artificially breaking up larger transactions into a number of smaller amounts falling within the £100,000 ceiling (section 9A(8) is the relevant anti-avoidance provision). Compliance with the *1986 Act* may be assisted by specifying the purposes and circumstances in which hedging transactions may be undertaken, or derivatives used, both in the financial risk management policy documents and in the internal arrangements for delegation, identifying the specific authority in section 9A. Whatever the hedging policies adopted, and however the control and authorisation arrangements are organised, it is important that they should be accurately and fully documented.

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