

Our response to the FSA's "Strengthening capital standards 3", CP 09/29

Introduction

The Building Societies Association represents mutual lenders and deposit takers in the UK including all 52 UK building societies. Mutual lenders and deposit takers have total assets of over £390 billion and, together with their subsidiaries, hold residential mortgages of almost £260 billion, 21% of the total outstanding in the UK. They hold over £250 billion of retail deposits, accounting for just under 23% of all such deposits in the UK. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches. Building societies alone account for about 32% of all cash ISA balances.

Background

Mutuals are operating in a unique set of economic conditions. There is currently little if any flow, in aggregate, of either new deposit savings or net new mortgage lending.

But the FSA is encouraging all institutions – building societies and banks – to increase the proportion of funding that they obtain from the retail market and this competition is forcing retail rates sharply upwards. To add to this, those banks that are supported by the state are able to compete unfairly for retail deposits. At the same time, building societies and banks will have to hold a significant proportion of their assets in high quality, low yielding liquidity. They make a loss on this which has to be recovered elsewhere.

This is a challenge for the sector, but it is not affecting mutuals in isolation. It is against this backdrop that the FSA is considering introducing far-reaching regulation that, if not implemented proportionately and fairly, will only serve to put the mutual sector at an even greater disadvantage. This is discussed in detail in our answers to the questions on changes to hybrid capital.

We therefore welcome the FSA's attempts to look at the wider economic impact of the most recent CRD amendments – estimated to be an increase in the amount of capital held by UK banks (*and presumably building societies*) of about 4%. Just as important is the pledge to look at the policies outlined in this consultation as part of the wider package of measures discussed in the UK and internationally. This is most welcome and we await eagerly its outcome.

Given the breadth of this consultation we have answered questions only on subjects that have a significant and/ or disproportionate impact on our members.

Chapter 3 - hybrid capital

CP 09/29 confirms that the CRD 2 amendments, as interpreted by the final CEBS implementation guidelines issued on 10 December 2009, introduce various new requirements (briefly catalogued at paragraph 3.15) for hybrid capital that did not previously apply in European legislation.

However, there is now further uncertainty ahead as a result of the Basel 3 proposals and, more particularly, the CRD 4 proposals recently published by the European Commission. So there is a risk that the detail of the rules for hybrids, now based on CRD 2, may be subject to further change. In the absence of any explicit commitment to grandfathering, at that later stage, of instruments that will qualify as hybrid capital under CRD 2, there may be a period of

“planning blight” - this uncertainty could severely reduce the raising of new hybrid capital, which could prove damaging to the prospects both for recapitalising the banking industry, and for maintaining its overall lending capacity .

We also support the point made by other commentators that hybrid capital must not in practice, even inadvertently, be expected to bear losses to a greater extent than core capital. But in its zeal to impose mechanisms, such as write-down, that favour recapitalisation, FSA is in danger of falling into this trap. The first example is Table 5 on page 28 of the CP, which is supposed to illustrate loss absorption by hybrids through write-down *pari passu* with core instruments, but in fact appears to illustrate that the “further loss of 50” is entirely absorbed by the hybrid write-down thereby handing an unjustified windfall to the core holders – not *pari passu* at all. A second example is the issue of deactivating “dividend stoppers”, which could have the effect of permitting dividend resumption on core instruments while hybrids have suffered both write-down and continuing non-payment of coupon – indeed on this point the CP is also at variance with paragraph 114(b) of the CEBS guidelines.

Turning to issues specific to our members, we disagree with the FSA’s suggestion in paragraphs 3.13 and 3.56 that PIBS¹ do not exhibit principal loss absorbency. This has been clearly established in detailed legal advice that the BSA has supplied to the FSA, and moreover it is also the clear conclusion reached by the FSA’s predecessor in 1991. However, the CRD 2 amendments taken together with the CEBS implementation guidelines now require a further specific measure – *to facilitate recapitalisation* – which is an entirely new requirement. According to the CEBS text : “The hybrid instrument must contain a meaningful statutory or contractual mechanism that will make the recapitalisation more likely by reducing the potential outflows to the hybrid holders at a prudent and timely enough trigger point.” This is then covered in proposed GENPRU 2.2.117A R.

Therefore we disagree with the implication of the statements in paragraph 3.13 and 3.56, which, while correct as to their ultimate effect, are also potentially misleading. What PIBS (and by extension PSBs) may need in order to comply with the CRD amendments as interpreted by CEBS is not principal loss absorbency *per se* (which they already typically possess), but the additional, and wholly new, requirement for a mechanism to facilitate recapitalisation as described. There are, moreover, other specific new requirements mentioned in paragraph 3.15 some of which² existing PIBS or PSBs may not have as contractual terms. Therefore, we accept that, for the reasons given above – and as correctly stated in paragraph 3.57 “[existing] PIBS...are unlikely to meet the [new/revised] hybrid capital requirements.”

We do not agree that, as suggested in paragraph 3.56, “In future, however, PIBS will have to contain a *loss absorbency mechanism* [emphasis added] such as write-down in order to be eligible as hybrid capital.” This falls into the same trap explained above. What PIBS will in future need – if they do not have it already – is a *mechanism to facilitate recapitalisation* – a distinct, if related concept.

FSA has itself recognised that write-down is not itself required – draft GENPRU 2.2.117A (5) (d) sensibly provides for “an alternative process which has the same or greater effect on the likelihood of recapitalisation...”. The BSA working with leading members and legal advisers are developing such a process – involving a reserve ledger which enables the society to demonstrate ongoing loss-sharing and crystallise that loss allocation in appropriate circumstances - and will be ready to discuss this with the FSA in due course. We invite the FSA then to agree globally that the BSA’s process in principle qualifies under indent (5)(d). We also point out that – since the fundamental nature of PIBS (or by extension PSBs) does not need to change - it may well be possible for a member mutual, in relation to an existing issue of PIBS or PSBs, to incorporate by agreement with the investors, both the mechanism to facilitate recapitalisation and the other relatively minor features now required, in which

¹ the arguments outlined in this response generally apply, *mutatis mutandis*, also to perpetual subordinated debt (“PSBs”) in the case of PIBS that were restructured as part of merger with another mutual organisation

² such as: coupon payments only out of distributable reserves; ACSM in core tier 1 instruments only

event (even if initially the mutual relies on the grandfathering provisions) it needs to be clear that once suitably retro-fitted, the instruments can qualify on the same basis as a compliant new issue. More generally, the Association expects FSA to cooperate reasonably with any mutual that seeks either to retro-fit its PIBS or PSBs to achieve compliance, or alternatively to redeem the existing instruments and re-issue on a compliant basis. Finally it should be made clear that where for whatever reason it is not practicable or economic either to retro-fit or re-issue existing instruments, these may nevertheless, even after the expiry of the grandfathering provisions, be capable of inclusion in tier 2 capital indefinitely.

Individual member mutuals will contribute their own specific and detailed insights on the chapter 3 proposals in relation to PIBS/ PSBs direct to FSA in their own responses: accordingly this response does not attempt to incorporate all such points – which the BSA will generally be prepared to support – but concentrates on more general matters of principle.

Q1: Do you agree it is appropriate to restrict SPV issues to the 15% hybrid tier one bucket?

We understand our members have not used this as they generally prefer direct issues, however we do not agree that this further, and superequivalent, restriction is necessary.

Q2: Loss absorbency mechanism – what practical issues do you foresee in structuring securities with conversion or writedown features?

In addition to the general issues of principle mentioned above, we believe there are practical issues on structuring convertibility / write-down features for our mutual members. As to **convertibility**, the prior requirement for a building society is a suitable “convert-to” instrument qualifying as core tier 1 that a society can issue. The FSA is well aware of the BSA’s, and the market’s, reservations regarding PPDS which therefore – pending satisfactory development of a superior core tier 1 instrument for societies – may restrict the usefulness of convertible hybrids to stressed situations and coercive exchanges (i.e. not raising new capital). As to **write-down**, we do not consider that formal principal write-down of PIBS is necessary but the alternative process –which may be regarded as a reserve ledger which enables the society to demonstrate ongoing loss-sharing and crystallise that loss allocation in appropriate circumstances – gives rise to similar practical issues regarding loss-sharing, the creation ex ante of a buffer against future losses, and accounting and tax treatment. These will be considered and analysed further ahead of the envisaged dialogue with FSA on GENPRU 2.2.117A R. (This mechanism can, we expect, be generalized to other mutuals as well as building societies.)

Q3: Trigger for activation of loss absorbency mechanism – Do you agree that in order for the mechanism to be effective in supporting the firm’s core capital in times of stress that the trigger needs to be activated at the discretion of the firm?

The trigger point should be clearly defined within the instrument, and legally certain (as GENPRU 2.2.117B, following CEBS’ paragraph 117, requires). This is also clearly necessary from the market/investor perspective. That being so, the implementation of the measures that can follow the trigger could involve some discretion for the firm – clearly, where a firm is able to find another way to cure the problem to the regulator’s satisfaction without implementing conversion or write-down, this is likely to be a better outcome for all concerned – including for market confidence generally.

Q4: Is the draft Handbook text for GENPRU 2.2 clear? Is any further guidance needed?

Within the limitations of the GENPRU structure, the new text appears reasonably clear. We have some technical comments on the use of the deferred share definition and the capital resources table for a building society. Again, individual members may identify other points of detail in their own responses.

Apart from the issues of principle covered above, we are concerned that the references to deferred shares, and the table in GENPRU 2 Annex 2R, even if legally correct, may be apt to

mislead the user. The underlying position is that within the totality of deferred shares – which will include all current and future PIBS, PPDS and any new core tier 1 instrument that is developed – some will qualify as core tier 1 under the CRD 2 amendments and the CEBS guidelines published in draft in CEBS CP33 (PPDS and the planned new instrument) and some will not qualify as core under the new requirements foreshadowed in the CP 33 draft guidelines but may qualify as hybrids (grandfathered existing PIBS and retro-fitted or re-issued or newly issued CRD2-compliant PIBS). At this stage we question whether the way these are dealt with in the text assists, or obscures, this understanding.

Q5: Are the proposed changes to FSA003 clear? Is any further guidance needed?

Yes, they are clear.

Q6: Has the CBA identified the relevant costs and benefits and have the costs been appropriately estimated?

We raise one general issue on the CBA (our members may contribute their own detailed points). The CBA implicitly assumes a continuous and perfectly elastic market for investment in the capital instruments of deposit-takers. In reality, the supply of such capital depends on quite discrete pools of investors – some traditional equity investors, other predominantly fixed-income investors. As the nature of hybrid capital is altered by these proposals, however well-intentioned, in a way that is generally adverse to the hybrid investor, it cannot and should not be assumed that this will merely result in an increase in the cost of such hybrids – it is quite possible, at least initially, that discontinuities will be observed: compliant hybrids³ may attract neither equity nor fixed-income type investors at all. Availability as well as price may be at stake. Moreover, there is a macroprudential dimension that the CBA does not appear to cover. The cumulative effect of (i) the CRD 2 changes relating to hybrids; and (ii) the CEBS guidelines on core capital, together with whatever results from Basel 3 and the European Commission's latest consultation, could well be that there is a very large demand for new issues, or refinancings on a compliant basis, of bank tier 1 capital. It cannot be assumed that the capacity exists to satisfy all this demand. So the aggregate effect may not be merely additive – rather as the demand for and scarcity of bank tier 1 capital emerges, the true marginal cost may depart radically from the assumptions made in CP 09/29.

Chapter 4 - large exposures

Many of the concerns on the proposed large exposures policy voiced by the building society sector are echoed in the submission made jointly by the British Bankers' Association, Association for Financial Markets in Europe and the International Swaps and Derivatives Association.

We welcome any move to simplify regulation but in this case we believe that it has come with such limitations and costs that – together with other overlapping changes made by the FSA – will serve only to stultify societies' businesses, which may inhibit mortgage lending. But we do think that the FSA should consider these proposals in tandem with other changes in motion, such as those in the proposed Basel Committee framework. These will increase the exposure value attributed to counterparty credit risk.

Our sector believes that the lower exemption limit of €100 million is likely to increase societies' risk and restrict their operations in future. We argue that a lower limit is no guarantee of reduced financial contagion. We have questions over some of the transitional provisions.

We note with concern the increasing prevalence of waivers in the large exposures regime and elsewhere in the consultation. We do not believe the FSA has taken into account the resources firms, and indeed its own staff, need to support these requirements.

³ especially if they are expected to absorb tranches of losses in certain situations ahead of core capital holders, as table 5 suggests

Q7: *Do you agree that we should implement this exemption [for limited licence and limited activity investment firms] (if we do not implement this exemption we would be superequivalent)?*

No comment, as not relevant to our members.

Q8: *Do you agree that setting a lower limit for the smaller firm exemption is both prudent and will reduce financial contagion in the banking sector?*

No. Setting a lower limit is not, when viewed properly in context, necessarily either prudent or likely to reduce financial contagion in the banking sector. The absence of, or inability to access, liquidity is a far more significant factor in bank failure, much more so than large exposures. Any restriction that artificially restricts liquidity is therefore likely to increase rather than decrease the incidence of bank failure.

a. Exemption limit

We are disappointed that the proposed LE regime has been made so restrictive. It follows that we are concerned at the proposal to reduce the exemption limit to €100 million when the directive allows for €150 million. Such a move will have several effects:

Credit risk

Building societies, like some small banks, collect retail deposits and may be net lenders to larger banks. Requiring them to split their deposits into smaller amounts and spread them between a greater number of credit institutions will force them to diversify away from the strongest institutions and lend to counterparties⁴ with a lower credit rating than they currently accept. At the same time they might receive a lower return on their deposits because of their lower nominal amount. In summary, they would be taking additional risk for a lower return. Smaller credit institutions have more limited numbers of counterparties with which they can deal, particularly during times of general economic uncertainty.

Exposures to other credit institutions have a very low default risk in comparison to other counterparties, due to stringent liquidity and solvency requirements. Also, they generally have access to refinancing from the central banks (or larger credit institutions), and are therefore less sensitive to an event risk.

If smaller banks switch from deposits with large institutions to buying government securities, it will remove a useful source of funds for larger banks, particularly in times of stress.

Currency risk

At the moment the euro and pound are roughly equal. What happens if/ when the pound returns to previous levels? Even if the FSA agrees to amend the exemption limit, such a move will take months to effect during which time building societies (and banks) will suffer financially. A more sensible approach would be to allow the €150 million exemption in full but add guidance suggesting that because of fluctuations, firms should operate well within that amount, maybe at a working limit of £100 million.

⁴ there is, as FSA should know, ample historical evidence of exactly this unintended consequence

Consolidation risk

Europe's financial markets continue to consolidate. This has the potential to reduce the pool of available counterparties, particularly for smaller credit institutions. Consolidation could inadvertently cause an institution to breach its limit, for example, two large exposures merge thereby creating one large commitment. Sufficient time needs to be given for an institution to run down its exposure in such an event without forcing it to take inefficient or uneconomic remedial action.

b. Exposures greater than 100% of own funds

We share concerns that the FSA is diluting the provision that would allow building societies and banks to have exposures of more than 100% of own funds, except *in exceptional circumstances*. We are disappointed to see this addition and request clarification on what it means in practice.

Article 111(4) of the directive states that "where the amount of €150 million referred to in paragraph 1 is applicable, the competent authorities may allow on a case-by-case basis the 100% limit in terms of the credit institution's own funds to be exceeded". There is no mention in the article of "in exceptional circumstances", but the phrase appears in BIPRU 10.6.10.

Furthermore, the waiver "option" is a deterrent to smaller building societies and banks. Waivers take time to process and we are concerned the regulator has sufficient resources to process them in an acceptable time. There should not be an additional layer of unspecified criteria to be met for approval to be given; this is superequivalent and will put smaller firms at a further competitive disadvantage.

The conditions in s.148 of FSMA are such that no firm is likely to be able to qualify. Success depends on the FSA's opinion of what constitutes "burdensome" or "non-achievement of the purpose for which the rules were made". We also question why the FSA considers a waiver to be required in the first place. Article 111 (4) qualifies Article 111 (1), (which itself forms the text of BIPRU 10.6.9 (3)) and specifically permits exposures of up to 100% *with the FSA's agreement*. The text of Article 111 (4) should have been copied out as a rule to reflect the directive's intentions; by relegating the article to guidance, the FSA is effectively emasculating it and being superequivalent.

When the removal of the inter bank exemption was first discussed, we supported the British Bankers' Association's emphasis of the importance small banks [*and building societies*] placed on retaining the ability to have large exposures to major counterparties. At the time it appeared that HM Treasury and the FSA supported the trade bodies and indeed both represented industry's views in the directive negotiations which resulted in the passing of Article 111 (4). It is, therefore, disappointing that having been instrumental in securing the provision, the FSA now appears to be intent on rendering it less effective.

As others have pointed out, without clarity on using the full €150 million allowance, it is likely that smaller banks [*and building societies*] will only be able to place the majority of their funds in government and supranational instruments, since boards are unwilling to compromise on credit risk appetite. This policy will have unintended consequences on smaller banks and building societies' liquidity policies. While the purchase of its instruments may help government funding, it does little to allow smaller players to maintain their competitiveness and, in the case of building societies, to continue to help people buy their own home.

If the FSA's objective is to reduce risk overall, it must recognise that if it prevents building societies and smaller banks from larger exposures to low credit risk institutions, it may merely reduce concentration risk at the expense of credit risk, which is clearly undesirable.

c. Transitional provisions

Societies were unable to find any reference to transitional provisions for the removal of the exemption for interbank exposures under one year. Given that these large exposures provisions are still under consultation with an expected policy statement issue date of Q3 2010, and an effective date of 31/12/2010, breaches could occur as a result of the late clarification of these rules. Some transitional requirements are therefore needed to give firms time to unwind any positions which may exist when the policy is issued and which would otherwise breach the policy at the end of the year.

We assume that investment holdings in residential mortgage backed securities master trusts will not need to be aggregated with any interbank exposure (under one year) to their issuers for large exposure calculation purposes. The master trusts are legally distinct from and generally have no recourse to, their issuers. Nonetheless specific guidance on the matter would be very much appreciated by societies. The CEBS guidelines do not shed any useful light on this issue, as they are focused on consideration of exposure to the underlying assets - in this case the individual mortgages, rather than consideration of exposure to the master trust schemes themselves.

Q9: Is our approach to the implementation of the national discretions clear?

We question why the regulator is not taking advantage of the discretions available (and not fully using one to help UK building societies and banks – see above). An example is the exemption from the LE limit for exposures to national governments and local authorities that are risk weighted at 20% under the standardised approach to credit risk. The number of local authorities willing to deal with societies is dwindling due to pressure to invest in government securities; not applying this national discretion has the potential to reduce this number further by disadvantaging, unnecessarily, the reciprocal placing of deposits by societies with local authorities.

We believe the waiver mechanism proposed with regard to the statutory liquidity requirements held in government securities is cumbersome and unnecessary. BIPRU 12.7 governs the extent to which firms may invest in government securities in managing the composition of their liquid assets buffer. Consideration should be given to information already supplied to firms and the degree to which liquidity and capital supervisory regimes should work together.

We share the joint associations' concern at the decision to no longer exempt covered bonds from the large exposures limit. Covered bonds must comply with the UCITS (Undertakings for Collective Investments in Transferable Securities) Directive, Article 22(4), which, under the CRD, allows for lower risk weights and higher investment limits. All covered bonds are regulated to ensure compliance with UCITS. They are structured to ensure timely payment of interest and principal even following an issuer default. Although investors have a dual claim against the issuer and the assets, the structure moves the risk of non-payment away from the issuer to the underlying assets. We believe that the exemption from the large exposure limits reflects this.

In addition, the FSA approves and regulates covered bonds in the UK. We understand that the purpose of these regulations is to produce high-quality covered bonds. Inclusion of covered bonds in the exposure limit would contrast to the FSA approving and regulating UCITS-compliant covered bonds.

Finally, the UK covered bond investor base is less developed than continental Europe. The inclusion of covered bonds in exposure limits would reduce the ability of UK institutions to buy covered bonds. It could stifle a nascent UK covered bond market. Ratings agencies might perceive that covered bonds are not a core funding product in the UK, which could lead them to use more penal assumptions when rating UK issuers.

There is a suspicion that by rejecting some of the exemptions, the FSA is imposing stricter rules on UK building societies and banks and thereby hindering competitiveness.

On a more detailed note, it would be helpful if the FSA could clarify that a firm's exposure to its own covered bond company in the form of inter company loan secured on mortgages falls within the revised definition of 10.3.15 R and is therefore treated as a look through to the underlying mortgages.

Q10: Are the provisions for the recognition of collateral and exemptions for residential and commercial property clear?

Our members find the draft rules open to interpretation, particularly the definition of a "prudent" valuation. We support the joint banking associations' call for less material on credit risk mitigation in BIPRU 10 to prevent inadvertent divergences.

Q11: Do you agree that there is no clear rationale within a backstop regime designed to limit the impact of unforeseen event risk to treat trading book and non-trading book exposures differently?

No comment.

Q12: Are there other market failures or risk issues that we should consider?

As we argue earlier, we are concerned that such a disproportionate response to concentration risk runs the risk of exacerbating credit risk. An example is the reduction of the inter bank exemption limit, which may force smaller firms to accept lower credit quality. We suggest the FSA considers the unintended consequences of its policies.

Q13: Are the criteria for the core UK group clear?

Intra group exposures are only potentially relevant where societies have material group entities other than the parent society. Nonetheless we welcome a regime that allows firms to extend exposures to "connected counterparties" in excess of the basic 25% LE limit provided certain conditions are met. We also welcome the FSA's proposal to continue the concept of fully exempting certain intra-group exposures within the UK and note the proposal to introduce a "core UK group" which will enable firms to exempt fully intra-group exposures from the LE limit. All entities in the "core UK group" will have to be fully owned and fully consolidated in the same UK group. These are virtually the same criteria as those used in the current solo consolidation regime except subsidiaries have to be only 75% owned (GENPRU 2.1.21R). We regard the 75% figure to be adequate.

But societies will have to first of all apply for a waiver to set up a "core UK group". We have expressed concern earlier at the over-zealous use of the waiver process. The main instance among societies will be lending subsidiaries – which, if wholly funded by the society, would generate enormous intra-group exposures. These entities used to get solo consolidation treatment for that reason. We therefore suggest that the FSA establishes a waiver by consent for such carefully defined types of subsidiary, which would help to cut down on the bureaucracy.

Q14: Do you support the application of a basic limit for all non core UK group intra-group exposures?

No comment.

Q15: Do you think the benefits of applying a limit lower than 100% will outweigh the costs?

No comment.

Q16: *Do you agree that the simplification of these [other intra-group exposures concessions] proposals will enhance the clarity of the large exposures provisions?*

No comment.

Q17: *What limits do you think are appropriate for intra-group trading book exposures?*

No comment.

Q18: *Do you think that aligning the treatment of intra group exposures within the trading book to the treatment of intra group exposures within the non-trading book will strengthen the protection offered to consumers and markets?*

No comment.

Q19: *Is the proposed transitional option for intra-group provisions clear?*

We think they are clear but if the proposed approach to intra group exposures goes ahead, more time will be required in the transitional provision. The joint banking associations' response suggested an earliest date of 2015. We agree with that.

Q20: *Are the changes to FSA008 clear?*

No comment.

Q21: *Are there any costs or benefits mentioned above that you believe would not materialise or would be of a different value?*

We believe that the lowering of the LE exemption limit will affect many smaller building societies and banks disproportionately. We have argued earlier why we do not think that the move will reduce contagion between firms, any more than the removal of the inter-bank exemption will. As the FSA itself notes in chapter 4.109, around 100 firms will be adversely affected by the reduced exemption limit alone.

Smaller institutions may have to increase credit risk to split funds into potentially riskier counterparties at the same time as facing lower returns from FSA requirements to place liquidity buffers in government stock or in a Bank of England reserve account – both consequences of the forthcoming liquidity regime.

As mentioned above, the FSA's large exposure and liquidity regimes appear to be at odds, a consequence of too many ill-considered policies made on the hoof.

Q22: *Are there any other costs or benefits we should consider?*

No comment.

Chapter 5 – securitisation

While we recognise that FSA has taken a predominantly copy out approach to implementation, there are a number of points of concern to our members. We understand the proposed timetable makes the implementation process difficult, but we are worried that the UK will introduce rules in advance of other jurisdictions. In certain cases, this will lead to a superequivalent approach which we do not support. We also question if the regulator has the supervisory resource to carry out these changes. As well as the arguments made below, we support the points raised by the joint banking associations' response.

Q23: *Would you find additional guidance useful? Please detail the specific areas and suggested text in your response.*

Societies are unclear whether they will have to submit waivers or notifications in respect of transactions they have already undertaken. If this is the case, it will be time consuming for them and the FSA. Like the joint associations, we believe that the significant risk transfer proposals should apply only to new transactions undertaken after the end of this year, which cover different asset classes than those undertaken previously by the firm.

We understand that the FSA wishes to change behaviours but it is not possible to change transaction structures retrospectively. Securitisation does have a role for building societies as well as banks; over regulation, however, serves only to impede economic recovery which, as far as societies are concerned, means stopping mortgage lending unnecessarily.

See also our answer to question 24 on retrospection.

Q24: *What guidance do you think should form part of CEBS guidelines? Please detail the specific areas and suggested text in your response.*

We support comments made by two of the larger societies:

Significant risk transfer

CEBS should note that rating agency credit enhancement requirements have increased significantly. The levels of credit enhancement required to achieve SRT make doing so extremely challenging. We note that no recent public securitisation achieved any SRT.

Additionally, paragraph 5.23 refers to meeting the SRT requirement on an ongoing basis. We would be grateful for clarification on whether such notification is required on a continuing basis and, if so, at what frequencies.

Investor due diligence

We welcome the broad principles behind Article 122a, paragraph 4, but make the following observations:

- Potential investors will need to understand what “independence of the valuer” means (BIPRU 9.15.11 R (6)). In an RMBS there is no *valuation* of the collateral, but rather a credit and cash flow *assessment*. It is unclear whether an assessment equates to a valuation in this context.
- BIPRU 9.15.11 R (7) refers to structural features. Guidance should set out precisely the nature and extent of the analysis required.
- Rating agencies’ current methodology is in the public domain but not to the extent that would enable an investor to recreate such analysis. Use of the word “validate” in BIPRU 9.15.13 R could imply that full remodelling of a transaction is necessary. If that is desire, we would object strongly. Remodelling of this nature would be virtually impossible.

Penalties

There should be comprehensive guidance on what constitutes non-compliance and how the resultant penalties will be calculated. Once CEBS publishes guidance, the FSA Handbook should be updated to include text specifically applicable to the UK. This should include what constitutes “negligence or omission” (BIPRU 9.15.17).

Master trust transactions

We also believe there should be clarification that the advice relates to master-trust transactions, where the scheme itself revolves rather than the assets.

Q25: Do you agree with our approach to notification?

We question if this will work in practice. As the joint associations have pointed out, the regulatory uncertainty created by the possibility of the FSA deciding significant risk transfer has not been achieved means that firms will most probably have to submit details of proposed securitisations well in advance of the transaction. Building societies, on the whole, smaller than many banks in the securitisation arena, may not have access to the sort of data the FSA is requiring in this instance. Again, we support the joint associations' suggestion of a materiality threshold for notification. But in any case, we believe the limit to submit documentation should be three months, not one.

Q26: Do you agree that the high level information requested should be set out in guidance? Please detail any additional areas that firms should submit to help our analysis.

No comment.

Q27: Do you agree that one month is a reasonable long-stop time period to receive any notifications?

As we say in our response to question 25, we have reservations over the notification proposal but if it had to go ahead, we suggest three months as a more practical period.

Q28: Do you agree with our proposal to assess firms' compliance via a waiver?

We support the comment made by one of our larger societies:

"It is unclear how the rules on waivers in BIPRU 9.13.10 R to BIPRU 9.13.14 R interact with BIPRU 9.3.8 R. The timeframe of six months appears unduly long and implies a time limit to a response under BIPRU 9.3.9 R. Further guidance should be given as to whether compliance beyond BIPRU 9.3.8 R would ever be required before a waiver will be granted."

Q29: Do you agree with our interpretation of the CRD?

No comment.

Q30: Do you consider further guidance necessary in this area? Please provide detail on key concerns in this area.

No comment.

Q31: Do you agree with our approach of providing guidance when the CEBS guidance is issued? Please provide detail of what the guidance should cover.

As one of the larger societies says, the detail and method of how to implement Article 122a should be discussed with industry. Investors should be free from onerous obligations, particularly in relation to securitisations that do not involve SRT.

Q32: How should we implement the Directive to make the sanction for non-compliance practically effective to assets originated on the trading book? Please provide detailed reasoning for your proposed approach.

No comment.

Q33: Are the changes to FSA046 clear? Please detail if you think there are areas where the form could be improved.

No comment.

Q34: *Do you agree with the securitisation CBA?*

We believe that capital requirements may have been underestimated for certain structures. This is certainly the case for certain re-securitisation structures. We believe the most significant benefit of the rules comes from the due diligence obligations set out in Article 122a. This equates to an obligation on an investor to understand the risk of an investment. We believe this provides better, if not the best, protection to investors rather than an arbitrary increase in capital requirements.

The incremental cost of non-capital compliance would be significantly above the estimate. The exact cost would, of course, depend on the detailed implementation of BIPRU rules. Societies will, however, need to commit significant resources to comply with the new framework, more particularly:

- the cost of SRT notification would be in excess of £10,000. This would be due to legal and other third party costs as well as internal resources. The cost would be closer to £50,000.
- due diligence and monitoring obligations must reflect the risks associated with a securitisation exposure. The increase in costs could be in the order of £100,000. This would especially be the case if new resources are required to run credit and cash flow models. This may result in some investors ceasing to take part in the ABS markets.
- disclosure requirements could have significant costs. This would depend on the detail requested but would be in excess of £100,000. The FSA should also note the extra cost of having to report loan-level data to the European Central Bank and Bank of England.

10 March 2010