



The BSA's response to the FSA's discussion paper, DP07/6: Definition of Capital

Background

The Building Societies Association represents all 59 building societies in the United Kingdom. Building societies have total assets of just under £350 billion and, together with their subsidiaries, hold residential mortgages of £245 billion, more than 20% of the total outstanding in the UK. Societies hold about £215 billion of retail deposits, accounting for more than 20% of all such deposits in the UK. Building societies also account for over 38% of all cash ISA balances. Building societies employ over 50,000 full and part-time staff and operate through more than 2,100 branches.

Introduction

We understand that this discussion paper has long been on the FSA's agenda, certainly before the credit crunch. But we strongly believe that that now is not the best time to consider changes that will tend to make the raising and, particularly the replacement, of subordinated debt more difficult and/or costly.

The question that has ignited all building societies' interest is number 53, on the proposal to treat PIBS in the same way as hybrids issued by banks. They are united in their opposition to this proposal.

Building societies are unable to issue ordinary shares so a major source of potential capital is closed to them. This makes access to interest bearing forms of capital particularly important. To apply the same limits on PIBS as those on hybrid capital instruments to banks places building societies with their simpler and lower risk business models, at an unfair disadvantage.

Finally, and significantly, some building societies have pointed out that the discussion of costs and benefits in Annex 2 appears to be wholly in terms of firms able to issue equity capital. However, societies are not able to do this, and so may be greatly disadvantaged by proposals, that shift the balance of risk and reward in favour of ordinary shareholders and against providers of interest bearing forms of capital.

Answers to specific questions

Q1: What are your views on possible grandfathering arrangements? Do you agree with the approach suggested above?

One society is happy with these arrangements but another has suggested a shorter timescale, perhaps one based on the remaining maturity of dated instruments.

Q2: Do you agree with this interpretation of going concern?

We agree with the definition insofar as stakeholders should have confidence in the continuing ability of the entity to trade but not with the qualification that “...its capital instruments [should] not hinder its future prospects in terms of recapitalisation.” As has been pointed out by a building society in its own submission, we believe this to be a judgmental assessment that ignores the point that if a firm has been wasteful of capital provided by current providers it is hardly likely to instil confidence in potential future capital providers.

Q3: Do you agree with our analysis of the characteristics of capital? Are there other characteristics that we should consider?

We agree that some appropriate proportion of capital should be available to absorb losses on a going concern basis and that for any capital to be of use it has to be available. But we do not agree that all going concern capital should be permanent since entities can manage capital down if it is surplus to requirements.

Q4: Do you agree with our analysis of loss absorbency?

We agree with the analysis that hybrid capital should only absorb losses after all equity has been lost. But we are concerned by the definition of loss absorbency suggested in section 5.3.”...any payments of dividends, coupons or principal reduce the probability that a firm will be able to meet its obligations as they fall due”. Any cash outflow (or reduced inflow) will have the same impact. Surely what is intended by going concern loss absorbency is the ability of the designated capital to absorb post-tax losses without triggering suspension of coupon payments for non-equity capital holders. For the top 10 building societies, which do not have access to share capital, subscribed capital (in the form of PIBS and subordinated debt) represents around 30% of total capital (based on 2006 figures). This leaves around 70% of capital in the form of reserves of a mutual institution, surely the highest and most resilient form of capital since it is unremunerated.

Any move to make PIBS or subordinated debt less attractive, from an investors point of view, runs the risk of depriving building societies of their only other sources of capital when, arguably, they have the highest proportion of truly loss absorbent capital.

There is an assumption within the paper that equity capital is fixed and that therefore, to be more loss absorbent, interest bearing capital should not be dated. But equity capital is probably the most flexible of all, since public companies may freely buy-back their shares or distribute their reserves as dividends. It could be suggested that equity should resemble building society PIBS or subordinated debt – at least these forms of capital require permission from the FSA prior to repayment.

Q5: At what point do you consider hybrid capital should absorb losses, other than from coupon cancellation?

Hybrid capital should only absorb losses once true equity has been lost. This is particularly important for building societies, where reserves are the only form of true equity. PIBS holders would therefore face a much higher risk of loss if more loss absorbent triggers were put in place.

If hybrid capital were to be made loss absorbent it would probably disappear as a class of capital. No holder of a loan would want to suffer loss unless all true equity had been exhausted.

Q6: Do you agree with our analysis of equity conversion and that such conversion would enhance going concern loss absorbency?

We do not believe that equity conversion is the right method of improving loss absorbency. Any change to loss absorbency by conversion to equity has to be considered in the context of those firms which do not have equity into which non-equity can be converted. Building societies would be effectively disqualified from issuing such capital if this were a requirement.

Q7: Can you identify any practical issues relating to write-down features?

No comment.

Q8: Do you agree with our analysis of write-down features?

No comment.

Q9: What do you regard as the most important factors in designing a trigger for a loss absorbency mechanism? Which of the options do you support?

No comment.

Q10: Are there any issues of international consistency that you consider are important to our suggestions regarding loss absorbency on a going concern?

No comment.

Q11: What practical implications might arise in relation to equity conversion or principal write-down mechanisms?

No comment.

Q12: How would you consider that the loss absorbency mechanisms described here would function from a legal, accounting and rating agency perspective?

No comment.

Q13: Do you agree that coupon deferral helps to conserve financial resources in a period of financial stress?

Possibly as a last resort. Most coupons on capital instruments represent very small proportions of total interest payable and pale into insignificance beside the alternative mechanisms at the disposal of management for addressing reduced profitability. The discussion seems to blur the distinction between what is important for conserving liquidity (for example, the mention of insolvency in paragraph 6.4), and what is important in maintaining adequate capital. In either case the probable immateriality of coupon payments needs to be borne in mind.

Q14: Do you agree that coupon deferral could be seen as a disincentive to new equity investment and thus may hinder recapitalisation?

No comment.

Q15: Do you agree that stock settlement mechanisms should ensure that coupons are settled immediately and do not accumulate?

No comment.

Q16: Do you agree that unless shares are issued directly to investors, ACSM may cause recapitalisation issues?

No comment.

Q17: Do you agree that an instrument with cash cumulative coupons is not loss absorbent on a going concern basis?

No comment.

Q18: Do you agree with the reasoning behind our current policy on dividend pushers?

No comment

Q19: Do you agree that dividend stoppers might hinder a firm's ability to recapitalise in a stress situation?

No comment.

Q20: Have we identified the issues relevant to mandatory coupon cancellation?

The major issues on coupon cancellation appear to have been identified. But much of the discussion seems to assume that coupon cancellation is the primary way of conserving cash. In practice, there are several options to conserve liquidity and the highly visible path of cancelling coupons - which may shake confidence generally and lead to further liquidity problems - seems an unusual area on which to focus.

Q21: Should mandatory coupon cancellation at trigger points be combined with discretion at other times?

No comment.

Q22: Could dividend pushers be acceptable if a policy of mandatory coupon cancellation were to be adopted?

No comment.

Q23: What are your views on trigger points for mandatory coupon cancellation? Is our analysis of options complete? As an issuer, what circumstances would prompt you to cancel coupon payments? As an investor, under what circumstances would you expect coupon cancellation to occur?

One society says that given the serious nature of coupon cancellation, such a step should be left to an institution when to determine.

Another society says that it would only agree with mandatory coupon cancellation if triggers were linked to regulatory capital and not accounting based positions. And even within regulatory capital, the only practical solution would be if it was linked to breach of Pillar 1 capital; incorporating Pillar 2 capital reduces transparency and therefore increases confusion amongst investors. As an issuer, coupon cancellation would only be considered as one of the last resorts when in cash flow difficulties; that is, when breaching capital requirements.

Q24: Are there other factors relevant to the subject of contingent capital?

No comment.

Q25: Could dated capital that cannot be repaid in times of stress satisfy the principle of being available when needed to the same degree as undated capital instruments?

No comment.

Q26: Are there mechanisms other than ‘lock-ins’ that could also achieve the same objectives of being available when needed?

No comment.

Q27: What are the practical implications of permitting going concern capital to be dated? What would be the market implications, for example on standard maturities and pricing?

As has been pointed out by one building society, if going concern capital were to be dated, and these maturity dates coincided with periods of stress, it may deter potential investors because, in the absence of renewing the funding, the capital base would be reduced.

Another society says that call dates and step-ups will still probably be the drivers of market pricing and standards, at least in the short-term. Flexibility must be maintained from the issuer’s perspective.

Q28: Should there be a minimum maturity, or minimum period to a call, for going concern capital?

Yes, the issuer and the market should decide what the maturity period should be.

Q29: Do you agree that the primary purpose of tier 2 capital is to absorb losses in liquidation? Or should tier 2 capital also help to prevent the insolvency of a firm? If so, how could it achieve this?

We believe there should be a clear distinction between the two tiers of capital. Tier 2 capital should therefore have the aim of absorbing losses in a gone concern scenario by:

- providing creditors with the assurance that there are other creditors whose investment is at risk before their own and thereby promoting confidence in the firm, and
- providing liquidity, on a long term basis, that may not be otherwise available.

Tier 2 capital could only help prevent the insolvency of a firm if it became riskier to investors. This would deter significant sections of the market from investing in the firm at all. To the extent that this deterrence is realised the supply of capital would be reduced and the situation that regulators wish to avoid would, in fact, be made more likely.

Q30: What benefit do firms gain from issuing regulatory tier 2 capital other than to meet regulatory requirements? Can you suggest a more efficient way of achieving the same objective? Should tier 2 capital be replaced by going concern capital in order to enhance going concern loss absorbency?

Societies see no reason why tier 2 should be replaced by going concern capital. Tier 2 capital has its own distinct use – to provide protection to depositors and senior creditors. Other than meeting regulatory requirements, having tier 2 capital as a proportion of overall regulatory capital allows issuers to manage overall cost of capital, and also widens the investor base providing further diversity of funding. In the absence of an alternative form of cheaper going concern capital, it would be extremely expensive to maintain total capital with tier 1 issuance alone.

The purposes of tier 1 and tier 2 capital, together with their risks and benefits, are clearly understood by investors. Tier 2 capital should not be replaced by going concern capital to enhance loss absorbency. It is the responsibility of the firm's management to ensure that it has adequate capital in total, and that the distribution of this capital should be appropriate between tiers.

Q31: Are there circumstances in which gone concern capital needs to have coupon deferral features?

No.

Q32: Do you agree that requiring gone concern capital to have a lock-in in times of stress could help the firm to continue as a going concern? What would be the practical consequences of requiring such a feature?

It is possible that a lock-in of gone concern capital in times of stress could help a firm continue as a going concern, but that is not the purpose of this capital. If gone concern capital has this feature in times of stress, it will render such capital less attractive to investors and/or more expensive. In either case, it will mean that there is less of it, and so make the likelihood of solvency minima being breached that much greater. Non-repayment of principal would be seen in the market by investors as a sign of severe trouble for the issuer.

Q33: Do you agree that it would be helpful to have greater flexibility in determining the maturity of gone concern capital? If yes, what safeguards should be introduced to ensure that the capital is available when needed?

We do not believe this would be helpful. If the holder of the capital instrument is a firm expecting repayment, then locking that firm in may cause:

- problems at that firm from a liquidity perspective (because locking in gives a visible sign of distress to the market and is therefore a deterrent to potential funding counterparties), and
- a general mark down in the market of such instruments rendering recapitalisation less likely and/or more expensive.

Q34: Is it helpful to distinguish between different sub-tiers of gone concern capital? Do the additional features currently required for upper tier 2 justify the higher cost of issuance?

Yes, societies agree it is helpful to distinguish between sub-tiers of gone concern capital. One suggested that tier 2 be simplified and kept for its core purpose.

Q35: Is there a distinctive role for tier 3 capital even if gone concern capital more generally was required to have lock-ins and more flexible maturity features? Does capital used to meet market risk requirements need to have any unique features to achieve its purpose?

It is possible that tier 3 capital could be redundant, given that there is little public issuance in the market at present anyway. But it is possible that even at these low levels, building societies could suffer if tier 3 was scrapped – based on the assumption that lock-ins would increase the cost of tier 2 issuance, and societies do not need any tier 3 capital.

Q36: Do you agree that there should be a minimum proportion of going concern capital in Pillar 1? And if so, do you agree that a minimum of 50% of a firm's capital requirements should be in the form of going concern capital?

We agree with a minimum of 50% of a firm's capital requirements in the form of going concern capital. As has been pointed out already by a building society, perhaps the discussion should be broadened into consideration of the volatility of earnings, and how likely it is that tier 1 may be needed to absorb going concern losses. If regulation is to be more principles based then surely it ought to start with a consideration of the type, magnitude and probability of losses that are likely to be sustained before the nature of the capital required is considered. Some firms will be more likely to need going concern capital while others, more stable, might require proportionately more gone concern capital. This latter point applies particularly to building societies, the vast majority of which do not have a trading book, and have a less volatile earnings profile.

Another society has suggested that it would be simpler to define tier 1 and tier 2 requirements independently, as they accomplish different things. So, tier 1 capital requirement would be X%

of RWA, tier 2 capital requirement would be Y% of RWA. The total capital requirement would then simply be the addition of the two elements.

Q37: Do you agree that common equity and reserves should make up the bulk of tier 1 capital requirements? In your view, what proportion of tier 1 requirements should be met with common equity and reserves? Should a higher proportion of hybrid capital instruments be permitted to count as capital held above the minimum capital requirements?

See above.

Q38: Do you agree that the same proportion of going concern capital is needed for market risk requirements as for credit and operational risk?

See above.

Q39: Do you agree that quality of capital should be assessed under Pillar 2?

Yes.

Q40: Is there a need to have sub-tiers within gone concern capital?

If the price of retaining a no lock-in feature of tier 2 capital is the continuation of two tiers, then we believe the current two tier structure should be maintained.

Q41: Do you agree that limits would be better expressed as minimum rather than maximum requirements? What disclosure issues are raised by permitting firms to issue more capital (not subject to limits) to improve capital ratios?

Yes

Q42: Do you agree with the rationale put forward for our current deductions? Do you think other matters are relevant, and if so for which deductions?

We agree with the rationale – and with a building society that has pointed out the lack of mechanism for assessing whether qualifying holdings are truly illiquid. This society refers to the full deduction of all holdings in subsidiaries. “Recent market conditions have highlighted that certain ‘liquid’ assets are not liquid in distressed conditions, while ‘illiquid’ subsidiaries have been successfully sold.”

Q43: Do you think the options of risk weighting or full deduction deliver a prudent response to the risks posed by these holdings?

They may be prudent but not risk responsive (see above).

Q44: Do you think we should change where certain deductions are made to reflect the ability of the capital to absorb losses?

One society agreed with the arguments set out in sections 10.8 to 10.10 but another questions why deductions are made from tier 1 if this tier of capital is meant to absorb losses on a going

concern basis. It continues: “Most of the deductions seem to be justified on the basis that the value of the asset is doubtful and/or it is illiquid. These are considerations that apply more on a gone concern than going concern basis.”

Q45: Do you agree with our analysis of the current policy on deductions, and for specific deductions, as set out above? What alternative proposals would you make for our policy on deductions? Are there other items that you think should be deducted?

Since most deductions are justified on what appears to be a gone concern, it would seem sensible to deduct them from total capital, rather than having the more complex deduction at different tiers approach, which seems difficult to justify.

One society suggests that the current (and proposed) requirement for a one for one deduction for investments in subsidiaries may be unduly harsh in some circumstances. Specifically, if an investment is held in a subsidiary in which there is some capital tied up, and the subsidiary is not excluded from consolidated reporting, this already penalises the institution. When the investment is structured in a way in which it could be unwound relatively easily if required, then the capital could be transferable to the firm to help absorb losses in a relatively short time frame.

Q46: Do you think that our current approach to any of these deductions is disproportionate? If so, how could we make it more proportionate?

See above for subsidiaries. In addition, one society questions why internally developed software (as required under IFRS) has to be deducted when externally acquired software is not.

Q47: Do you agree that we should apply certain deductions to specific categories of firm?

We do not believe there should be certain deductions for specific categories of firms.

Q48: Do you agree with this approach to share premium and other types of capital reserve?

We agree.

Q49: Do you agree that reserves should all be considered as part of going concern capital? Have you specific comments relating to the options suggested in the table?

We agree.

Q50: Do you agree that there is scope for simplifying the prudential filters regime?

We agree.

Q51: Do you support our continued emphasis on the substance of the capital item rather than its accounting classification? What are your views on applying a consistent valuation basis for all capital instruments and the relative merits of cost and fair value?

We support this emphasis.

One society prefers the fair value approach as the historical cost approach uses out of date information. By defining the fair value in terms of expected future cash flows, the fair value would naturally adjust for the impact of loss absorbency. But another society refers to the potential drawbacks to using fair values for capital instruments in the measurement of solvency. “As the fair value will often be driven by market perceptions which may, or may not, accord with reality there is a risk that perceptions of distress (which reduces the market value of an instrument) may reduce the amount of regulatory capital available at precisely the time a firm needs it most.”

Q52: Do you believe that there is scope for greater management responsibility in the area of interim profits?

We do believe there is scope for greater management responsibility in the area of interim profits. Greater reliance should be placed on management accounts, especially the inclusion of interim profits on an unaudited basis.

Q53: Do you agree that PIBS should be subject to the same principles as hybrid capital instruments issued by banks?

Societies do not agree with the proposal to subject PIBS to the same principles as hybrid capital instruments issued by banks. PIBS should not be categorised as innovative Tier 1 capital and should not be subject to the 15% limit against all Tier 1 capital.

Building societies are unable to issue ordinary shares so a major source of potential capital is closed to them. This makes access to interest bearing forms of capital particularly important. To apply the same limits on PIBS as those on hybrid capital instruments to banks places building societies with their simpler and lower risk business models, at an unfair disadvantage.

If PIBS with coupon step-ups to be classed as hybrids and disallowed as tier 1 capital, there could be a long-term adverse affect on building societies’ profit margins, and, consequently, their ability to boost tier 1 capital in the only other way possible, from contributions to reserves. In times of relatively high interest rates, if a society requires additional capital and is obliged to issue undated PIBS without a step up, it will lock in reduced margins, if not losses, as interest rates fall subsequently.

Where existing PIBS are treated as hybrids and do not qualify as tier 1 capital, building societies will be left with unnecessarily expensive tier 2 capital and also be required to raise further capital to bolster tier 1 capital.

Share capital in a bank is the most subordinate position after reserves and PIBS are the most subordinate capital for a building society after reserves. So in terms of loss absorbance, PIBS are in exactly the same position as share capital.

Q54: Do you agree that the same principles, especially going concern, loss absorbency, should apply to partnerships and LLP capital, as they do to limited companies?

No comment.

Q55: Do you agree that the analysis of going concern and gone concern capital in Chapters 4 and 8 should apply, as far as relevant, to mutual institutions, partnerships and LLPs?

No comment.

Q56: Are there any special features, not addressed above, that we should take into account in the definition of capital for mutual institutions, partnerships and LLPs?

No comment.