Ring-fencing and Proprietary Trading Independent Review: Call for evidence

Restricted
13 June 2021

Building Societies Association

Introduction

The Building Societies Association, as the representative body for all 43 UK building societies as well as six of the larger credit unions, is delighted to contribute to the Ring-fencing and Proprietary Trading Independent Review's call for evidence.

Ring-fencing as a structural constraint on large banks is relatively new. It has affected the behaviour of existing banks and new entrants. We believe that the experience of the building society sector, which has had its own current structural limits set out in statute for almost 40 years, shows that the effects of such constraints on financial stability are best demonstrated over the long term. Of course, the legislation must be periodically reviewed and modernised – while keeping its original intention and spirit – to reflect changes in the wider world and to enable firms to compete on a fair basis to meet society's needs.

However, if there are unintended consequences of ring-fencing, notably on competition, for now these may be better addressed by applying the existing powers of other regulators rather than via changes to ring-fencing laws or regulation. If this remains a more persistent issue, regulations could be changed to ensure that the ring fenced banks hold a more appropriate level of liquidity.

Background

The Building Societies Association (BSA) represents all 43 building societies in the UK, which together account for 23% of outstanding residential mortgages, and 18% of household savings. Building societies are financial service providers that are owned by their members. They are required by legislation to focus their activity on residential mortgage lending, funded mainly by retail savings, and are prohibited from engaging in certain riskier banking activities such as trading or market-making in securities, commodities or currencies and entering into transactions involving derivatives, except for the purposes of hedging risks.

Building societies were not caught by ring-fencing legislation when it was introduced. Not only did Government recognise that building societies were not the cause of the financial crisis, and were therefore not the target of the Independent Commission on Banking's (ICB) proposals, it was also recognised that it was not legally possible to apply the ring-fencing concept to an ultimate parent body within which mortgages and retail savings reside, such as a mutual building society.

Alternatively, building societies were already constrained by their own legislation that limited their lending and funding activities and prohibited them from certain risky banking activities all together. In developing its proposals, the existing building society legislation was cited by the ICB as an informative basis for structural limits on banking activities, as were subsequently recommended in the form of ring-fencing:

> "The precedent in building society legislation appears to provide a particularly good basis for the risk management functions of ring-fenced banks."
> (ICB Final Report, 2011).

As the RFPT Independent Review's Call for Evidence acknowledges, ring-fencing formed part of a wider range of regulatory reforms that were introduced following the financial crisis.

Impact on financial stability

The Covid pandemic led to unprecedented shifts in economic activity. Reforms made after the 2008-9 financial crisis, including ring-fencing, meant that the financial system was able to support households and businesses through these changes, rather than amplifying the disruption. This provides evidence for the effectiveness of the various reforms overall. However, while tumultuous, the Covid pandemic did not trigger a financial crisis, due to the huge monetary and fiscal support rapidly put in place. So in many important respects ring-fencing remains untested. We therefore don't believe the case can be made that the structural reforms are wholly effective, but nor can they be shown to be ineffective.

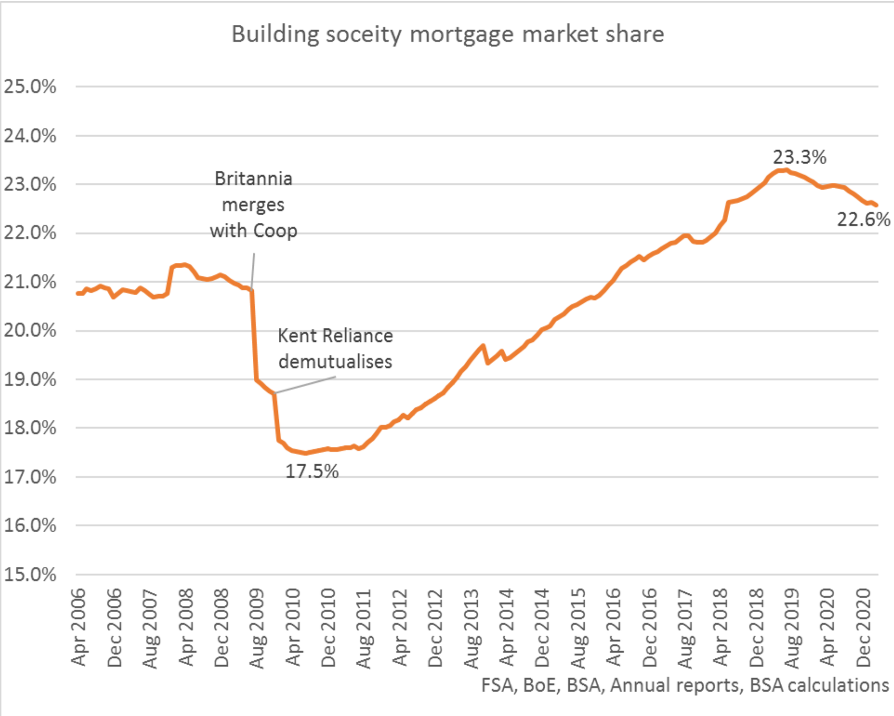
We believe that the current threshold of £25 billion of eligible deposits remains appropriate and shows the reforms having a desirable effect. Both Northern Rock and Bradford & Bingley had deposit books of roughly this size just prior to the financial crisis. The legislative limits on building societies apply to all societies, regardless of size. Given ring-fencing's objective is to enhance financial stability and protect the taxpayer, we think it appropriate that the controls and constraints that come with ring-fencing should apply well before a retail bank becomes systemically important. We have seen some recent entrants, such as Marcus, that are subsidiaries of global investment banks grow rapidly towards, and then carefully manage their deposit balances to be below this threshold, as their express strategy is to raise low cost funding for investment banking activities[1] – precisely the separation that ring-fencing is intended to bring about. Ring-fencing is therefore having the desired effect on bank behaviour by preventing substantial growth without enforcing arrangements to avoid contamination of retail deposit operations by potential future losses from riskier parts of the Group.

[1] https://www.reuters.com/article/us-britain-goldmansachs-marcus-exclusive-idUSKBN23G270

The BSA has frequently pointed to evidence[2] that a diverse range of financial service providers has benefits in terms of

- greater financial stability as shocks do not affect all firms in the same way, and
- competition and choice, as firms compete on different bases and innovate drawing on varying influences.

As further evidence of the benefit of having different types of provider in the system, in the wake of the financial crisis, mutual building societies grew their share of the mortgage market as the big banks repaired their balance sheets and some specialist lenders left the market. The building society sector's share of outstanding mortgages grew from 17% in 2010 to over 23% by early 2019, and in some post-crisis years, without the contribution of the building society sector the stock of mortgages in the UK would have shrunk. The building society sector has broadly maintained its market share since 2019, demonstrating its strength prior to and since the introduction of ring-fencing. We believe the diversity that a strong mutual sector brings is in itself beneficial to financial stability.



Impact on customers, competition and competitiveness

The PRA consulted over the course of 2015 and 2016 on the implementation of ring-fencing, such that the impacts started to be felt as the affected banks implemented changes in intervening years in advance of the implementation deadline in January 2019. The evidence of the impact of ring-fencing therefore becomes evident as the structural changes were made at the banks. Banks were already reducing their reliance on wholesale sources of funding following the financial crisis, but this change was amplified by ring fencing. As they were formed, some of the ring-fenced entities had very low loan-to-deposit ratios.[3]

As ring-fencing required deposits from UK households and SMEs to be held in the ring-fenced entity, the banks matched these liabilities with the equivalent UK assets – notably UK mortgages and SME loans. However, the majority of the excess liquidity was directed to the mortgage market. This competition caused rates to fall, to the benefit of borrowers. This is

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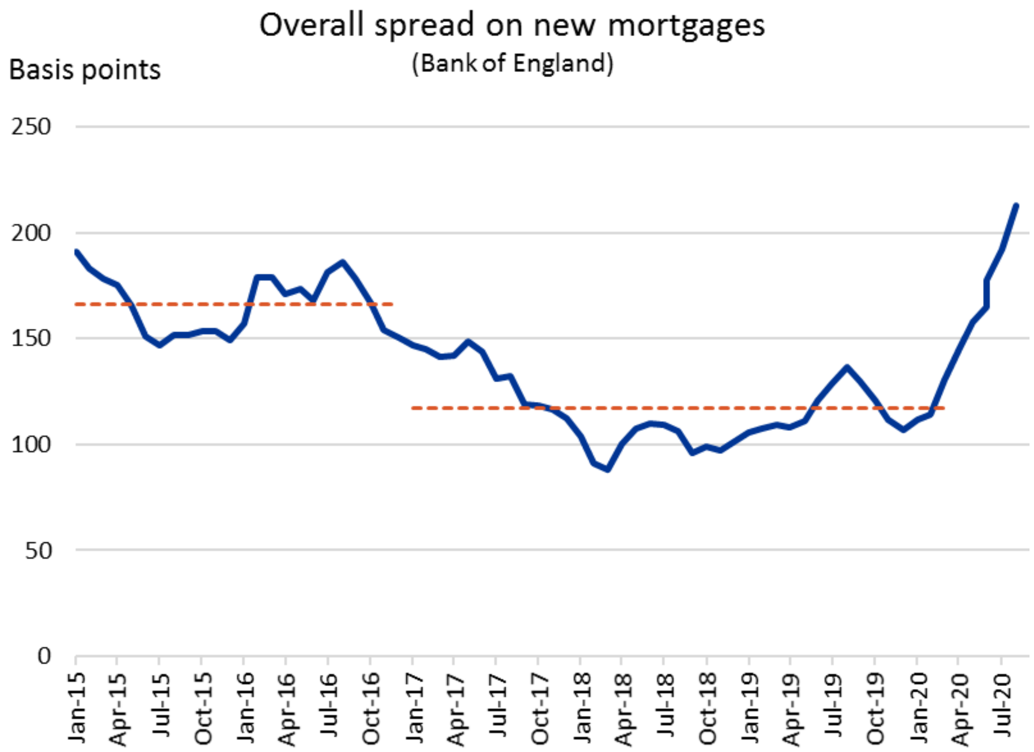
[2] See for example, Haldane and May, Nature (2011)

[3] The Panel has doubtless seen the study in a 2020 BoE working paper examining the impact on the shift toward retail funding in the ring fence: https://bankunderground.co.uk/2020/11/27/separating-deposit-taking-from-investment-banking-new-evidence-on-an-old-question/

demonstrated by the reduction in the spread on new mortgages shown in the chart below. Across 2015 and 2016, the average spread on new mortgages was 167bps over relevant reference rates. By 2017 to 2019, this had reduced by 50bps to 117 bps. There were many reports of the intensity of competition in the mortgage market at the time, and some lenders left the market[4] which may indicate that, with hindsight, some ring-fenced banks were established with too much liquidity.

The spread increased during the Covid-19 pandemic as lenders withdrew or increased risk premia. However, the competition in the mortgage market may return as the economy recovers, though it might be a transitory effect until the ring-fenced banks have run down this liquidity. If the excess liquidity remains a more persistent issue, or if the issue has been exacerbated by increases in savings deposits through the pandemic, regulations could be changed to ensure that the ring fenced banks hold a more appropriate level of liquidity by allowing some to leave the ring-fence for certain specific uses, but it does not justify fundamentally changing the structure of ring-fencing in terms of operational separation and governance.



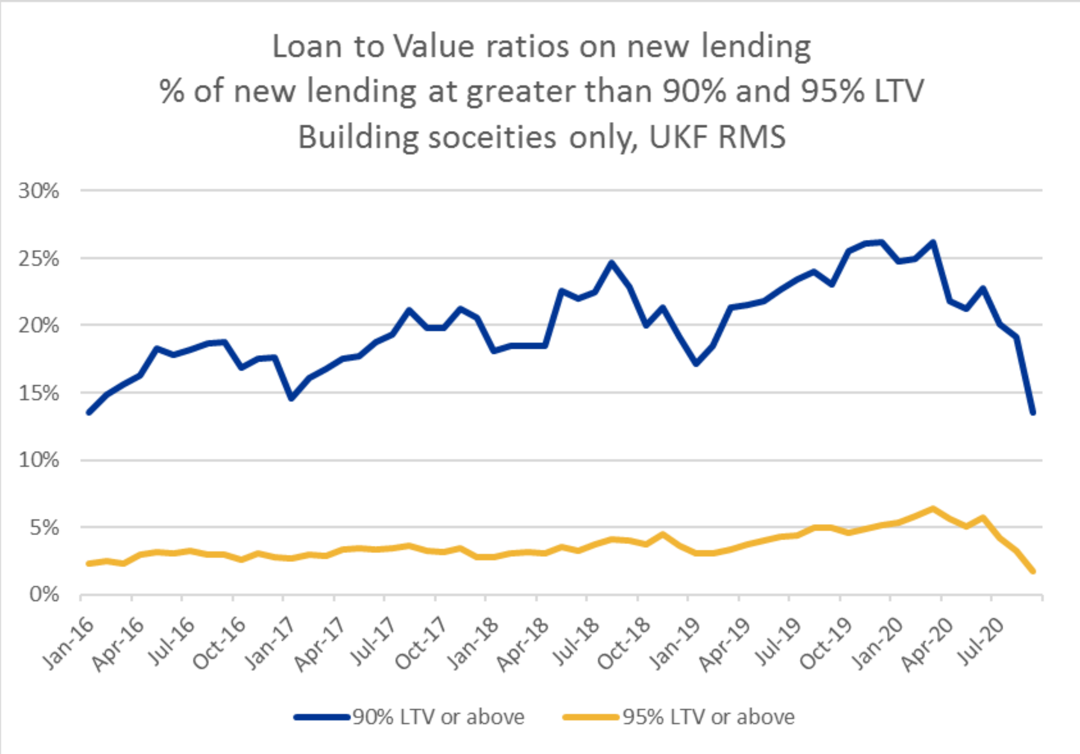
Ring-fencing followed the implementation of the findings of the FCA's Mortgage Market Review, as well as the FPC's recommendations in relation to the mortgage market. These led to a greater formal assessment of a borrower's ability to repay their mortgage, and put limits on lending at higher loan-to-income ratios. Also, specific to building societies, the PRA's Supervisory Statement SS20/15 provided guidance that limited the extent to which smaller societies can lend in certain segments of the mortgage market, without demonstrating suitable risk management controls are in place. Together, these reforms helped to constrain increased risk-taking even with the increase in mortgage market competition due to ring-fencing.

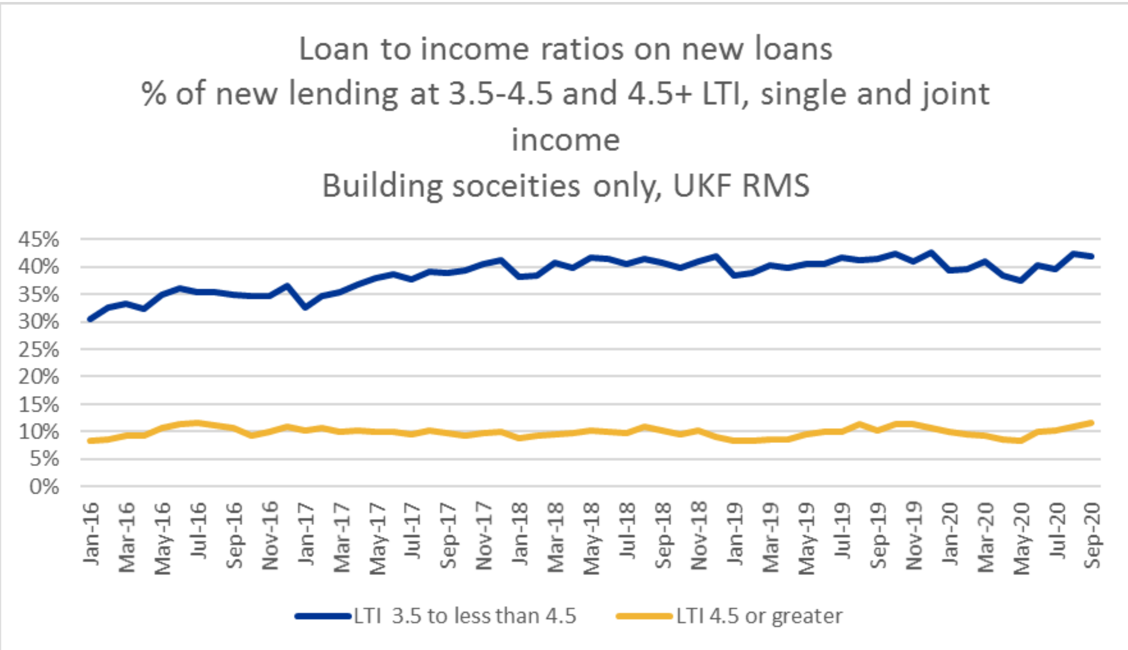
There was a slight increase in the proportion of lending by building societies at 90% and 95% LTV, but since early 2020 this reduced due to the effects of the pandemic. The proportion of lending at high LTI ratios has been relatively flat (see charts below). There is therefore not

[4] For example, "UK's biggest 15 lenders hit by price war", FT 12 August 2019, https://www.ft.com/content/bb2fd5e2-b9f3-11e9-96bd-8e884d3ea203

obvious evidence that lending by building societies at the aggregate level has become riskier since the introduction of ring-fencing.

No building societies were part of the PRA's review of fast growing firms, which resulted in a reminder from the regulator for those firms of the need to ensure governance and risk management capabilities remain aligned with the firms' business model risk profile and appetite[5].





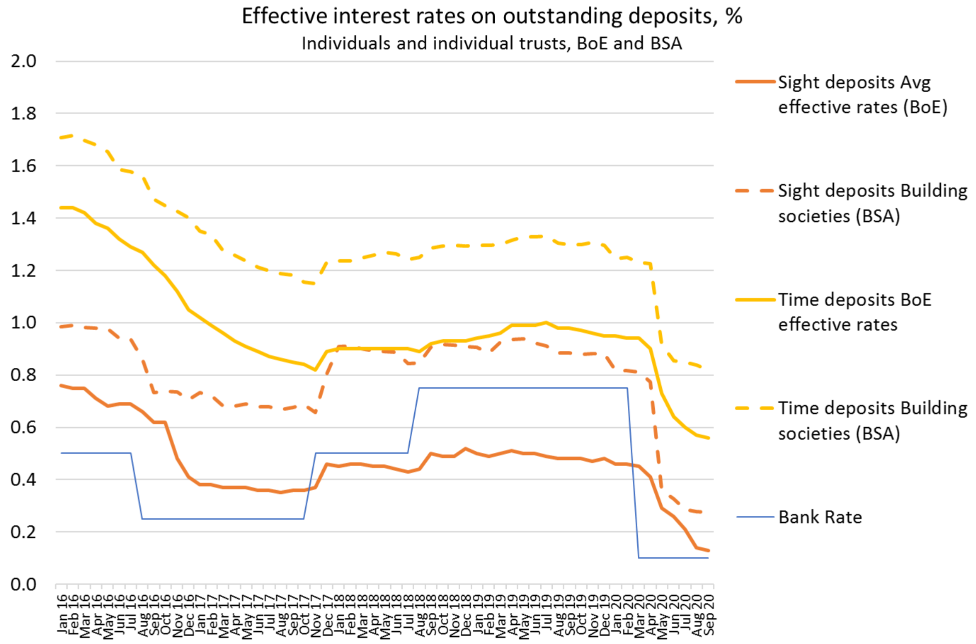
At the same time as the ring-fencing changes were taking place, changes were occurring in the wider macroeconomic environment. Following the EU Referendum in 2016 the Monetary Policy Committee reduced interest rates from 0.50% to 0.25% and introduced a new Term

[5] PRA 2019 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2019/review-and-findings-fast-growing-firms.pdf

Funding Scheme (TFS). Although already low, the reduction in interest rates put further pressure on margins in banking. This was offset somewhat by the TFS, which reduced funding costs.

With excess liquidity, as well as access to the TFS, ring-fenced banks did not have to compete to attract retail funding.

As member-owned deposit takers, building societies sought to insulate saving members from this low interest environment. The chart below shows the differential between major bank pricing and building society pricing in the savings market. Building societies have paid saving members more than the market averages at major banks, to the tune of £3.8bn since 2016, as societies have sought to protect the interests of their savings members during the period of low interest rates.



Improving competition

Although not a requirement of ring-fencing legislation or regulation, ring-fencing has led to an increase in the similarity of the activities of ring-fenced banks and building societies. Reforms that increase lending to SMEs or the number of alternative asset classes that were held in the ring-fenced entities in practice could bring welcome diversity.

However, ring-fencing is not necessarily the best way to remedy any unfair competitive advantages of the large universal banking groups; issues which are also the responsibility of the Financial Conduct Authority and Competition and Markets Authority. For example, the FCA's Strategic Review of Retail Banking Business Models (FCA, 2018) built on its Cash Savings Market Study to find considerable competitive advantages at the large retail banks that conferred to them lower costs of funding relative to other firms. However, the BSA did not think that the proposed Single Easy Access Savings rate would have been an effective solution, and while we were pleased when these plans were cancelled, these competitive distortions remain unaddressed. In the future, ring-fencing does introduce thresholds and legal definitions that could be helpful for targeting interventions at those firms' retail operations.

Yet ring-fenced banks retain much greater freedom to diversify than is permitted under building society legislation. Building societies do not wish to alter their principal purpose of lending secured on residential property, funded mainly with retail savings. To ensure that there are not distortions to competition between banks and building societies the Building Societies Act must also be kept up-to-date. There are some modernisations to the Building

Societies Act that would give societies more flexibility to respond to changes in the external environment.

We are currently exploring amendments with HM Treasury that would update the Building Societies Act to ensure that building societies are not put at a competitive disadvantage in sourcing funding via platforms or from SMEs, as well as other changes[6].

In addition, regulation of banks and building societies outside of ring-fencing must be appropriate. We strongly support the PRA's intention to develop a Strong & Simple regime that maintains robustness while making the compliance burden more proportionate, and will be engaging comprehensively with the PRA's current Discussion Paper[7]. We are and will be engaging fully with the PRA and Bank of England's reviews of MREL and the Leverage Ratio to make sure they are appropriately targeted[8].

Preserving the integrity of ring-fencing in subsequent regulatory reform

Future regulatory reform should be careful to preserve the intentions of the structural reforms that have been implemented via ring-fencing. A notable example is capital regulation, such as the recent consultation on IRB risk weight floors. These should be applied at the level of the ring-fenced entity, not at a group level, so that the ring-fenced bank would be truly resilient on a standalone basis in a crisis. If capital requirements are lessened for ring-fenced banks, the structural separation is effectively weakened. Furthermore, applying risk weight floors at a group level would give the ring-fenced bank a competitive advantage as it benefits from the floor being applied across asset classes in its non-ring fenced division, diluting the floors' intended focus on residential mortgages.

Conclusion

Ring-fencing as a structural constraint on large banks is relatively new. We believe that the experience of the building society sector, which has had its own current structural limits set out in statute for almost 40 years, shows that the effects are best demonstrated over the long term. Of course, the legislation must be periodically reviewed and modernised – while keeping its original intention and spirit – to reflect changes in the wider world and to enable firms to compete on a fair basis to meet society's needs. We believe it is right that building societies continue to operate under the Building Societies Act, with appropriate modernisation, and not be subject to ring-fencing.

If there are unintended consequences of ring-fencing, notably on competition, for now these may be better addressed by applying the existing powers of other regulators rather than via changes to ring-fencing laws or regulation, but if the excess liquidity in ring-fenced banks persists then amendments might be needed to allow a limited amount of retail deposits to leave the ring-fence for specific uses.

[6] BSA response to Future Regulatory Framework Review

[7] PRA DP 1/21

[8] BSA MREL DP response

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The Building Societies Association (BSA) is the voice of the UK's building societies and also represents a number of credit unions.

We fulfil two key roles. We provide our members with information to help them run their businesses. We also represent their interests to audiences including the Financial Conduct Authority, Prudential Regulation Authority and other regulators, the Government and Parliament, the Bank of England, the media and other opinion formers, and the general public.

Our members have total assets of over £448 billion, and account for 23% of the UK mortgage market and 18% of the UK savings market.