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**STRENGTHENING CAPITAL STANDARDS – IMPLEMENTING CRD 4
RESPONSE TO PRA CONSULTATION PAPER 5/13**

Introduction

The Building Societies Association is pleased to comment on the PRA's proposals in CP 5/13. We represent mutual lenders and deposit takers in the UK including all 45 UK building societies. Mutual lenders and deposit takers have total assets of nearly £380 billion and, together with their subsidiaries, hold residential mortgages of over £250 billion, 20% of the total outstanding in the UK. They hold nearly £260 billion of retail deposits, accounting for 21% of all such deposits in the UK. Mutual deposit takers account for 30% of cash ISA balances. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

The BSA fully recognises the importance of the CRD 4 package in restoring financial stability. Most of the CRD 4 content is mandated at EU level, with no flexibility for the UK. This response, like the consultation paper, therefore concentrates on those matters where the PRA makes policy choices within the limited discretion afforded by CRD 4. (We use the same terminology and abbreviations in this response as in the consultation paper.) The BSA also welcomes the PRA's engagement with the BSA and its membership on CRD 4, both at a meeting between practitioners from several BSA members and key PRA policy staff, and also at a successful and well-attended seminar on 17 September.

Executive summary

Much of the content of CP 5/13 is sensible and welcome – we give several examples later. But some of the policy choices proposed by PRA are unwelcome and, in our view, unjustified – and in certain instances renege on clear commitments given by the FSA in October 2012. And because of the cumulative impact of these measures in requiring firms to hold more CET 1 capital, sooner, than CRD 4 itself, we consider they will prove especially damaging to mutuals if implemented.

We also challenge some key aspects of the impact assessment in the consultation paper. This fails to identify (separately from the impact of the minimum CRD 4 measures mandated at EU level) the incremental impact of the PRA's policy choices. And one of the most damaging PRA proposals does not even appear to have been included in the set of assumptions / calibrations. So the conclusions on net costs / benefits may be seriously flawed.

We welcome the decisions not to accelerate the introduction of the capital conservation buffer, or the minimum CRR paths for phasing-out of grandfathered non-compliant capital instruments and phasing-in of deductions from AT 1 and T2. But we strongly oppose the immediate application of 100% of the CET 1 deductions and filters (noting in passing that the FCA has made the opposite policy choice – to adhere to the phasing-in schedule).

We also challenge the proposals to require, in due course, all of Pillar 2 to be held in CET 1 capital. These proposals are neither justified, nor even internally consistent.

Better, more enlightened approaches have already been proposed in at least one other EU jurisdiction – from which PRA could learn.

We welcome the clarification that, through publication of the necessary proxy data, PRA is exercising the national discretion to keep (for the time being) the revised standardised risk weight for buy to let mortgages at 35%.

Also welcome is the lack of major change to the rules on IRB, particularly those relating to models and validation.

Separately from CP 5/13, we also welcome PRA's announcement that well-capitalised firms can commence the move towards the more favourable Basel 3 / CRD 4 liquidity coverage ratio, from the current legacy FSA/PRA regime.

Our general and detailed comments are structured by chapter as requested. In responding, we have concentrated on those matters of greatest, or distinctive, relevance to BSA members, so we have no comments to make on the following chapters: 5 (passporting etc), 9 (market risk) and 10 (operational risk). We have also grouped comments on the supervisory statements with the corresponding policy chapters of the consultation paper.

We also note that the PRA has (as of end September) yet to consult its own practitioner panel on the exceptionally important matters contained in CP 5/13. PRA's choices in CP 5/13 represent perhaps the most significant *policy* decisions it currently faces – so we find it astonishing that, since the PRA is obliged by law to consult its own practitioner panel, it had not done so. We expect this failure to be rectified as soon as possible.

PRA is also in the process of collecting from BSA members an additional *ad hoc* return (FSA 003+, due by 4 October) covering the impact of CRD 4 implementation on their capital etc, and which will, we expect, illustrate some of the damaging consequences of those proposals to which we have objected. It is imperative that PRA takes on board the aggregate results of the FSA 003+ exercise before making final decisions on some of these policy choices.

CRD 4 involves a major change for the UK regulator from the familiar minimum harmonisation approach of the previous directives (which allowed UK goldplating) – to the Single Rule Book comprising a directly-effective Regulation and a revised Directive which for the most part has maximum harmonising effect. This means that goldplating is prohibited except where the CRD 4 package retains explicit national discretion. The BSA will remain alert to possible infractions by the PRA in this area and will be ready to pursue remedies through the appropriate European channels.

Chapter 2 – Capital buffers

Paragraph 2.12 recognises the particular difficulty for mutuals to build up capital buffers composed of CET 1. So we welcome and support the wise decision not to accelerate the introduction of the capital conservation buffer. Introduction from 1 January 2016 in line with CRR is quite soon enough.

We disagree with the unduly optimistic suggestion in paragraph 2.10. While it may be true that the consequences of breaching CRD 4 buffers are less extreme than those of breaching minimum regulatory requirements, there are three factors that will work in the opposite direction, and which we expect to predominate.

First, the deductions and filters applied to CET 1 introduce substantial and uncontrollable volatility into firms' CET 1 ratio. This arises particularly from the pension–related deduction and the filters for fair value adjustments.

Second, firms face the possible introduction or increase of the countercyclical buffer at any time. Even with a 12 month lead-in, firms could still face substantial increases in their CET 1 requirement which might not be easy to meet (for a mutual) purely from accretion of surplus.

Finally, although the language in chapter 2 is superficially reasonable, the general rhetoric from the authorities, and recent actions by Bank/ FPC/ PRA, and policy choices elsewhere in the consultation paper, give firms no confidence at all as to the future stability and predictability of capital requirements (notwithstanding that those should have been definitively settled by CRD 4). Instead the picture is of a foolish "race to the top" (of CRD 4), followed by years of uncertainty as regulators plan to bring in ever further tightening.

Although the theoretical regulatory consequences of using buffers are less severe, and we agree that buffers must be capable of being used (otherwise they just represent an increase in the minimum requirement), nevertheless market and external perceptions will also come into play. Dipping into the capital conservation buffer (the top CRD 4 buffer, as shown in chart 3.1, and the first to be eroded) triggers external consequences in terms of restrictions on distributions. So, given all the foregoing, we think it is most implausible that – as assumed in the impact assessment – firms (and especially mutuals) will halve the voluntary buffers they currently hold.

Chapter 3 – Pillar 2, Supervisory Statement 1 - Pillar 2

The BSA disagrees with the two key proposals in this chapter on the quality of capital to be used in Pillar 2, and we challenge whether an additional PRA buffer is necessary other than in exceptional cases.

We support, on balance, the PRA's preference to retain the present practice of Pillar 2A being set as guidance. In addition to the points set out in paragraph 3.17, we think it likely that Pillar 2A stated as a requirement would become generally disclosable in the context of capital raising – whereas we consider that Pillar 2A should remain confidential between PRA and firm.

(i) Pillar 2A should not be all-CET1

We strongly oppose this move, and contest the false logic of paragraph 3.13. While CRD 4 does place greater reliance on CET 1 (both as a higher proportion of Pillar 1, and as the sole component of the CRD 4 buffers) it also places greater emphasis on (for instance) the loss absorbency of AT1, by requiring a high-level trigger for write-down or conversion, and overall reaffirms that both AT1 and T2 have an appropriate place in Pillar 1. Since Pillar 2A (by PRA's own analysis) is in effect an extension of Pillar 1, and not a buffer, the logic of 3.13 falls down. It is in fact *inconsistent* with CRD 4 to exclude all non-CET 1 capital from contributing to Pillar 2A in a similar way to the CRR's prescription for Pillar 1.

A more enlightened approach has now been confirmed in Denmark. Finanstilsynet (the Danish FSA) published on 12 June for short consultation a paper[1] described in the official English translation summary[2] as "concerning guidelines for contingent capital instruments designated to fulfil the Pillar 2 add-on". In brief, AT1 instruments with a higher trigger (at least 7% CET 1) could be used to supplement CET 1 in the Pillar 2 add-on. On 2 September Finanstilsynet published[3] a further paper[4], confirming, post-consultation, this key proposal. Why has this excellent idea not been taken up in the UK? Denmark has even more extensive experience of actual loss absorption in the resolution of banks than the UK, so it would seem sensible to learn from the Danish experience.

(ii) PRA buffer should not be all-CET 1

We do not agree either that the PRA buffer (corresponding, where applicable, to the top slice of current Pillar 2B/ CPB, net of certain CRD 4 buffers as illustrated in chart 3.1) needs to be held exclusively in CET 1. Until recently, PRA's predecessor the FSA took the opposite view: as stated in CP 09/30 and PS 10/14: that the regulator might / should specify on an individual basis, for particular reasons, that *some* proportion of the CPB be held in a particular form of capital[5]. This would naturally include circumstances where a firm was required to hold some, perhaps most, but not all, of its CPB in CET 1. At this point, we need to refer to chart 3.1 in the current consultation paper. This chart illustrates that – out of the total of the PRA buffer assessment, which corresponds to the current CPB – the majority will automatically be held in CET1 because it comprises the capital conservation and systemic buffers, which are CET 1-only. Therefore it is clearly unnecessary for PRA to require, *a priori* ,the entirety of the top-slice PRA buffer also to be held only in CET 1. A modified continuation of the current approach (whereby, PRA could – exceptionally, where this was truly justified - specify with reasons why some or all of the top-slice PRA buffer needs to be held in CET 1, in addition to the CET 1-only CRD buffers) would be sensible.

(iii) PRA buffer should be exceptional

Chart 3.1 illustrates a wider truth: the proliferation of additive buffers, at their maximum, at least doubles the basic capital requirement. Pillar 1 is 8% of RWAs, to which are added (using the sequence in the chart) a countercyclical buffer of up to 2.5% RWAs, a systemic buffer of up to 3% RWAs, and a capital conservation buffer of 2.5% RWAs. These buffers add up to a further 8% of RWAs, i.e. doubling the Pillar 1 requirement. And for systemic firms, for instance, the Pillar 2 add-ons will be even higher, through G-SIB and O-SIB surcharges. That being the case, we find it very hard to believe that an additional top-slice PRA buffer is justified except in truly egregious cases. If the majority of firms are not in PRA's view adequately covered by these substantial CRD buffers – both static and countercyclical – we suggest PRA's risk appetite is wrongly calibrated.

Chapter 4 – governance

[1] Vejledning til Lov om finansiel virksomhed § 124, stk. 5 – Krav til kapital til opfyldelse af solvensbehovstillæg under 8+ metoden

[2] http://www.dfsa.dk/en/nyhedscenter/pressemeddelelser/2013/guidelines-contingent-capital-instruments.aspx

[3] http://www.dfsa.dk/da/nyhedscenter/pressemeddelelser/2013/vejledning-om-krav-til-kapital-efter-8-plus-metoden.aspx

[4] http://www.dfsa.dk/~/media/nyhedscenter/2013/vejledningsolvensbehovstillaeg8metoden.ashx

[5] Moreover, this remains PRA's approach in relation to the CPB for the time being, as stated in the Supervisory statement on Pillar 2, on page 6 of Appendix 2 to the CP.

We note that the consultation paper does not address the remuneration provisions of CRD 4. The main issue of interest to BSA members is the meaning of “significant” in the CRD 4 obligations described in the chapter: “significant” firms must establish a non-executive risk committee, and an independent risk management function, and their directors face limits on other directorships.

CRD Articles 88 and 91 relate significance to size, internal organisation and the nature, scope and complexity of a firm’s activities. This closely parallels the concepts in the PRA’s new impact categorisation, as set out in its *Approach to Banking Supervision*, which mentions size, complexity, business type and interconnectedness. It is noteworthy that while category 1 firms are described as “most significant”, and category 2 firms as “significant”, firms in category 3 or lower are clearly not regarded by the PRA as “significant” at all. We suggest there is a direct correspondence with the governance measures – ie category 3 and below firms need not apply the requirements specified in Articles 88 and 91 as for significant institutions.

Chapter 6 – Definition of Capital, Supervisory Statement 2 – Definition of Capital

We welcome several wise decisions by PRA to adhere to the carefully calibrated minimum transitional paths set out in both Basel III and CRD 4 – especially, the phasing-out of non-compliant legacy capital instruments, the application of deductions from AT1 and T2, and the application of a 1250% risk weight (rather than deduction) on holdings in non-financial sector entities above certain thresholds.

However, the unexpected proposal to bring in almost all CET 1 deductions and filters immediately, 100%, on 1 January 2014 is extremely unwelcome. We are clear that these deductions need to be implemented in due course, but we are equally clear that for good reason both Basel III and CRD 4 outlined a very modest glide path, beginning in 2014, but only at 20% a year. And FSA committed in October 2012 not to accelerate this transition path.

The FSA’s statement[6] on transitional provisions for capital resources was clear and specific, and our members were entitled to rely on it, and did so – to their subsequent detriment. We reproduce the key text below:

The draft European Union legislation to update the capital requirements framework, known as CRD IV, contains a number of transitional provisions relating to own funds requirements, the grandfathering of capital instruments, and the application of regulatory adjustments to own funds. Whilst the CRD IV legislation remains subject to change until it is adopted, this communication sets out the FSA’s intended implementation of these specific transitional provisions. The FSA will consult on these proposals in due course once the CRD IV legislation has been adopted; however, given the importance of these measures for firms’ capital planning, the FSA has decided to give advance notice of its intentions specific to this area.
The transitional provisions in the draft CRD IV[1] legislation set out a minimum pace of introduction of the new rules on own funds[2], starting when the legislation comes into force and ending in full implementation by 1 January, 2022.[3] Where the provisions allow competent authorities to accelerate the pace, the FSA’s intended approach would be as follows: ***the minimum pace of transition set out in the CRD IV legislation will not be accelerated, except where applying the minimum***

[6] http://www.fsa.gov.uk/about/what/international/basel/crd/ccr_crd/transitional-provisions

transitional provisions in CRD IV would have the effect of weakening standards relative to what is in force in the U.K. prior to the CRD IV implementation date. *For the purposes of assessing whether there would be a weakening, the standards used will be the FSA Handbook.[4] This approach would be used to calculate the binding Pillar 1 capital requirement for all firms subject to the CRD IV capital regime, without exception.*

This general position was reaffirmed in FSA's last statement[7] on CRD 4 in February 2013. PRA has now without warning reneged on that clear commitment, causing extensive detriment to our members. This breach of trust is not acceptable.

Even more remarkable is the contradiction that has now emerged on this matter between the two competent authorities in the UK. The FCA, responsible for CRD 4 implementation for the majority of investment firms, has clearly honoured the FSA's October 2012 commitment, which is referred to at paragraph 4.21 (page 33) of its CP 13/6: "CRD IV for Investment Firms". Accordingly, FCA has decided not to accelerate the CET 1 deductions and filters. The PRA now needs to repair the breach of trust, and honour its predecessor's commitments, by doing the same.

Different aspects of these deductions impact individual BSA members to varying extents. For some members, the deduction of defined benefit pension fund items will be the most significant – indeed, overnight introduction of this particular deduction is especially unhelpful as the item itself brings in substantial volatility. For other members, it is the wholly unforeseen immediate deduction of deferred tax assets (some possibly rising from recent transactions) which is particularly unjust. Nor – as we identify below – is this particular measure supported by any cost-benefit analysis whatsoever.

We also note the superequivalence implicit in paragraph 3.2 of the Supervisory statement: PRA expects firms issuing AT1 instruments to set their trigger at an (unspecified) higher level than the 5.125% minimum set by CRR, and an early approved transaction has identified the benchmark as being at least 7%. It also demands permanent write-down or conversion, whereas CRR clearly permits temporary write-down and write-back. However, neither the policy chapter, nor the statement, indicate how AT1 that *does* comply with these superequivalent expectations can be put to better, wider use by the firm. This is where, for instance, the approach now confirmed in Denmark (see above) is more enlightened. The Danish FSA decided that AT1 with a trigger of at least 7% can contribute to Pillar 2. If PRA intends to proceed with its superequivalence in relation to AT1, then as a minimum it must follow the sensible Danish approach and let such higher-trigger AT 1 also be used for Pillar 2.

Specific IRB questions

1. Basel 1 floor

On Basel 1 floors, we would welcome a more comprehensive example that explains, for example, what is included within the own funds required with respect to pillar 2 and the capital planning buffer under CRD III and the new buffers under CRD 4 and an understanding of how this translates into the Basel I equivalent.

We also query the explanation in section 2.3 of page 14 of Appendix 2. This states that if expected losses less value adjustments is negative, the absolute value of the

[7] http://www.fsa.gov.uk/library/communication/statements/2013/crd-iv-implementation

difference is added to capital. In the example however, the difference appears to be positive, but is still added. Our understanding is that the example is correct arithmetically, but welcome a review of the wording and explanation to confirm this is the case and clarify the direction in which the difference should be applied.

The CRR extends the Basel I floor as a transitional provision until 31 December 2017, subject to review by the Basel Commission by 1 January 2017 (CRR Article 500). For a firm that has been calculating capital requirements under the standardised approach which is not subject to this floor, this seems inappropriate as it could potentially lead to higher capital requirements than had been required for some years under the standardised approach.

The reversion to the Basel I floor under IRB could have a differential and potentially competitively disadvantageous effect on a mutual which typically has a predominantly mortgage based balance sheet. In this situation, the lower mortgage risk weights under IRB compared to the floor are not offset by relatively high risk weights, more comparable to Basel I on unsecured lending.
We therefore seek assurance from the PRA that it will consider using the provision to waive the application of the Basel I floor or to use the standardised floor based on non-modelled CRR approaches described on page 14 of Appendix 2 in cases where the Basel I floor leads to material disadvantage and disincentive to apply IRB.

2. **Variable scalar approach**

We would welcome an updated view of PRA expectations for mortgages in light of the experience of the industry in developing compliant variable scalar approaches. For example, does the PRA strongly encourage such an approach for retail mortgages or would it allow, or even welcome, a point in time ratings philosophy for mortgages where a firm thought that was more appropriate?

Chapter 7 – Credit risk, Supervisory Statement 3 – credit risk

Buy to let

The BSA welcomes the clarification that the current risk weighting of 35% for most buy to let mortgages under the revised standardised approach can continue under CRR.

Specific IRB questions

1. Attestation

Section 7.20 consults on the proposal for an annual attestation by a SIF that the IRB rating systems approvals have been carried out adequately. While we recognise that this follows a general trend for more personal responsibility and accountability and fully accept this general direction, we would appreciate more clarity as to exactly what is being attested. For example, is it purely relating to the adequacy of the governance as indicated by the wording of section 7.20, or is it a more general attestation of compliance against BIPRU 4 or its equivalent under CRD 4?
The consultation does not specify who should provide the attestation, other than that it should be a SIF. If the PRA adopts the approach of SIF attestation, we suggest it allows firms the flexibility to nominate the most appropriate person within the firm, rather than tie it to a particular role or individual.

2. Materiality

We note that the mandatory requirement for a materiality threshold set by the regulator is a new, or at least more tightly constrained, requirement. Although this has the benefit of consistency across the industry, we question whether it is sufficiently material to warrant the required changes to systems and processes. It is worth bearing in mind the immaterial nature of EADs and hence RWAs and ELs of the exposures that might be affected by this requirement.
In assessing the impact, we would like to know if the prescribed limit must be applied not just to the IRB default definition, but also to an institution's internal policies and procedures. BIPRU 4.3.57(5) requires consistency between the materiality used in the default definition and that used in risk management. Although this has a minimal impact from a business perspective, it may have systems implications. Institutions will be reluctant to change operational systems and processes to accommodate this requirement.

Finally, there may be some institutions for which £100 is too high a threshold. It would constitute a significant unauthorised access, for example those accounts that do not have lending facilities extended to them.

3. Loss given default

We note that the 40% retail mortgage property sales reference point in section 12.8 of Appendix 2 was published before the recent drop in house prices, which have seen indexed valuations remain at approximately 20% below their peak value for some time. We ask if there is any intention to update this reference point in light of actual experience from industry during this long period of reduced house prices. Such feedback might provide better guidance and more consistency across the industry.

Chapter 8 – Counterparty credit risk, Supervisory Statement 4 – Counterparty credit risk

These chapters mainly concentrate on matters relating to more advanced approaches not relevant to the majority of our members. But there is one surprising omission – PRA appears to say nothing in either chapter 8 or in the supervisory statement as to its implementation of the discretion provided for in CRR Article 385.

One of the most troublesome and challenging areas of CRD 4 compliance for our smaller members is the calculation, for the first time, of the credit valuation adjustment for that part of OTC derivative portfolios that is not being cleared through central counterparties (whether legacy books, or current non-standardised contracts) but remain as bilateral transactions.

Most BSA members would typically use the standardised method under Article 384, but this may still prove a burdensome calculation for members, and a waste of effort in relation to smaller bilateral remnants of OTC portfolios. Article 385 allows a much simpler alternative – to apply a multiplication factor of 10 to the risk weighted amount resulting from the CCR original exposure method under Article 275. This needs supervisory consent, and smaller BSA members are likely to want the flexibility of this option, but CP 5/13 omitted any reference to the Article 385 discretion. Consequently, our members remain in the dark as to whether this important concession will be made available to them as intended in CRR.

Chapter 11 – Large exposures, Supervisory Statement 7 – large exposures

We welcome the PRA's clarification that it does not intend to set a lower limit than €150 million in relation to the 25% large exposures limit as provided by Article 395 (1) of the Capital Requirements Regulation. Lowering this limit would have caused significant problems for our sector.

We also welcome the clarification that the PRA will continue to exempt exposures to central banks and governments as provided by Article 400(2)(g)-(h) of CRR.

Where an institution has breached the LE limit on an exceptional basis, CRR enables PRA to allow the institution to comply with the limit. PRA has said it will consider whether to exercise this discretion. We do not understand why this has to be "considered" and urge the PRA to exercise this discretion forthwith. Since it will be on a case-by-case basis there is little likelihood of this being abused.

Chapter 12 – liquidity

We agree with the PRA's decision to continue to apply the liquidity reporting contained in BIPRU 12 and SUP 16 until the liquidity coverage ratio comes into force in 2015 (definition and calibration still to be agreed). PRA considers its liquidity regime to be in line with the objectives of the LCR though nonetheless reserves the right to change it once the ratio is fully set out.

The EU has mandated a phased introduction of the ratio. It has addressed concerns that too rapid implementation of the original ratio could have detrimental impact on the real economy by phasing it in over five years starting with a minimum of 60% of the LCR in 2015, rising to 100% in 2018. A phased approach also gives individual institutions time to make balance sheet adjustments.

The PRA's own transition path has been published. In August 2013, it lowered the amount of individual liquidity guidance the largest institutions are required to provide (to approximately 80% of the LCR) so long as they meet the 7% core equity capital ratio set in the recent PRA exercise. The retail outflow coefficients are also smaller. We understand a similar approach will be rolled out to those on the simplified ILAS approach ie smaller banks and building societies. Although not part of this consultation, we urge the PRA to make the requisite changes as soon as possible.

We note that when CRD 4 liquidity reporting comes on stream in 2014, LCR data will have to be reported at least monthly, and net stable funding no less than quarterly. In addition, institutions have to provide data for a series of additional liquidity monitoring metrics intended to help supervisors assess liquidity risk profiles.

We note that at that stage the PRA will not exercise other competent authority discretions provided for in the CRR liquidity requirements (relevant to reporting requirements, issuing of guidelines, the LCR and stable funding). It would have been helpful to have had these listed/ discussed even if they will only be considered in 2015.

Chapter 13 – Reporting and disclosure

COREP and FINREP returns require far greater detail and scope than UK institutions have ever had to provide. Yet the PRA is continuing to require them to continue to

submit existing returns not covered by CRD 4's harmonised reporting obligations – and is even considering overlaying these in future with more domestic returns.

We do not understand why PRA is demanding such unprecedented data; we have seen no sign that such extensive data are helping the regulator do its job properly. For many years the IT costs for the old FSA, and now the PRA and FCA, have been spiralling – such an increase in data does not help to contain them.

Certain pre-GABRIEL building society returns such as MFS1 and QFS1 should no longer be required once CRD 4 takes effect. We urge the PRA to make this clear to our members, and soon. The preparation, review and governance of these returns is significant for some members. Nor is it clear that, under CRR, PRA is even permitted (in European law) to continue requiring these returns, as they cover an area where CRR has "exclusive competence".

But we do welcome the decision not to exercise the discretion in Article 99(5) to allow competent authorities to extend the application of FINREP.

We are also grateful to the PRA for its advice on dealing with the unintended consequences of the scope of FINREP. Under sections 2-5 of Article 99 of the CRR, regulatory consolidation groups that publish their group accounts using IFRS come within the scope of FINREP. UK building society legislation requires a building society to be at the head of any group. There is therefore no possibility of a holding or a trading company being at the head of a regulatory consolidation group of which a building society is a part. This requirement catches all ten building societies that report using IFRS – those that have issued PIBS – and potentially all other societies that decide to adopt IFRS over FRS 102 when the current UK GAAP is switched off.

Section 4 of the Article says that the financial information to be reported "… is necessary to obtain a comprehensive view of the risk profile of an institution's activities and *a view on the systemic risks posed by institutions to the financial sector or the real economy*". This strongly suggests that the CRR aims FINREP to be collected only by systemic institutions, not domestic mutuals.

The cost to building societies of installing FINREP systems and the associated review and governance processes is disproportionately high and will have a significant impact on their financial position. The data they will provide, on the other hand, will have absolutely no impact on assessing systemic risks to the financial sector or the real economy. This appears to contradict section 5 of Article 99 which states: "The reporting requirements shall be proportionate to the nature, scale and complexity of the activities of the institutions."

An apparent unintended consequence of the CRR in the UK is that local and regional mutuals could be caught by the wording in this Article: global investment banks owned by holding companies, for example, would not.

The cost benefit analysis annex discusses compliance costs associated with the move to harmonised reporting. These are "significant" but "not expected to be large enough to have a macroeconomic impact". Building societies and small banks believed costs to be heaviest for external consulting and IT related services. Table 15.I shows total compliance costs for the building society sector to be £278 million. That is more than "significant": at more than half the sector's retained surplus for the last financial year, it is no surprise that this expenditure has already led to customer-facing investments being cancelled or postponed.

We note that there is no requirement for firms to submit returns using XBRL (though national supervisors have to use XBRL for data transmission to the EBA). Yet the FCA – as the PRA's agent – is requiring affected UK firms to use XBRL. There is no reference to this decision in the consultation. We argue that consideration should have been given to allowing firms a range of data submission options. XBRL represents a sizeable cost for many firms, particularly smaller mutuals. There are relatively few suppliers, for example. We would be interested to know if XBRL has been factored into the cost benefit analysis.

On disclosure of the leverage ratio, the PRA says the CRR requires firms to disclose the leverage ratio from 2015. That is only part of the story. Article 499 (3) of the regulation allows competent authorities from 1 January 2014 to 31 December 2017 to permit institutions to calculate the end-of-quarter leverage ratio where they consider those institutions may not have sufficiently good quality data to calculate the ratio as a mean of the monthly ratios over a quarter. Such a discretion would be a huge benefit to the mutual sector which would not have access to the quality data required by the regulation. The absence of monthly-averaged data from the majority of mutuals would make no conceivable difference on a macroprudential level.

How does the PRA propose to make this derogation available to BSA members who might legitimately expect to make use of it (as it is not mentioned in the consultation)? The FCA has already recognised the desirability of this derogation for its firms – see paragraphs 4.39 and 4.40 of its parallel CP 13/6 – and intends to make it available.

Chapter 15 – economic analysis

The BSA appreciates that attempting to estimate the economic impact of, and to perform cost/benefit analysis on, a package as complex as CRD 4 is indeed a challenging task. Chapter 15 provides some useful indications of the overall expected impact of introducing CRD 4, highlighting differences between large and smaller banks. This material is valuable so far as it goes.

A particularly revealing analysis is of the compliance costs of reporting and disclosure requirements (COREP, FINREP and Pillar 3 enhancements) set put in the Annex to this Chapter. The text says that "the compliance costs are expected to be significant" - an understatement. The costs for building societies, broken down in Table 15.H, are quite astonishing: one-off costs of £87 million, ongoing costs of £103 million (presumably annual), and total costs of £189 million.

What the text does not go into is what (if any) the expected benefits of COREP, FINREP et al amount to. The BSA has yet to identify any *benefit* whatsoever from either COREP or FINREP. Nor does the PRA expect that COREP or FINREP will satisfy its own data requirements, as building societies still await further proposals from PRA for extra information. So – as a result of the UK authorities' failure to block COREP and FINREP during the negotiation of CRD 4 - BSA members will have had to waste nearly £200 million, which would otherwise have gone straight to reserves and boosted CET 1. That £200 million could have supported at least £6 billion of net new lending, even if constrained by a leverage ratio around 3%. Instead, it is being wasted.

But there are also one or two important defects in the Chapter 15 approach. One specific point relates to the policy calibration in Table 15.J. This is an extremely useful summary of the calibrations and assumptions used in estimating costs and

benefits of the CRD 4 package. In relation to changes to the definition of capital (including all deductions from CET 1) the implementation date is given as "phased" from 2014 to 2019. This is also made explicit in the paragraph describing the baseline for calculation: paragraph 15.21 states the assumption that required capital accumulation or raising rises in a linear fashion from 2014 to 2019. As pointed out above, the CET 1 deductions are almost all being imposed 100% on 1 January 2014 – they are not being phased in at all. So it appears that the analysis has ignored the serious effect of front-running these deductions.

The more general defect in chapter 15 is this. While it is of course important to be aware of the overall costs of implementation of the CRD 4 package, CP 5/13 has a narrower focus – on the specific choices PRA is required to make in areas where there is any residual flexibility or national discretion. The option of non-implementation of CRD 4 is not available – not least because the largest part, the CRR, needs no implementation but is directly and automatically effective. What is really needed, we suggest, to inform both our members, and PRA's final decisions, is ***what are the incremental costs and benefits of the policy choices adopted by PRA***, taking as a baseline the bare minimum of CRD 4. This approach would have highlighted for instance the impact of accelerating the CET 1 deductions, or of requiring Pillar 2 to be met entirely from CET 1. Paragraph 15.23 nods in this direction, saying that it is not possible to calculate the incremental benefits of any particular individual measure, as these diminish as the overall level of capital requirements rise, and depend on the order in which they are assessed. But in order to justify its various proposed superequivalences, PRA should - as a minimum - have assessed the costs and benefits of its policy package, over and above a baseline of assumed implementation of bare minimum CRD 4. If, as paragraph 15.23 hints, such assessment would have revealed that the extra PRA measures bring only small marginal benefits, but involve non-trivial costs, their lack of justification would be apparent.

The impact on mutuals is covered at paragraphs 15.44 to 15.47. Paragraph 15.45 correctly identifies that, although mutuals will be able to issue mutual CET 1 instruments in accordance with Article 27 of CRR, these remain untested. So, alongside earnings retention, the immediate adjustment to the demand for higher CET 1 is more likely to have to be met from deleveraging than is the case for proprietary banks. And it is in this context that the sudden and unforeseen implementation of the CET 1 deductions on 1 January 2014 is particularly objectionable. As our members have explained at a face to face meeting with PRA policy staff, a sudden step change of this nature cannot be coped with by extra earnings retention (remembering that mutuals, unlike proprietary banks, already retain, rather than distributing, their earnings), leaving in the short term some severe deleveraging as the only alternative. Since the front-running of the CET 1 deductions was not apparently included in the impact assessment it is all the more imperative that, based on the results of FSA 003+, PRA pauses and reconsiders this sudden and damaging move.

2 October 2013