Funding the Audit, Reporting and Governance Authority

BSA response to the FRC consultation

October 2022

Building Societies Association

Summary

We are pleased to submit comments on behalf of BSA members on the proposals for funding the Audit, Reporting and Governance Authority. These are framed around our view that the vast majority of building societies should not fall under the current, EU-derived definition of a public interest entity, a group that will bear a considerable part of the ARGA levy.

We do support the FRC's aim of levying the right groups proportionately but believe it does not go far enough. We think the overall funding requirements should comply as far as possible with the "polluter pays" principle.

Detail of the response

Question 1 *Do you have any comments on the proposed guiding principles for ARGA's overall funding arrangements?*

We welcome the FRC's "aim is to ensure that the right groups are levied in a proportionate manner." Rather than target the groups perceived to have the deepest pockets, the FRC has tried to include all groups that may benefit from its regulation.

Much rests on what constitutes the *right* funding group (or group of market participants as the paper also calls it). But the aim of levying the right groups proportionately does not go far enough. We think the overall funding requirements should comply as far as possible with the "polluter pays" principle. We recognise that this principle has never been taken to its full extent in regulation (for example, payment of fees based entirely on outcomes). But it is important to maintain a position where those entities/ individuals requiring ARGA action should take the major share of its funding costs. The FRC could also consider providing incentives for better and more prudent behaviour.

Public interest entities are proposed to fund the costs of regulating corporate reporting, including reporting and audit standard setting, monitoring, and enforcement against directors. As we have pointed out to government and regulators previously, the current definition of a PIE needs to be re-examined as a matter of urgency.

Removal of building societies from PIE status

We continue to lobby hard[1] for the removal of the majority of building societies from the scope of PIE in the UK. We consider they should be subject to the same size thresholds as relevant PIEs ie £750 million turnover and 750 employees. Removal of PIE status for the majority would be consistent with the strong and simple agenda[2] which the PRA and BoE have adopted. It is also consistent with the independent report from the Taskforce on Innovation, Growth and Regulatory Reform[3] which recommends a new proportionality principle be put at the heart of all UK regulation.

The original application of PIE status to all building societies is an unfortunate result of the interaction of two pieces of inflexible EU legislation. The PIE concept was introduced by the Statutory Audit Directive, and generally focused on larger listed entities, but included other categories which were all given blanket PIE status – such as "credit institutions". This latter category, defined in the Capital Requirements Directive, means that essentially the same rules apply to global systemically important banks, and to the smallest building society. There was no attempt, or indeed opportunity, to forestall the application of PIE status to smaller building societies as an artefact of these EU laws. Now that the UK has left the EU, re-examining some of these EU mistakes ought to be a priority.

We have taken some comfort from the government's response to the consultation on strengthening the UK's audit, corporate reporting and corporate governance systems. Paragraph 1.6.53 says: "The Government recognises that 'public interest' may evolve over time, and that the PIE definition may need to evolve with it. Therefore, the Government intends to legislate so that Ministers can amend the size threshold by secondary legislation in future, as well

[1] Click here to access link to our formal response to BEIS and open letter to government.
[2] For example, see PRA consultation paper, "The Strong and Simple Framework: a definition of a Simpler regime firm", CP 5/22.
[3] Report from the Taskforce on Innovation, Growth and Regulatory Reform.

as including or excluding groups with specific characteristics such as sector or company type, if it proves necessary to change the scope in the light of changes in circumstances." If this happens, as we advocate, in the very near future, then the FRC's aim for proportionality can be reached more cleanly and more quickly.

Activity blocks

ARGA's annual funding requirement will be based on "activity blocks", and allocated to the prescribed groups of market participants ("funding groups"). There is no detail on tariff bases however, a factor which influences immensely the costs to levy payers. The PRA and FCA use modified eligible liabilities, roughly UK deposits, as a tariff base for both building societies and banks. This is fundamentally flawed and we have long argued against this tariff base for our sector. We trust the FRC will work with us to develop a metric[4] more suited to mutuals.

Transparency

We welcome the fact that information on the costs and activities funded by levy payers will be publicly available. This will include the apportionment model and the way in which levies are calculated. We do acknowledge that this is a consultation paper on principles rather than detail. But we do at the same time urge the FRC to be wholly transparent on matters on funding and outcomes. We have in the past castigated regulators for opaque accounting policy changes, vague budgets and vague headings such as "investment". For example, our response to the FCA's fees and levies rates proposals consultation for 2021/ 2022, we questioned the use of a "rebased" budget. Our response[5] noted:

[4] While we understand the regulators require an expedient and clear metric, modified eligible liabilities is an indiscriminate and blunt measure of risk or impact. It has a disproportionate effect on domestic deposit takers such as building societies, which by their nature tend to have high levels of MELs. While the very largest building societies' size and customer base mean they are systemically important, they operate a lower risk business model, compared to most financial services businesses such as banks. In part, this is due to restrictions imposed by building society legislation and to the PRA's supervisory statement on building societies' treasury and lending activities. But in the main, this lower risk model is a result of societies' – in common with all mutuals - desire to serve their members with straightforward, well-designed, low cost products.

[5] FCA regulated fees and levies: rates proposals 2021/ 2022 – BSA response.

Some would argue that this rebasing is a fudge to deflect attention from growing overheads. When other organisations take on different responsibilities, there often follows a change in budget but rarely an overall increase. They manage with the resources they have, particularly in economically difficult times. In our response last year we stated: "We recognise the need for an adequately resourced conduct regulator staffed by competent, experienced and effective people. But there is also a need for budget clarity, robust budgetary control, resistance to 'mission creep', and prioritisation of tasks as resources simply cannot cover everything. There is no clear correlation between high spending regulators and successful ones." That viewpoint has not changed.

We would like assurance that the FRC will not make the same errors.

We note that ARGA's funding model should be "as far as possible, stable from the perspective of ARGA's levy-payers". From a building society perspective, stability is less important than proportionality. If any levies are eventually levied on our sector, they should only reflect the work done on it. They should therefore not contain elements of corporate overheads affecting other sectors. This might mean the levels of any future levies may vary.

Of even greater concern is the assertion that levy contributions should not be adjusted to reflect the risks associated with individual sectors or entities. This suggests that a larger but safe entity could end up paying a higher levy than a riskier entity, in effect subsidising the riskier entity. This also appears to run contrary to the report from the Taskforce on Innovation, Growth and Regulatory Reform, which says: "The UK needs to establish its own modern, agile and effective approach to regulation. The UK should adopt a new Proportionality Principle that reflects the risk and the desired outcome."

Our concern with the proposal to set a minimum size for the organisations to which levies will apply centres on the threshold. How many entities will be affected; how often will the threshold be revisited? What happens if these entities – or entities now outside the scope of the levy - need extra supervision/ help – who pays then?

Size, while a reasonable indicator of impact, is a poor proxy for risk; we suggest the FRC considers alternative approaches that incorporate a significant element of "polluter pays" as well as provide incentives for better and more prudent behaviour.

We disagree with the proposal that ARGA should not seek to retain financial sanctions under any of the ARGA enforcement regimes. After accounting for any expenses, surplus monies should be returned to the funding group in which the enforcement occurred. Otherwise there is a possibility that these sanctions become a tax by the back door.

Question 2 *Do you have any comments on the proposals for setting ARGA's annual funding requirement?*

Again the AFR proposal reflects the practices of regulators such as the PRA and FCA. We welcome different budgets for each of the four enforcement regimes and the undertaking not to cross subsidise the different regimes. We do, however, have concerns about "corporate overheads". These have the potential to be very large and opaque. How are they going to be monitored and apportioned?

The proposals state that for "other elements of ARGA funding, the funding requirement for each scheme will be based on the annual budget adjusted for over or under-spends for the previous year." That method seems somewhat basic, especially for an accountancy regulator. Is there not a more refined way? As stated, it gives the impression that these parts of ARGA funding will not be comprehensively examined once an initial budget is set out.

We are concerned with the statement that "there should also be provision for top-up levies in the event of under budgeted costs, and for levy funds to be pooled as cash flow, albeit separate annual accounts will be maintained for each regime." Firstly, top-up levies should only be used rarely and in unforeseen emergency situations: they should not be relied on for BAU expenditure. Secondly, pooling of levy funds, even for cash flow, could inadvertently lead to cross subsidisation, something the FRC says in several places it will avoid.

We would like to know what measures FRC/ ARGA will take to stop this happening in cash flow.

Question 4 *Do you have any comments on the proposed approach to setting ARGA's annual levies for its responsibilities in relation to audit?*

We have only a general observation to make. Many building societies have experienced at some stage difficulties in engaging external auditors. There are, very simply, few audit firms that qualify. Should building societies, or the majority, remain PIEs any move that reduces the already small pool of external audit firms should be resisted. Disproportionately high levy levels could contribute to a decision to withdraw from the PIE audit market.

Question 6 *Do you have any comments on the proposed approach to setting ARGA's annual levies for its responsibilities in relation to corporate reporting?*

Corporate reporting is an area that affects building societies as they are all currently classified as PIEs. It will form a sizeable part of ARGA's activities and so is important to get the levy funding for this area right. It is proposed that the levy will be based on size, a measure we believe to be a poor proxy for risk. Metrics based on size will always have a disproportionate effect on mutuals such as heavily regulated building societies with their lower risk models and domestic focus.

If no, or limited, risk factors can be incorporated into the levy, we believe the previous year's turnover to be an appropriate metric.

The consultation paper says that the costs of UKEB will be recovered through ARGA's annual preparers levy from those preparers required to adopt UK-endorsed IFRS. We understand that to mean that those entities that adopt IFRS voluntarily will not be charged.

Question 7 *Do you have any comments on the proposed approach to setting ARGA's annual levies for its responsibilities in relation to corporate governance?*

We agree with the FRC's proposal that ARGA's work on corporate governance should be funded by listed companies and large private companies. Recent experience suggests that these areas pose the greatest risk to the economy so this proposal seems a proportionate 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 £477 billion, and account for 23% of the UK mortgage market and 18% of the UK savings market.