

BANKING REFORM : delivering stability and supporting a sustainable economy

Response by the Building Societies Association (BSA)

Executive Summary

- This is a preliminary response. The BSA will respond in greater detail to “The Future of Building Societies” discussion document
- The BSA broadly agrees with the White Paper’s analysis of the problems with the UK banking sector
- Mutuals were not part of those problems, but will be part of their solution - a sustainable, lower-risk banking sector in the UK
- Ring fenced retail banks and building societies must continue to be able to offer retail investment products and services, including structured retail deposits
- There is no need to prohibit either secondary market purchases of mortgage books or the securitisation of mortgages originated by a subsidiary
- The ring fence must not impede necessary, or prudent, use of insurance policies
- The governance proposals are problematic for mutual banks
- Application of a *de minimis* exemption for ring-fencing needs to consider the potential for distortions to competition if ring-fencing is applied to all building societies
- Changes to depositor rankings must be introduced in a consistent and coordinated manner to avoid confusion
- The BSA opposes any levy on its members to pay for the activities of the Financial Stability Board – on the “polluter pays” principle this cost should fall on G-SIFIs and large, internationally active banks

Introduction

1. The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK including all 47 UK building societies. Building societies have total assets of almost £330 billion and, together with their subsidiaries, hold residential mortgages of £210 billion, 17% of the total outstanding in the UK. They hold just over £215 billion of retail deposits, accounting for 19% of all such deposits in the UK. Building societies account for about 31% of all cash ISA balances. They employ approximately 39,000 full and part-time staff and operate through approximately 1,700 branches.

2. The BSA has welcomed the Treasury’s proposals to cater for building societies in the context of the wider banking reforms through parallel amendments to the Building Societies Act, as outlined in a companion document to the White Paper, “The Future of Building Societies”. Accordingly, the BSA will be responding at much greater length and in much greater detail to the specific proposals in that companion document. In this response to the White Paper, the BSA will therefore attempt only preliminary coverage of those matters, as well as addressing other issues raised in the White Paper that are not specific to building

societies, but may affect BSA members, particularly other banking mutuals, directly or indirectly.

General observations

3. The BSA broadly agrees with the analysis set out in, and underlying, the White Paper as to what went wrong with the UK's banking sector and led to the crisis. We share the Government's concern that large, complex, and therefore "too big to fail" universal banks exposed the public finances, and so taxpayers, to massive risks requiring expensive bail-outs. The implicit guarantee conferred on such banks was anti-competitive, and worked to our members', and consumers', disadvantage by hindering potential challenge to the large incumbents. And the costs of banking failures – such as the Bradford & Bingley PLC bank and the Icelandic banks – fell not only on the taxpayer but also on the rest of the deposit-taking sector through the enormous, unprecedented and ongoing levies required for the Financial Services Compensation Scheme. BSA members' 25 million individual customers have typically been affected twice: both as taxpayers, and as the ultimate owners of mutual businesses burdened by FSCS levies. So we support sensible measures to ensure that such a combination of damaging losses can not recur.

4. Mutual deposit-takers, like co-operative banks in other parts of Europe, were not part of that problem, but at the BSA we regard our members as very much part of the solution – a sustainable, lower-risk banking sector that is not prone to wild casino-style speculation and greed but is instead focused on the real needs of individual and small business customers. We welcomed the recognition in the ICB report that the risk management function for ring-fenced banks could follow the building societies' precedent.

Ring-fencing retail banks - Chapter 2

5. The BSA also broadly agrees with the policy aim of the proposed ring-fence – to insulate domestic utility banking from the much greater risks and volatility in wholesale and international investment banking ("casino banking"). As mentioned above, building societies are already naturally ring-fenced by their existing legislation. So the general approach proposed in "The Future of Building Societies" – to amend the Building Societies Act where needed to implement a broadly similar ring-fence for societies as for retail banks – is sensible, and has the BSA's support – provided a number of boundary issues identified in this response, and in our subsequent response to "The Future of Building Societies", are satisfactorily resolved.

Scope of mandated services (consultation box 1)

6. We are content with the scope of services (accepting deposits only) that will initially be mandated – or as the White Paper explains, protected – and for power to define further mandated services if needed. As to the threshold above which firms cease to be SMEs and can deposit with any bank, we favour the simplicity and consistency of using the group of criteria in the Companies Act 2006 definition based on turnover, balance sheet total and number of employees. We note that this is the current basis for defining which small businesses are eligible for FSCS protection. Basing the threshold on these three criteria reduces the risk of fluctuation. Again, for simplicity, we do not favour opt-outs, except in the special circumstance where a small company is part of a larger group. Turning to individuals, we agree that a free investable liquid assets test is the right basis to exempt high net worth individuals from having to deposit with ring-fenced banks or building societies, and this has to be assessed at the single bank level as the White Paper proposes. We would be content with a threshold of at least £250,000 i.e. at the lower end of the range canvassed in the White Paper. Finally, we favour an assessment over a sustained period of at least three years for dealing with instances where either SMEs or individual might cross the relevant threshold – this should avoid either category being inconvenienced by having to move in and out of the ring-fence.

Scope of prohibited services

Geographical restrictions (consultation box 2)

7. We agree that the Credit Institutions Winding-up Directive and the proposed Recovery and Resolution Directive will reduce the challenges to cross-border resolution within the EEA. So we are broadly content with the proposed geographical restriction to the EEA provided the Government can deliver - as a special case - bilateral arrangements with the authorities in the Channel Islands and the Isle of Man that enable BSA members to continue to operate, whether by branches or subsidiaries, in these territories. Our members' activity in these islands forms a natural extension of their personal banking, savings and mortgage business in the UK itself, and the close links with the islands, and the absence of currency risk, make such operations a low risk undertaking – they have nothing to do with casino banking.

Financial institution exposure (consultation box 3)

8. We agree with the general principle of restricting exposures to financial institutions that may either transmit contagion or give scope for arbitrage. However, care is needed that broad brush restrictions, though well-intentioned, do not exclude transactions or involvement with other financial institutions which are either harmless, or even positively necessary.

9. We address in more detail, in our separate response to “The Future of Building Societies”, the question of involvement with retail investment businesses such as fund managers, insurance companies or IFAs. This again is a natural extension from cash savings, does not involve the kind of risks mentioned in the White Paper, and has nothing to do with casino banking. Sensible business links between our members and, for instance, the insurance companies whose retail investment products they offer, must not be compromised by the ring-fence.

10. Our members will also use a range of insurances for their own protection – including some that are obligatory – employers' liability, premises insurances, fidelity cover – which necessitate transactions with insurance companies that give rise to substantial economic exposures. As mortgage lenders, our members may also make use of various kinds of mortgage insurance for risk mitigation. Again, all these sensible, prudent and necessary arrangements must not be compromised by a simplistic and unthinking implementation of the ring-fence.

Financial product restrictions (consultation box 4)

11. The BSA is broadly content (apart from four specific areas) with the approach to financial product restrictions. We address in detail in our response to “The Future of Building Societies” how the existing restrictions in the Building Societies Act should be adapted to parallel the ring-fencing requirements for banks.

12. Our members' biggest concern relates to selling retail investment products – box 4 asks about the desirability of permitting ring-fenced banks to do so. That there is no consideration within the text of the White Paper of this broader issue prompts us to wonder whether the wider scope implied by the consultation question is intended.

13. Retail investment products, such as collective investment products, OEICs, unit trusts and life assurance-based investments are typically components of longer-term savings portfolios. As such, the sale of retail investment products is a good fit with, and complements, building societies' core savings and lending business – as mentioned above. It has nothing whatsoever to do with casino banking or any of the risks that the White Paper proposals generally seek to address. Income from the sale of retail investment products has been a key contributor to building society profitability for several decades and is likely to remain so in the future, notwithstanding the likely impact of the implementation of the Retail Distribution Review in January 2013.

14. The RDR is widely expected to reduce the availability of advice about retail investment products. BSA members, with their extensive branch networks, are well placed to continue to advise upon and sell such products, or to introduce customers to third party providers of such advice. We see no justification for any new ring-fencing restriction on this area of business, which would be quite unnecessary, disproportionate, and damaging to consumers.

15. Another concern relates to structured deposits. The White Paper acknowledges that structured deposits may be provided in ways that are relatively safe. We concur - structured deposits are offered by several BSA members in order to offer a full range of savings and investment options. The principal of the deposits is covered by the FSCS, as they are taken by the society or mutual bank. The generation of the equity-linked return typically involves the BSA member transacting a derivative with an investment bank, but this does not expose the society or bank to increased risk across a variety of global financial markets to any greater extent than providing a fixed rate mortgage, which also involves the use of derivatives, so should not cause any greater difficulties in insulating BSA members' core services or in resolving them. The customer's investment, and any returns made on it, is therefore not at risk because it is backed by the society or bank should the provider of the derivative fail. Structured deposits have proved popular with customers in the current very low interest rate environment as they offer the opportunity of higher returns combined with capital certainty. We are strongly of the view that BSA members should continue to be able to offer structured deposits.

16. We do not agree with the restriction on secondary market purchases of loans. While the vast majority of any BSA member's mortgage lending is self-originated, there are from time to time opportunities to buy reasonable quality mortgage books – for instance, from other lenders deciding to exit the market. Such activity should remain under prudential oversight – as it always has been – but there is no need for an outright ban. (Indeed, an outright ban could prove highly counterproductive when the authorities next have to resolve a failing bank - like Bradford & Bingley- under the SRR – as that bank's mortgage book could in future only be transferred to a non ring fenced bank – and the ring fenced banks and building societies to whom that book would have the most attraction and complementarity would be precluded from buying it.) The same goes for the securitisation of assets originated outside the mutual bank or building society itself – BSA members often originate mortgage lending destined for securitisation in a subsidiary company, possibly with a distinct brand – this practice is well established, has enabled lower funding costs to be passed on to consumers, has caused no problems, and again need not be subject to an outright legislative ban.

Ancillary activities (consultation box 5)

17. Clearly it is necessary for a ring-fenced bank or society to fund itself, run a prudent but efficient treasury, and hold a constantly renewed pool of liquid assets. Some of the exemptions mentioned in the White Paper – buying and selling gilts, transacting derivatives to manage the bank's own interest rate risk, or holding other short term debt instruments – are essential – indeed the ring-fence regime would be totally unworkable without them. So they need to be more than an afterthought. And, as stated above, we do not agree that securitisation of assets originated or held in a subsidiary should be precluded.

18. The best safeguard against either the risk of evasion or arbitrage – or the greater risk that the new legislation unintentionally frustrates some essential activity in a way not foreseen at the time of enactment – is to future proof the ring-fence regime so that it can be adapted from time to time.

Intra group relationships (consultation boxes 6 to 10)

19. The issues raised in this section do not in general concern the BSA's building society members, since the building society is always at the head of its group and the question of intra-group links with non ring-fenced subsidiaries does not arise: this is the "Apex problem" that we address in more detail in our response to "The Future of Building Societies". But these issues do affect our mutual bank members.

20. One major concern relates to governance. The White Paper proposes a majority of independent directors on the board of the ring-fenced bank. But this is problematic for mutual and cooperative banks, as these have to be structured as company subsidiaries of an I&P or other mutual entity, whose directors are elected by the wider membership. Requiring a ring-fenced mutual or cooperative bank to have no more than a third of directors representing the parent mutual clearly conflicts with its mutual governance and accountability. This is therefore another area where flexibility in these requirements is needed.

Scope and *de minimis* (consultation box 11)

21. The Government proposes a threshold for banks but no *de minimis* exemption for building societies. Building societies are already extensively ring-fenced by their existing legislation. If anything, it could be argued that this means that a higher *de minimis* could be applied to building societies than to other banks to reflect this. Under the proposed reforms, although banks with less than £25 billion of mandated deposits will be exempt from ring-fencing, building societies of the same size or smaller will still be subject to any ring-fencing amendments to the Building Societies Act. If the same threshold were to apply to building societies, all but the largest couple of societies would probably be exempt.

22. There is therefore a potential competitive disparity if medium-sized banks are not subject to ring-fencing legislation that constrains building societies of the same size. One of the high level principles the Treasury proposes as a guide for reform in *The Future for Building Societies* is that building societies should be able to compete fairly in the future world of financial services. The BSA will describe in more detail how potential competitive distortions between building societies, ring-fenced and non-ring-fenced banks could be reduced when it responds to *The Future of Building Societies* discussion document, including the sector's views on the appropriate level of a *de minimis* exemption.

23. Factors relevant to this issue include how satisfactorily amendments can be made to the Building Societies Act that resolve the various potential boundary issues for building societies detailed in this response (also to be described in our response to *The Future of Building Societies*), the potential for a non-ring-fenced bank to compete unfairly with building societies, and to what extent a non-ring-fenced bank could be easily resolved and the impact of such a bank's failure, including its impact on the FSCS.

Loss absorbency – chapter 3

Capital and leverage

24. The BSA generally opposes superequivalence in implementation or application of international or European prudential requirements. On capital, the CRD 4 package should provide a consistent and adequate framework for both minimum requirements and buffers, with scope for additional buffers for systemic banks. It goes without saying that we believe these additional buffers should not be applied to smaller banks and building societies. We do not favour higher requirements for UK banks alone – nor should Pillar 2, which is an institution specific tool, be used covertly to increase Pillar 1 requirements for UK banks generally.

25. The BSA strongly endorses the decision in the White Paper not to attempt to increase the minimum leverage ratio beyond the Basel III international standard. The leverage ratio will in fact be implemented in the EU, including the UK, through the CRD 4 package. The BSA has argued that a single leverage ratio across all business models is anyway a blunt and inappropriate measure, and particularly damaging to low-risk businesses like building societies and other mutuals. The BSA therefore supports the approach taken in the European Parliament, where the leverage ratios under CRD 4 will be differentiated according to riskiness of business model – so that banks (and societies) following a low-risk model will have a lower ratio, the generality of banks will have the same ratio as in Basel III, and high risk banks will have a higher ratio. We call on the UK Government to support this sensible and innovative approach in the European Council.

PLAC and bail-in

26. The BSA has consistently argued that the need for the bail-in tool arises for systemic banks only, therefore its impact should also be focused on systemic banks, and this view is supported by the conditions attaching to its use proposed in the EU's draft Recovery and Resolution Directive. Since systemic significance will not be constant over time, and the threshold too can vary according to the authorities' risk appetite, we recognise that a statutory framework for bail-in, with suitable safeguards, that theoretically applies to all deposit-takers, as proposed in the RRD, is probably necessary.

27. Of critical importance is that use of bail-in, and any required maintenance of a stock of liabilities that are capable of bail-in, is genuinely targeted on the most systemic banks. In that context, we draw attention to the criteria set out in Article 39 of the draft RRD for determining the minimum amount of liabilities eligible for bail in, which clearly (and correctly in our view) emphasise the size, business model, risk profile, and interconnectedness of the institution.

28. The draft RRD also addresses the question of whether there could be a role for subordinated debt, that does not qualify as Tier 2 capital, to be bailed-in first, before a more generalised bail-in of eligible senior debt. Article 43 is fairly simple and clear – if necessary, bail-in –or statutory write-down – extends beyond capital instruments first to non-qualifying subordinated debt, and only affects eligible senior debt if the quantum of write-down needed cannot be satisfied from full write-down of all capital and subordinated debt. We think this approach is principled, and relatively simple – we do not favour the more complex ICB prescriptions of primary and secondary bail-in, nor do we see any need to multiply the layers of different kinds of loss absorbing debt of slightly differing degrees of subordination. Finally, we note that any UK mechanism for bail-in must be consistent with the RRD, as ultimately European law will take precedence in this area, and any attempt to complicate or over-engineer bail-in will be counterproductive as the market will not necessarily understand the complexities.

Depositor preference

29. The BSA continues to support full retail depositor preference, going beyond the FSCS coverage limit. As the White Paper/discussion document suggests, this may need to be accomplished by using the Butterfill Act to equalise the current rankings of deposits and share accounts at building societies, as well as new primary legislation to prefer retail depositors at both building societies and banks. The BSA also reaffirms its overriding concern that nothing should be done to change current priorities until the final policy outcome for both banks and building societies is totally settled – and then, the moves to achieve that for building societies should be done at the same time as for banks, with carefully controlled and coordinated communication. Both markets and consumers will only be confused by sequential, poorly-coordinated changes.

30. The White Paper correctly identifies that depositor preference, leading also to an equivalent preference for the FSCS in respect of any claim following from paying out preferred deposits, does indeed mitigate the burden on the FSCS from any one bank insolvency or resolution. Given the heavy burden of FSCS levies that building societies already bear in order to deal with the bank failures during the 2008 crisis (particularly at the Bradford & Bingley PLC bank and the Icelandic banks) such a reduction of the future burden is welcome. The White Paper notes, however (footnote 18 on page 48) that the current RRD proposal would curtail these benefits – this is because Article 99 states (in paragraph 2) that deposit guarantee schemes must rank *pari passu* with unsecured non-preferred deposits in the context of resolution. So, unless Article 99 is changed, the benefit of relieving the burden on the FSCS will not be realised. We urge the Treasury to work closely with the six EU states that already have depositor preference in order to secure a better outcome on Article 99, rather than give up on introducing depositor preference.

Industry levy

31. The BSA notes the proposal for future levies on the banking industry if needed to contribute to the costs of the Financial Stability Board. Since these international financial stability risks are (i) not restricted to deposit-takers as such, but arise especially from wholesale investment firms (like Lehmans, Bear Stearns, and many others) ; and (ii) arise typically from G-SIFIs or large internationally active banks, any levy should likewise fall entirely, or primarily, on G-SIFIs and large, internationally active banks – on the “polluter pays” principle. For the same reason, the BSA opposes any material levy affecting its members.

Competition – chapter 4

32. BSA members, with an organisational structure and culture very different from the dominant PLC banking model, provide important choice, competition and diversity in the UK banking market. The BSA has made a separate submission to the Parliamentary Commission on Banking Standards, addressing these organisational and cultural differences, and their implications for behaviour and treatment of customers.

33. The BSA has recently repeated some market research on customer perceptions of, and customer service at, PLC banks and mutuals including building societies, and published the results in July. The results indicated higher levels of customer trust and customer service at mutuals. The full publications may be accessed through these links:

<http://www.bsa.org.uk/mediacentre/press/trust.htm>

http://www.bsa.org.uk/mediacentre/press/customer_service_july12.htm