

THE FUTURE OF BUILDING SOCIETIES

Submission by the Building Societies Association

Executive Summary

- The Building Societies Association (BSA) welcomes the Government's recognition that the UK has a thriving, innovative and efficient building society sector that plays an important role in the economy, providing consumers with a mutually-owned option for their deposits and mortgage lending.
- Applying ring-fence regulations to building societies provides an opportunity to modernise the Building Societies Act, while maintaining the distinctive nature of building societies that follows from their mutual ownership. The BSA believes the high level principles proposed by the Treasury – to enable the sector to be able to compete fairly in the future, while protecting the sector's distinctive approach – should provide a useful basis for reform.
- Building societies add to the diversity in financial services markets, but there is also valuable diversity within the building society sector itself. There will therefore be a diverse range of visions for the sector, including which markets some societies will look to expand into. However, building societies' visions share some common themes, notably that they are committed to their mutual status, and as such;
 - Societies are focused on members' interests by delivering the saving and borrowing services (and, depending on the society, a range of other services) that members need, giving good value through sustained competitive pricing together with high levels of customer service.
 - Building societies manage their businesses so that they are sustainable over the long-term. This means low-risk strategies, including prudent lending, ensuring they have the requisite skills and expertise, and maintaining strong capital and liquidity positions.
 - Societies will compete with other providers, and each other, by continuing to improve the efficiency of their operations, keeping control of costs while maintaining services, and responding to feedback from engaged members.
 - Societies will develop opportunities for more of their members to contribute, in deeper and more meaningful ways, to decisions on how the institution is run. This will include societies continuing to play an important role in the communities in which they operate.
- A range of activities support building societies' principal purpose, and these should not be prohibited under amended building society legislation. These activities enable societies to offer a full range of saving and housing services, and are far removed from the wholesale and investment banking services the ring-fence was intended to exclude. Constraints on building societies' organisational structure – whereby the building society must be at the apex of the corporate group – means that continuation of these services requires them not to be prohibited for building societies.

- More detailed amendments to the Building Societies Act would allow societies to offer a wider range of derivative products than at present, remove the prohibition on building societies creating floating charges and seek to avoid unintended consequences from restrictions on exposures to other financial institutions or on the use of certain financial products.
- Other changes required to modernise the Act are also necessary to ensure that requirements on building societies reflect the operating environment of today, for example, in relation to electronic communications and disclosure to members via the Summary Financial Statement, and to build in enough flexibility so that legislation does not unduly constrain building societies in the future as the operating environment evolves.

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. Building societies are owned collectively by their customers. As the Government recognises in the discussion paper, this means they exist to maximise benefits for their members, rather than profit for external shareholders. This has a fundamental effect on the activities that building societies undertake and the way in which they do business. Rather than focusing on short-term gains for external shareholders, building societies can focus on delivering value to members on a sustainable basis over the long-term. This different approach means that societies provide a competitive challenge to shareholder-owned banks, improving consumer choice, and also add to the resilience of the financial system by making it more diverse. Building societies' focus on customers also results in demonstrably better levels of customer service¹.

3. To ensure building societies can expand on their important role in the future, the BSA welcomes the Government's approach to building societies as outlined in *The Future of Building Societies* discussion document, and we look forward to working with the Government to help it achieve its objective in the Coalition Agreement of supporting diversity in the financial services sector and promoting mutuals. This may represent the most fundamental review of the building society sector's role since a Green Paper in 1984 that was the precursor to the Building Societies Act 1986. Aside from a key safeguard against demutualisation that was easily circumvented, that Green Paper led to successful deregulation of building society legislation. It restated the core purpose of building societies, with legislation that generally built in sufficient flexibility for the sector to evolve to subsequent changes in the external environment without compromising on societies' principal purpose. It therefore represents a useful example of legislative change in the financial services sector.

4. As the discussion document acknowledges, building societies did not cause the financial crisis. They are therefore not the primary target of the reforms recommended by the Independent Commission on Banking (ICB), and it is important that they are not the victim of unintended consequences when these reforms are implemented. The Government also recognises that building societies have an important role to play in the future of UK financial services, so as well as doing no harm, building society legislation should be appropriately amended so that building societies are not unfairly prevented from achieving the visions they have for their future roles.

¹ "Mutuals: Better customer service" BSA, 2012, http://www.bsa.org.uk/docs/publications/customer_service12.pdf

5. This response takes the requests for views and information listed in Chapter 4 of *The Future of Building Societies* in turn. Terminology defined and used in either the White Paper or the discussion document is used in this response without further definition.

The Government welcomes views on its vision for the building societies sector and proposed approach to the legislative framework.

6. The BSA supports the Government's vision for "a thriving, independently minded and sustainable sector that is able to continue to offer consumers a mutually-owned option for their deposits and mortgage lending". Since the financial crisis, the building society sector has examined its historical role, and the purpose it should fulfil in the future. The sector will build on its heritage to reinforce the focus on members' needs and those of their communities, supporting aspiring homeowners and promoting a culture of saving by providing trusted and transparent services.

7. In addition to the diversity a thriving mutual sector brings to financial services sector overall, the BSA supports the Government's recognition of the valuable diversity within the mutual sector itself. Building societies differ in terms of size, scope of activities, focus (from a broad national customer base to a specific region or locality or affinity group) and in their strategic approach. Therefore, each individual building society will have its own vision for the ways in which it will develop and innovate in the future. For some building societies there are opportunities to expand into new markets – for example, into current accounts or SME lending – where this aligns with the long-term interests of their members, supported by the development of suitable controls and expertise, and where they are not prevented by regulatory barriers. Others, however, will continue to focus exclusively on their core operations.

8. Of course, there will be some common threads to these visions as societies' principal purpose – to make loans which are secured on residential property and funded substantially by members – is set out in current legislation. This focus will continue to allow societies to fulfil a role valued by consumers and beneficial to society more widely. Building societies are committed to their mutual status, and this provides the following common foundations for their individual visions:

- They are focused on members' interests by delivering the saving and borrowing services (and, depending on the society, a range of other services) that members need, giving good value through sustained competitive pricing together with high levels of customer service.
- Building societies manage their businesses so that they are sustainable over the long-term. This means low-risk strategies, including prudent lending, ensuring they have the requisite skills and expertise, and maintaining strong capital and liquidity positions.
- Societies will compete with other providers, and each other, by continuing to improve the efficiency of their operations, keeping control of costs while maintaining services, and responding to feedback from engaged members.
- Societies will develop opportunities for more of their members to contribute, in deeper and more meaningful ways, to decisions on how the institution is run. This will include societies continuing to play an important role in the communities in which they operate.

9. The BSA also welcomes the Government's two high level principles that will guide its consideration of amendments to building society legislation to support these visions being realised. Firstly, building societies should be free from inappropriate burdens so they can compete on a fair basis, subject to the second principle, namely that the sector should continue to offer a distinct alternative to large shareholder-owned banks.

The Government welcomes views on whether the Building Societies Act should be amended to broadly reflect the ring-fencing requirements, with no *de minimis* exemption.

The Government welcomes views on its proposed approach to aligning the Building Societies Act with the prohibited services proposals for ring-fenced banks and on whether there are any services that should be allowed for building societies even though they are prohibited for ring-fenced banks.

General observations

10. The BSA supports the Government's proposal to introduce ring-fencing type requirements via amendments to the Building Societies Act rather than applying the ring-fencing legislation to building societies on top of the Act. This approach should avoid building societies being subject to two sets of legislation that cover similar areas but that might differ in detail (thereby adding unnecessarily to compliance costs) and enable the distinctiveness of building societies to be preserved.

11. The Building Societies Act 1986 has not been substantially amended since 1997, and there are a few areas where it has needed modernising to reflect the changes to the operating environment over the last fifteen years and to enable the sector to compete on a fair basis with other providers. Therefore, as well as implementing relevant ring-fencing requirements, these necessary revisions are described below.

12. The Government proposes there be no *de minimis* exemption for building societies. Therefore, although banks with less than £25 billion of 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 £25 billion threshold were to apply to building societies, all but the largest couple of societies would probably be exempt. In the unlikely event that the Treasury's more detailed proposals for amending the Building Societies Act do not, in the BSA's opinion, provide a satisfactory outcome on issues such as the apex problem (covered in detail below) and so appear likely to constrain societies' legitimate business, the BSA could no longer then support the application of *de minimis* exemptions to banks but not to societies. However, as long as building societies are not so constrained by the ring-fence proposals introduced via amendments to the Building Societies Act, the lack of a *de minimis* exemption should not cause them major obstacles to achieving their visions. Currently, restrictions set out in the Building Societies Act do not cause major barriers to smaller building societies, so any changes that relax these restrictions to align them with ring-fenced banks should also not cause these societies problems.

13. If ring-fencing requirements apply to all building societies, the £25 billion threshold for banks may be too high. There is a potential competitive disparity if medium-sized banks are not subject to ring-fencing legislation that constrains building societies of the same size. And a universal bank with £10 billion mandated deposits is borderline systemic, and a £20 billion bank (approximately the size of Bradford & Bingley before it failed) certainly can be. It would be particularly necessary to bring the threshold on deposits down if it is also to apply to non EEA branches. And since the damage done by a failing universal bank relates to its total size, not necessarily just the size of mandated deposits, the threshold should be set at £10 billion of total assets, or £5 billion of mandated deposits, whichever is lower. This would ensure that medium sized non-ring-fenced banks, which could still be systemic, would be operating on an equal basis to building societies, and would add to financial stability because these institutions would be required to place their mandated deposits into a ring-fenced subsidiary, aiding resolvability.

14. It is not just legislation that constrains building societies' activities. The Specialist Sourcebook for Building Societies, which forms part of the FSA's Handbook, provides rules-based guidance solely for building societies regarding their treasury and lending activities. There is no equivalent sourcebook for banks. However, if building societies are to compete on a fair basis with other deposit-takers, the Sourcebook represents one of the most

substantial barriers to competition – particularly for smaller societies. If the Sourcebook is necessary for building societies, we question why something similar would not be considered necessary for all banks, and particularly for ring-fenced banks, which will often have business models and structures similar to each other, and to building societies. If this is not the case, the FSA will need to consider if the Sourcebook should be removed for building societies so that they can operate on the same basis as ring-fenced banks. It would also seem sensible and logical, for *non* ring-fenced banks, with their much looser and riskier statutory framework, especially those that undertake retail deposit business but are exempt from ring-fencing under *de minimis* proposals, to be subject to a new Sourcebook to further restrain and mitigate the risks they pose both to their depositors and to the wider banking system.

Prohibited services - the Apex problem

15. The Building Societies Act currently provides a permissive regime, setting out some specific activities which societies cannot do, but otherwise leaving the scope of their activities fairly open. This can fit with the concept of the ring-fence as the vast majority of societies' activities would be permitted in the ring-fence, with deposit taking mandated. We generally support the Government's intention to amend the prohibitions in the Building Societies Act so they are aligned with the proposed restrictions in ring-fencing legislation.

16. However, some mutuals conduct various important activities that might not be permitted within the ring-fence if it were to be applied to building societies. These activities currently tend to be conducted by subsidiaries owned by the building society and the Building Societies Act requires the building society be at the head of the corporate group. However, under the ring-fence proposals this structure may not be permissible (depending on the activity – we understand that a lending subsidiary would be permitted). This is what we have called the "Apex" problem. Yet, given the nature of these activities, we believe a strong case exists for permitting them in building societies though they would not be permitted in a ring fence bank, under the proposals in the White Paper.

17. The White Paper says that "it remains the Government's view that ring-fenced banks should largely be prohibited from carrying on international and wholesale and investment banking services", and intends to prohibit dealing in investments as principal in primary legislation. The diverse activities currently conducted by building societies are far removed from this type of investment banking. Instead they include estate and lettings agencies, independent financial advice, and servicing mortgages and savings on behalf of other firms. All are closely related to building societies' principal lines of business; savings and financing house purchase.

18. The aim of the ring-fencing policy is to insulate critical banking services from shocks elsewhere in the financial system and to make it easier to preserve these services under an orderly resolution. Building societies' activities would not prevent these objectives being achieved, as they;

(a) Support building societies' core function of intermediating between saving and borrowing members. Conducting such related activities can help societies to better understand these markets, and help them better meet members' needs. For example, an estate agency can help a society to understand the housing market, and to respond rapidly to changes in the demand for different mortgage features.

(b) Do not make it more difficult to resolve the firm, nor do they increase the firm's exposure to global financial markets. These activities tend to be conducted on an agency basis, with no principal at risk. Capital is therefore not held against market risk for these subsidiaries (though some may be held against operational risk).

(c) Can make the provision of building societies' core functions more stable by diversifying sources of earnings, making the group more robust to adverse shocks in one of its businesses, and enabling the group to sell subsidiaries to raise capital

quickly if necessary, particularly as rapidly issuing new external capital instruments may not be a simple option for all societies.

19. The contribution of these activities is often clearly disclosed under segmental reporting in a building society's annual report and accounts. Further, many building society subsidiary activities are directly authorised with the FSA, and prudential supervision considers the gross and net risks arising across the whole corporate group. Building societies' risk management systems routinely assess risks from subsidiaries to the whole group, and the recently introduced Recovery and Resolution Plans banks and building societies are required to produce involve assessing how subsidiaries could be dealt with.

20. It is also instructive to consider the kind of services building societies offer –many of which fall under the general heading of personal financial services and services relating to property – and how these fit fully within the Treasury's original vision for building societies' diversification set out in the July 1984 Green Paper "Building Societies – a New Framework" (Cmnd 9316) which led to the 1986 Act.

21. In the July 1984 Green Paper, specific reference was made to the desirability of building societies being enabled to move into (amongst other things) estate agency, investment advice, mortgage servicing and other agency activities.

22. At paragraph 4.08, the Treasury stated:

"The entry of building societies into estate agency would greatly increase competition. It would enable the societies to offer an integrated service for house buying. This would be welcome to many house buyers."

23. Those societies that maintain estate agency subsidiaries today could readily demonstrate to the Treasury how they have fulfilled the Treasury's 1984 vision, with no material risk to the society.

24. At paragraph 4.17, the Treasury stated:

"It can be argued that the legislation should go further so that those societies which so wished could offer the maximum range of financial services to individuals, subject to the general legislation on investor protection. That range might include arranging for the purchase or sale of stocks and shares and providing more general financial and investment advice."

25. The Treasury then followed up this sound analysis in the 1986 Act with the result that societies have been able to undertake a range of investment business, and agency stockbroking. For a sector whose core remains the mobilisation of shorter-term cash savings to lend on mortgages, the natural extension to serve members' needs is to enable them to access longer-term equity-based investment. At a time when individuals are encouraged to be more financially self-reliant, it would make no sense at all to drive building societies out of such investment business.

26. Moreover, the Independent Commission on Banking's Final Report specifically recommended that "advising on and selling products from non-ring-fenced banks, where no exposures arise for the ring-fenced bank as a result" would be permitted within the ring-fence. We would welcome confirmation from the Government that in accordance with this recommendation, an Independent Financial Adviser owned by a building society would be permitted under the ring-fence rules applied to them, so that these parts of the business do not fall foul of the apex problem.

27. At paragraph 4.13 of the 1984 Green Paper, the Treasury stated, during a discussion of societies' possible agency services :

"Or they might provide a mortgage management service on behalf of other lenders."

28. That observation was specifically in the context of the Treasury advocating that societies should take over the management of local authority mortgage books, but the same model applies equally to servicing the mortgages of other lenders – including other societies.

29. We revisit these paragraphs of the July 1984 Green Paper to underline that societies' activities in each of these areas are not a matter of having found and exploited some loophole in the Act, or made foolish forays into high-risk activities, but rather a clear response to explicit (and farsighted) Government policy at the time. This produced considerable benefits for consumers as it resulted in greater competition and increased access to products via trusted providers. So the BSA urges the Treasury in these matters to hold fast to the strategic vision it developed in 1984, and retain these various activities within the scope of what societies are permitted to do.

30. In the next sections we address in detail how the modifications to the Building Societies Act should cater appropriately for building societies in the ring fence environment proposed by the White Paper. We refer in turn to each set of the more detailed proposals in the White Paper to consider how they should be applied to building societies.

Ancillary activities - Section 9A

The Government welcomes views on whether section 9A of the Building Societies Act should be amended to mirror the restrictions on ancillary services in the ring-fencing legislation.

31. The BSA strongly supports the Treasury's approach of "taking the best from both regimes, based on high level principles". We cover in this response the high level points relating to section 9A, but will be happy to provide the Treasury with additional detail and analysis.

32. The present restrictions on financial trading in section 9A of the Building Societies Act have worked satisfactorily for most societies, with only minor amendment, since they were introduced in 1997, and were commended in the ICB's final report. But modest updates to the detail of section 9A, necessitated by developments in financial products and in societies' own business, had been under discussion with the Treasury for some time. Given the Treasury's decision to adapt section 9A in order to apply ring-fencing requirements, some of these specific updatings may prove no longer necessary, as the Treasury has indicated that where the ring fencing requirements are more liberal than the Building Societies Act, some of the restrictions in the Act can be removed. For completeness, however, we record points below in the course of responding to specific proposals in the Treasury's paper.

33. We agree with the proposal to allow building societies to offer an expanded range of simple derivative products, subject to the same safeguards as ring-fenced banks. Such a change should automatically deal with two improvements to Section 9A that the BSA had already requested: (i) allowing societies to offer derivatives that might be categorised as futures or options as well as contracts for differences (as currently permitted); and (ii) allowing a society that is leading and/or acting as agent for a syndicate loan – such as to a housing association – to transact a derivative with the customer for the whole amount of the syndicated loan. However, we oppose the possible restriction, suggested in the White Paper itself, that a derivative could only be provided to holders of a mandated deposit – which would, contrary to the Treasury's general intention, represent a narrowing of what building societies can presently do. First, the customer requiring a derivative may well be a mortgage borrower, who need not have a separate savings account with that society. Second, the need to provide interest rate protection derivatives in connection with syndicated loans, typically arising in the case of loans to housing associations, will be for customers who don't necessarily fall into the SME category – indeed, for the loan to be syndicated, it will naturally be for a large amount, so unlikely to be provided to an SME.

34. We also support the proposal to remove the upper limit on foreign currency transactions with customers.

35. We also deal here with the issue of using commercial options, as this relates specifically to Section 9A. A society may, in the course of its normal business, quite properly wish to enter into an option to acquire shares or other property. For instance, in a joint venture where the society may want or need the ability to buy out the other party on agreed terms. We are quite clear that there was no intention at the time of the 1997 Act to restrict societies in this way – but an unwanted result of how the various definitions interacted was to cast doubt on societies' ability to use commercial options. So – in revising Section 9A – we think it is important to make a clearer distinction between financial derivatives and commercial options.

36. We refer below, in the section on building societies and capital, to the need to allow societies to undertake small scale market making in their own deferred shares.

Section 9B

37. We strongly advocate the repeal of Section 9B, which prohibits floating charges from being created by a society. One result of the financial crisis is that more and more financial transactions or operations have to be collateralised by cash or securities to mitigate the risk to the counterparty. A common feature of such arrangements is that until the security interest crystallises, the collateral will be dynamic – particular securities may be moved in and out of the collateral account and replaced by others. And obligations towards payment, clearing or settlement systems also need to be secured and collateralised. Even the use of various Bank of England liquidity facilities, which require collateral, was unnecessarily complicated by Section 9B. As a result, the Treasury has been obliged on three recent occasions to amend Section 9B in primary legislation to head off real, practical problems in societies' treasury management.

38. One original reason for the prohibition in section 9B was that it could give a chargeholder excessive control over the society, to the detriment of members and other creditors, especially through the exercise of the power to appoint an administrative receiver. Since the changes made by the 2002 Enterprise Act, however, the ability to appoint such a receiver has been severely curtailed – a receiver cannot now be appointed except in relation to charges created prior to those changes coming into force. Since there cannot be any building society floating charges in this category, the repeal now of section 9B could not introduce the risk that an administrative receiver might exercise too much control.

39. We recognise the Treasury's general concerns regarding risk and members' rights. But the original concern has been mitigated anyway by the Enterprise Act, while in practice – as outlined above – Section 9B has increased other risks by complicating societies' ability to collateralise. Nor do collateral arrangements of the kind described above infringe members' rights – if anything, the inability to use collateral efficiently, and the legal risk posed by Section 9B, operate to members' disadvantage. So, the BSA's conclusion is that Section 9B adds no value, the original concerns that might have justified it have now largely been superseded, and by itself poses risks, and therefore should be repealed in its entirety.

40. The real risk posed by the increased demand for collateralisation – which applies equally to ring-fenced banks and societies - is of *encumbrance*: more and more of an institution's assets are pledged to various secured creditors (e.g. through covered bonds, repos, margining etc), leaving unsecured creditors – including depositors – in a weaker position. This can be addressed as a microprudential matter by the FSA/PRA - existing section 9B does not solve this problem anyway.

Financial institution restrictions

The Government welcomes views on whether the proposed restrictions on exposures to financial institutions for ring-fenced banks should also be applied to building societies.

41. 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.

42. First, we note that the existing restrictions on building societies' equity ownership of other financial firms (paragraph 3.27) do not inhibit societies from owning some categories of investment firm, insurance companies or fund managers. Indeed, we would argue that the possibility of such ownership should be seen in the context of the natural extension from the core business of cash savings: once an individual has satisfied her need for simple cash savings, she may wish to invest for the longer-term through a variety of vehicles – a life policy, regular savings into collective investment schemes – and may need independent financial advice in doing so. While many societies may choose to meet these needs by linkage with an existing provider, there seems to be no reason in principle why a society should not set up or own the provider. In one instance a society set up and owned both a life assurance company and a unit trust management company to provide a range of longer term products to its members. We think the case against the proposed restrictions are most powerful in relation to fund managers, and investment firms that are not broker-dealers – using the Treasury's own criteria in paragraph 2.32 of the White Paper, these firms do not perform financial intermediation, are not highly leveraged nor display a high level of maturity or liquidity mismatch, nor a high degree of interconnectedness.

43. Care is also needed as to what may constitute an economic exposure. It is clear, and sensible, that a society's own liquidity management and hedging transactions – which may give rise to claims on non ring-fenced banks or other financial entities – should be excluded. But a society will, for instance, incur significant economic exposures to insurance companies simply by virtue of the range of corporate insurances that it is prudent or even obligatory to maintain – employers' liability, premises insurance, fidelity cover and so on. These must clearly continue to be permitted.

Financial product restrictions

44. There are several examples of financial product restrictions proposed in paragraph 2.36 of the White Paper which are not appropriate for building societies. First, the restriction on secondary market purchases of loans. While the vast majority of any society'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 building society itself – societies 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.

Structured deposit products

45. The White Paper, at paragraph 2.45, considers the potential risks to banks of structured deposits. It acknowledges that structured deposits may be provided in ways that are relatively safe. We concur - structured deposits are offered by several building societies 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. The member's investment, and any returns made on it, is therefore not at risk because it is an obligation of the society (i.e. regardless of whether the provider of any ancillary hedge might fail). The generation of the equity-linked return typically involves the society transacting a derivative with an investment bank, but this does not expose the society 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 building societies' core services or in resolving a building society. 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 societies should continue to be able to offer structured deposits.

Selling retail investment products

46. The scope of the consultation question posed in the White Paper (Question 4) goes much wider than the relatively narrow question of structured deposits, in that it seeks "views on the desirability of permitting ring-fenced banks to sell retail investment products". 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.

47. Retail investment products, such as collective investment products – OEICs or 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. 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.

48. The RDR is widely expected to reduce the availability of advice about retail investment products. Building societies, 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. Whilst we would acknowledge that such activity can pose prudential risk to societies, that risk can generally be easily managed and could be mitigated further by banning the sale of certain products deemed to be "toxic", such as the traded life assurance policy funds. FSA already has some powers in this regard and these are to be enhanced with the inception of the Financial Conduct Authority in 2013. But we consider that it would be disproportionate, as well as damaging to consumers and to building societies, if societies were to be precluded from offering retail investment products per se.

49. Finally, the prohibition on making markets in securities should not extend to a society's small scale market making in its own deferred shares, which may be necessary to provide liquidity for a new loss-absorbent capital instrument. This activity would again be subject to prudential control, but there should be no outright legislative ban.

Geographical restrictions

The Government welcomes views on its proposed approach to geographical restrictions.

50. We welcome the Government's moves towards permitting ring-fenced banks, and therefore building societies, to maintain either branches or subsidiaries in Guernsey, Jersey and the Isle of Man. Societies' activity in these islands again forms a natural extension of

their 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 much lower risk undertaking than say operating a subsidiary in a remote EEA state (which the ring fenced legislation is obliged to permit). Societies may also continue to operate in Gibraltar as this is treated as within the EEA.

Further reforms to Building Societies Act

Lending and funding limits

The Government welcomes views on the level and method of calculation of the funding and lending limits.

51. Overall, the BSA broadly agrees with the Treasury that nature limits should be maintained and do not need to be changed in the near future. But we explore below how they could be improved and made more flexible.

52. The paper's description of the present funding limit is not strictly correct – the 50% limit refers not to retail (as opposed to wholesale) deposits, but to members' share accounts as distinct from deposits (whether retail or wholesale). The reason why share accounts generally have a retail nature is that only individual members can open share accounts, and societies sometimes place an upper limit on each member's investment in a given share account. But a large investment in a share account – a larger society may set the upper limit for a share account as high as £ 1 million – still qualifies within the funding limit. Nor is it strictly correct to say that the definition does not include investments by SMEs. An SME sole trader (e.g. a window-cleaner) can hold a members' share account. Incorporated SMEs cannot however open share accounts. They can, however, open retail deposit accounts – but these will count against the funding limit.

53. The funding limit has been amended by statutory instrument in 2007 (SI 2007 / 860) so that a proportion of retail deposits by individuals in offshore subsidiaries – up to 10% of the group total - which would otherwise count outside the funding limit (as these deposits cannot be members' share accounts), may instead be disregarded in the funding limit calculation.

54. Given that unincorporated SMEs can already hold share accounts, and that SME deposits generally are to be mandated to ring-fenced banks/building societies, the BSA would support a re-formulation of the funding limit so that SME deposits no longer counted against the limit. This could be done either by disregarding some, or all, SME deposits in the calculation, or providing that SME deposits are to be included with members' shares. The BSA would be happy to engage with the Treasury on a modest re-design of sections 7 and 8 to cater for SMEs more fully. Funds deposited with societies in products such as structured deposits should also be capable of being classed as retail as the deposits ultimately derive from individual customers, as discussed above, though they do not confer membership rights.

55. On the lending side, there is no distinction by nature of borrower, only by nature of security: accordingly, a loan fully secured on residential property to an SME counts within the 75% nature limit in the same way as a loan to an individual owner-occupier. And societies already lend to SMEs on the security of commercial property, though this falls outside the 75% limit.

56. The Act currently gives the Treasury flexibility to reduce the lending limit percentage from 75% down as far as a floor of 60% by affirmative statutory instrument. The BSA would support an increase in that flexibility – requiring primary legislation – by moving that floor from 60% down to 50%. However, no change is envisaged to the current 75% limit at any point in the near future.

57. One further concern, based on recent experience, is that section 92A could unintentionally impede acquisitions of business that are fully consistent with the statutory principal purpose and nature limits. Section 92A controls the acquisition or establishment of a non-core business – the test is whether the activities have “no connection” with loans secured on residential property. This test is easy to apply on the asset side, but becomes problematic where a society contemplates acquiring a deposit book. While it can be successfully argued that the acquisition of the deposits is connected with residential loans because the funds are used to finance such lending, the matter may not be free from doubt, and the opportunity should be taken to revise section 92A to put beyond doubt the treatment of acquisitions of savings or deposit businesses. A further reason for doing so would be to ensure that a transfer to a society of a deposit book - in the course, say, of resolving a failed bank under the SRR – should not be complicated by uncertainty as to whether the society might be obligated to follow the section 92A procedure and put the transfer to a member vote.

Building societies and capital

The Government welcomes your views on whether, and how, the Building Societies Act should be updated to support the issuance of a new, loss-absorbent capital instrument.

58. The principal regulatory constraints on societies’ raising capital through a new core tier 1 instrument are in Articles 25 to 27 of the EU Capital Requirements Regulation that is awaiting final adoption, and in any regulatory technical standards prepared by the European Banking Authority based on mandates in that Regulation. The BSA will update its Model Rules to cater for issuance of such new core tier 1 instruments which will take the form of building society deferred shares. There are two principal further changes to the Building Societies Act that have been under discussion with the Treasury, which are needed to support issuance. (There are also a number of other areas where capital issuance could be facilitated by minor improvements to the 1986 Act – the BSA will be happy to have more detailed discussions with the Treasury on these matters.)

59. First, in order to cater for the situation where a society transfers to another mutual using the route provided in the Butterfill Act, or otherwise transfers to a company, changes are needed to section 100 (2) and (8) in order for some or all of the core tier 1 capital not to be irreversibly degraded into subordinated debt - tier 2 capital - on transfer. Section 100(2) requires that on a transfer, the member’s shareholding turns into a deposit (and this applies to deferred shares too). Section 100 (8) provides that priority rights to acquire shares in the successor cannot be conferred on members who have not held their shares throughout the two year qualifying period. Consequently, the deposits that result from application of section 100(2) to a deferred share on transfer cannot be applied in subscription for new company shares in the successor unless the deferred shareholder has held the shares continuously for two years before the qualifying day (or has otherwise continuously been a shareholding member). Since, in the general case, the new core tier instrument will be tradable, at any one time some holders may, and others may not, satisfy the two year qualification. So a proportion of any new core tier 1 instrument would necessarily be degraded to subordinated debt rather than converting into core tier 1 ordinary company shares in the successor.

60. The second change has already been referred to: societies should be free to undertake modest market-making (only) in their own deferred shares, in order to provide liquidity for any issue of a new core tier 1 instrument. At present societies could in theory do this, for individual amounts of up to £100,000 only, by virtue of section 9A (1) (a) and (2) (a). This needs to be made a specific exception to the ring fence, and the BSA favours the lifting of the £100,000 statutory limit, with such capital repurchases subject only to prudential controls. But this of course would not extend to any other market making, including in other societies’ instruments.

Summary financial statement (SFS)

The Government welcomes your views on whether, and if so how, the requirements for summary financial statements should be changed.

61. The origin of the SFS also lies in the Treasury's 1984 green paper, which noted that the prevailing requirement to circulate the full audited accounts to virtually all members had become self-defeating. The new SFS was to be a simple document, presenting information in a readily understandable way. Since 1987 when the SFS provisions in the Act took effect, the whole area of deposit-takers' disclosure to stakeholders has been revolutionised by the introduction of "Pillar 3" as part of the Basel 2 /CRD changes in 2006. Annual financial accounts of building societies have also been made longer and more complex for those societies that have had to adopt International Accounting Standards, and some of that length and complexity has unfortunately spilled over in to the SFS produced by those societies. Finally, the "Pillar 3" disclosures will be substantially extended and enhanced yet again under the EU Capital Requirements Regulation. How far does the content of such disclosures matter to ordinary society members? So the BSA supports a more thorough re-examination of the purpose and specification of the SFS: in today's world, is it still possible to produce a short document that gives individual members an adequate financial overview of their society? Are the risk-related Pillar 3 disclosures as important for members as annual accounts information? How far is there overlap and duplication between the various requirements? The BSA would like to offer to establish a working group of experts from a number of building societies to give an initial consideration to these questions, and to examine what information members would value (as opposed to wholesale creditors, ratings agencies, etc, which have separate relationships with societies), and how this can be best disclosed to them.

62. There is also one matter where a small change of primary legislation is needed, whether or not the SFS is extensively revised. A curious provision of the Act (section 76 (9)) obliges a society to send or give a copy of the old SFS to any new member at any time in the year until the next SFS is available. The practical consequence of this is that societies have to keep stocks of the SFS at all branches for the whole year. There is provision for the SFS to be provided electronically – see section 76(9A) to (9D) – but this depends on individual agreement with each member. We suggest that a much more sensible approach would be for a society to be able to make the SFS available on its website for the remainder of the year, but for the present section 76(9) to be deleted so there is no need to keep stocks of paper copies. New members would be notified of the online location when they joined the society but could not demand paper copies. These changes would have modest environmental benefits.

Other changes

The Government welcomes your views on whether any other elements of the building societies legislation should be updated.

63. The BSA continues to seek, on both cost and environmental grounds, a step change in societies' ability to use **electronic communications** for statutory notices and documents sent to members. There is limited provision, through an Order made in 2003 under the original Electronic Communications Act 2000, for societies to use electronic means instead of sending paper documents, but only where each member gives individual consent. A leading society that has embraced electronic communications nevertheless has found that its use has plateaued at a relatively small proportion of members. To achieve a transformation that could reduce the millions of paper documents still having to be sent, a more radical approach is needed. In the period since the 2000 Act, this has been achieved for companies – changes in the Companies Act 2006 effectively allow electronic communication through a website to be the default mode for certain purposes – such as sending of company annual reports – shareholders need to opt back in to continue to receive paper documents. The BSA strongly encourages the Treasury to deliver a similar result for societies – so that

instead of needing individual members to opt in, electronic communication can become the default mode, from which members can opt back in to paper documents if desired. The environmental benefits from this change would be substantial.

64. The BSA continues to call for inflation-related updating of the **deceased investors limit** (Schedule 7 to the Act). This provision protects societies that pay out small sums to personal representatives in advance of probate. The limit was set at £5,000 in the Act, but more than 25 years later, needs to be revalorised – the BSA calls for a new limit of £15,000 to cater both for past inflation and provide slight inflation proofing for a few years. This uprating can be achieved by secondary legislation under powers in Schedule 7.

65. The BSA also requests a minor change to the provisions governing **building society mergers** to facilitate the assimilation of the range of savings and loan accounts offered by the merging societies. This is a well-established practice, effected by the “instrument of transfer” called for under section 94, but relies on an implied statutory power to do so. Greater clarity and certainty would be achieved by an express statutory power to vary the terms of savings or mortgage products to enable assimilation upon a merger (or transfer of business).

66. Section 117(3) of the Building Societies Act allows a building society to change its **financial year end** to 31 December only. We suggest this is unnecessarily restrictive, and should be removed so that building societies enjoy the same flexibility that banks enjoy in this area: this restriction does not apply to banks, which could in theory move their financial year end to any date.

Leverage ratio

The Government welcomes views on leverage ratio, and would encourage the building societies sector to submit their views in response to the white paper.

67. The BSA strongly endorses the decision in the White Paper not to attempt to increase the microprudential 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 capital Requirements Regulation. 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. The BSA therefore supports the approach taken in the European Parliament, where the leverage ratios 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.

Loss absorbency and bail-in

The Government welcomes views on the statutory bail-in tool, and would encourage the building societies sector to submit their views in response to the white paper.

The Government welcomes your views on the application of PLAC requirements to building societies.

68. Ring-fence capital buffers and PLAC requirements should be proportionate to the risks posed by a financial institution, as proposed by the Government in the White Paper. Simple small building societies are unlikely to be systemic, so the additional requirement should not apply to them.

69. 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.

70. 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.

71. 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

The Government welcomes your views on its proposed approach to building society creditor hierarchies.

72. 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, as well as new primary legislation to prefer retail depositors. 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.

73. 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 Bradford & Bingley 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.

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