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HM TREASURY CONSULTATION ON BAIL-IN POWERS IMPLEMENTATION

RESPONSE FROM THE BSA

Introduction

The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK including all 45 UK building societies. Mutual lenders and deposit takers have total assets of over £330 billion and, together with their subsidiaries, hold residential mortgages of over £230 billion, 18% of the total outstanding in the UK. They hold over £230 billion of retail deposits, accounting for 19% of all such deposits in the UK. Mutual deposit takers account for over 30% of cash ISA balances. They employ approximately 39,000 full and part-time staff and operate through approximately 1,600 branches.

This submission responds to HM Treasury's consultation published on 13 March 2014 on the implementation of bail-in powers under the recent Banking Reform Act. We concentrate on the two issues of direct relevance to the BSA, its members, and their customers: the theoretical ***application of bail-in to building societies*** (on which we have already had an exchange of correspondence with the Financial Secretary), and the introduction of ***retail depositor preference*** (which the BSA has supported for some time).

Application of bail-in to building societies

We welcome the reiteration (in section 3 of the document) of the Government's commitment, set out in the Coalition Agreement, to promoting mutuals and fostering diversity in financial services. We agree that the bail-in powers should be capable of being applied to building societies (where justified by the fairly high threshold of systemic considerations). But we consider it is more important that the bail-in stabilisation option can be used *appropriately* and *effectively* for building societies, rather than (a priori) necessarily *"in as similar way to banks as possible".* That would be to fall into the error of basing all thinking on the single model of the proprietary PLC bank. Therefore, the BSA disagrees with some aspects of the Government's approach, and we reaffirm the arguments already made in correspondence with the Financial Secretary, which we develop further below. As also made clear in that correspondence, we have no objection to the specific measures embodied in the draft SI, so long as these are not regarded as exhaustive. The BSA will continue to work on alternative, more appropriate solutions.

The Treasury proposal, that bail-in requires the prior or concurrent demutualisation of the society in order to deprive members of their rights, is justified by reference[1] to "one of the basic principles of bail-in" that owners should lose control of the firm. But this principle, while it may be fundamental in the proprietary PLC bank context, does not necessarily read across to other corporate forms, such as mutual or cooperative banks, savings banks, public banks or banks operated by religious or charitable entities. And in the recently-adopted Bank Recovery and Resolution Directive (BRRD), the clear focus is on the allocation of the economic costs of resolution first to holders of equity or other "instruments

[1] In correspondence the Treasury has claimed this is a "fundamental principle" of bail-in, defining "owners" as those who were previously able to make decisions relating to the firm and who enjoy the economic value generated by the firm.

of ownership”. The conversion, or bail-in, of non-equity liabilities may well lead to dilution for the original owners, or even a change of ownership, but that is a secondary consequence of the allocation of losses. This is made clear at Article 34[2], which states the **general principles governing resolution**. Article 34 itself makes no reference to the “basic principle” that the Treasury asserts – moreover, Article 34.6 makes express provision that employee representation on a bank board is *not* to be prejudiced by resolution action. The change that is mandated by Article 34 is that the management body and senior management team must be replaced. There is passing reference to the Treasury’s “basic” or “fundamental principle” in Recital 39 to BRRD (stating that *shareholders* should no longer retain responsibility for an institution that has passed into resolution) while other relevant Recitals (47 and 67) clearly focus on economic losses, and Recital 49 underlines the importance of respecting the particularities of the (original) legal form of the institution. Indeed, it is abundantly clear from the final text of BRRD that the Directive does not presuppose that other corporate forms need to be converted into PLC-type proprietary companies in order to be resolved, as the Directive makes careful and inclusive provision to cater for resolution that respects and preserves the original corporate form.

We also considered that the Treasury has misinterpreted the term “instruments of ownership” as used in BRRD (including Article 47) by applying it to building society membership rights deriving directly from a customer relationship, and not from an “instrument”. Our view is indeed strengthened by the term’s definition - in the latest BRRD text at paragraph 61 of Article 2 (Definitions) - as follows :

'instruments of ownership' means shares, other instruments that confer ownership, instruments that are convertible into or give the right to acquire shares or other instruments of ownership, and instruments representing interests in shares or other instruments of ownership;

The term “shareholders” is also defined in the succeeding paragraph 62 :

‘shareholders’ means shareholders or holders of other instruments of ownership;

It is also clear from the use of the terms elsewhere in the Directive[3] that “instruments of ownership” are “instruments” which can both absorb losses allocated to them, and provide new capital where they result from the conversion of liabilities: that is, they are (or are convertible into) CET 1 instruments that confer ownership. In the building society context, that means deferred shares - primarily CCDS- and not members’ savings held in share accounts.

We also challenge the Treasury’s analysis of the effect of bail-in converting a building society’s liabilities into CCDS – again, this results from the (unnecessary and undesirable) attempt to implement bail-in in “as similar a way to banks as possible” – that is, the PLC straitjacket. At the point of resolution, it is impossible to know *a priori* what long term value may be recoverable from the CET 1 instruments that bailed-in creditors receive – that mainly depends on whether the resolved entity is successful after re-launch, and other wider economic and market circumstances, not on the nature of the instruments, or their level of voting rights. CCDS will of course vary as to how deep and liquid their market is – but the same is true of bank ordinary shares: where a privately-owned bank is resolved, the new ordinary shares allocated to bailed-in creditors will have no immediate market unless a listing is also organised, and even then the market maybe very thin. For this reason, later in the consultation document, the Treasury describes how the independent valuer is to determine their value – with a methodology being prescribed by SI.

[2] All references to BRRD Articles or Recitals are to the text as adopted by the European Parliament on 15 April 2014, pending appearance of a definitive text in the Official Journal.
[3] See, for instance, Recital 62, and paragraph 75 of Article 2 (Definitions).

The suggestion that converting debt into CCDS would leave bailed-in creditors worse off than in insolvency – and land the Government with a large compensation bill – is in our view- unwarranted scaremongering. It is possible that a bailed-in creditor might eventually achieve a higher return if a building society is demutualised and then bailed in, compared with bailing-in within the building society structure, but that is the wrong counterfactual. The value attributable to the CCDS into which bailed-in liabilities are to be converted will differ in each case, and will therefore influence the conversion ratio so as to provide reasonable compensation. This area is now determined by the provisions of BRRD (Article 50) and EBA guidelines will be provided to clarify *"how affected creditors may be appropriately compensated by means of the conversion rate"*.

So, in response to the group of **Questions QQ 1 to 3** the BSA's position is as follows:

We accept that demutualisation may be one option through which resolution and bail-in of a building society could be carried out. But we reject the notion that demutualisation is a necessary step, and we reject the misapplication by the Treasury of the notion that PLC-type "owners" should lose control, and the misinterpretation of "instruments of ownership". We describe below a straightforward alternative route for resolution with bail-in within the building society structure. Ensuring this option is also available, is fully in accordance with BRRD Article 43.4 which states (emphasis added) :

*Member States shall ensure that resolution authorities may apply the bail-in tool to all institutions or entities …….. **while respecting in each case the legal form of the institution or entity concerned** or may change the legal form.*

We use two examples to illustrate resolution with bail-in within the building society structure. In **Example A**, a large society has issued a full range of capital instruments (listed CCDS, additional tier 1 convertible into CCDS, and tier 2). In **Example B**, the society has issued only tier 2 capital, but its rules cater for the issuance of CCDS. In both cases the resolution, and write down of capital instruments and (if necessary) the bail-in of other liabilities, will take place strictly in accordance with BRRD, beginning with the valuation required by Articles 36 and 46 to determine the quantum (X) of loss absorption (by write-down or conversion of capital instruments or eligible liabilities) needed to complete the internal recapitalisation of the failing entity.

In **Example A**, we make the assumption that the AT1 instruments have already been contractually converted into CCDS as the society dropped through the high-level trigger. So at the point of resolution, there will be an enlarged pool of CCDS constituting the "instruments of ownership", and these will be the first to be written down in accordance with Article 59. Then the T2 instruments will be converted into CCDS. Only if X is larger than the total of original CET 1, AT1 and T2 instruments is bail-in of other liabilities needed, in which case they too will be partially written-down and replaced by an equivalent amount of CCDS. The resolution authority will also ensure the requisite changes to the governing body and senior management (in accordance with Article 34.1 (c)), and the amount of CCDS allocated by way of conversion of T2, or partial bail-in of other liabilities, will be determined in accordance with Article 50. The end result is that the recapitalised society will have a new pool of CCDS (deriving from T2 conversion and bail-in) and new senior management, and should be able to continue as a going concern. The retail savings accounts of ordinary members (and the resulting membership rights, as well as the membership rights of mortgage borrowers) need not be affected at all. The new CCDS resulting from bail-in and conversion will have voting rights, but on the same one member one vote basis as applied to the original CCDS, now written-down. In this Example, the original CCDS were already listed, so providing some basis for valuation (though as with the resolution of a bank, there is no necessary correlation with the pre-resolution value of the CCDS, or in the bank case, the ordinary shares).

In **Example B**, depending on the value of X, the tier 2 capital will need to be converted to CCDS, and some other liabilities may also be required to be bailed-in, with partial

conversion into CCDS. The amount of CCDS allocated on the conversion of bailed-in liabilities will be determined in accordance with Article 50. So, whereas previously the society had no CCDS, it will now have a pool of CCDS deriving from conversion of tier 2 and bailed in debt. The governing body and senior management will be changed (as per Article 34.1(c)), and the recapitalised society will be able to continue as a going concern. Again, the retail savings accounts of ordinary members (and the resulting membership rights, as well as the membership rights of mortgage borrowers) need not be affected at all. The new CCDS will have voting rights on a one member, one vote basis as already provided by virtue of the society's Rules that cater for CCDS issuance.

There is one recent example of use of resolution tools, on the Dunfermline Building Society in 2009, which resembles the original situation of Example B, except that in 2009 bail-in and CCDS were not available, the partial transfer tool was used, and the residue of the society had to be put into administration and run down. The costs of this partial administration were enormous, and the whole procedure is now recognised to have destroyed value. Were Dunfermline to have failed under the BRRD regime, it could have been resolved along the lines of Example B. The existing tier 2 subordinated debt of the society would have been converted to CCDS, some other liabilities would have been bailed-in and also converted or partially converted to CCDS (with conversion rate settled in accordance with Article 50), and the society's internal recapitalisation –together with senior management change – would have allowed it to continue as an independent society. Depending on subsequent trading, and other circumstances, the CCDS could in fact have achieved a reasonable value. Moreover, given what we now know about the actual costs even of a partial administration, the costs of the NCWO counterfactual – a *whole-firm insolvency* of Dunfermline – would have been colossal. So, contrary to the assertions in the Treasury's paper, it is highly unlikely that any NCWO compensation would have been triggered solely because the CCDS do not confer voting control of the recapitalised society.

Turning to detailed **Questions QQ 4 to 6**, we are broadly content with the Treasury's approach, where the demutualisation route is one possible option. We have no additional comments on the detail.

The creditor hierarchy

Question 7: Do you agree that early transposition of the BRRD is the best approach for aligning creditor hierarchies and ensuring the bail-in tool is effective?

We agree with the proposal to transpose early the BRRD provisions concerning creditor hierarchy.

We welcome the BRRD provisions which accord preference to eligible deposits and a "super-preference" to covered deposits. Whilst the new creditor hierarchy may have some impact on the wholesale deposits market, we judge that any potential negative impact will likely be mitigated by the beneficial effect of a reduced burden on the FSCS arising from any future banking failures even if, as we all hope, such events will be rare. Future FSCS costs are an important consideration for a building society sector still bearing the burden of a disproportionate share of the legacy compensation costs arising from the bank failures of 2008. Moreover, to the extent that the changes to the creditor hierarchy are understood by retail depositors (which admittedly may be limited) they should help engender increased confidence in the safety of retail savings.

It had previously been proposed by HM Treasury that a two stage approach be adopted, involving an interim step of equalising the ranking in insolvency of the savings accounts of building society members with that of other creditors, and only some time later promulgating preferred status for the former. That approach could have given rise to confusion. A key merit of the approach now being proposed is that it will provide certainty and consistency. It is particularly important that the creditor hierarchy of building societies is to be changed at

the same time as that for banks and that the current differences in the respective creditor hierarchies of the two classes of deposit taker will be removed in a way that is clean and transparent.

Safeguards and NCWO - General (Questions 8 to 15)

We agree that careful provision is needed to safeguard protected arrangements, such as security, title transfer collateral, set-off and netting arrangements. Building societies use all of these arrangements from time to time, but we do not think they raise any distinctive issues. On these, and other technical issues, we welcome the engagement of other expert stakeholders.

The No Creditor Worse Off principle is fundamental to the whole exercise of resolution, with or without bail-in, and it is important to get the counterfactual right. We agree that the "insolvency treatment" should assume no resolution action, and no financial assistance from either the Bank or the Treasury. The "actual treatment" clearly needs assumptions as to the value of relevant securities, and a methodology for calculating that value – and this is particularly important where (as the BSA contends) bail-in can take place within a building society structure in which case the securities allocated to bailed-in creditors will be CCDS, which are less familiar and less widespread than ordinary shares and therefore may be more difficult to value by reference to existing securities in issue from other sound firms. This area is fully addressed in the BRRD (Article 50).

NCWO – Building societies (Questions 16-17)

Where resolution of a building society proceeds through the demutualisation route, we agree that in theory the "relevant persons" are the society's members holding share accounts (in respect of their membership only) and the eligible creditors.

Group Companies (Questions 18 to 20)

We agree with the Treasury that capital markets arrangements, such as covered bond and securitisation structures and their vehicles, should be protected. Building societies use both covered bond and securitisation structures from time to time, but we do not think this gives rise to any distinctive problems.

The question of whether to bail-in any net uncollateralised exposure of either covered bond or securitisation vehicle is difficult. Leaving them out of bail-in could, as the Treasury suggests, incentivise under-collateralisation. But including them could equally incentivise over-collateralisation, and increase asset encumbrance. Presumably BRRD (text now finalised) has already made this choice – in which case we think it would not be sensible for the UK to do anything divergent for an interim period as this will only confuse the markets.

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