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Our response to two Basel Committee consultations: Strengthening the resilience of the banking sector (CP 164) *and* International framework for liquidity risk measurement, standards and monitoring (CP 165)

Introduction

The Building Societies Association represents mutual lenders and deposit takers in the UK including all 51 UK building societies. Mutual lenders and deposit takers have total assets of almost £375 billion and, together with their subsidiaries, hold residential mortgages of almost £240 billion, 19% of the total outstanding in the UK. They hold over £245 billion of retail deposits, accounting for just under 22% of all such deposits in the UK. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

Summary

The Building Societies Association welcomes the opportunity to respond briefly to these two consultations. Our members are essentially domestic institutions, so do not fall within the category of large internationally active banks to which the Committee's remit extends. Nevertheless we have a number of high-level comments and observations on the contents of the two documents.

Overview

We agree with the Committee that the resilience of the international banking sector needs to be strengthened in the wake of the recent banking crisis. Although our members, like many mutual and cooperative banks across the world, did not cause or contribute to the crisis, or require recapitalisation with massive state aid, they have not been immune from its effects, even while continuing to conduct their traditional business in a prudent manner. In the UK, our members have carried a disproportionate share of the cost of deposit compensation necessitated by the major failures of proprietary banks, both UK-based banks and overseas (Icelandic) banks operating in the UK. So it is directly in our members' interests that the resilience of internationally active banks is strengthened. Moreover, the Committee has correctly identified at paragraphs 248 to 255 (capital conservation best practice, and experience during the financial crisis) that one of the key contributors to the low pre-crisis level of resilience was the practice of over-distribution by proprietary banks, both to shareholders, and also to staff, at the expense of retaining earnings to build capital.
Many of the individual measures proposed in CP 164 make sense as a response to the crisis.

But we have two overall concerns: double-counting and overall calibration. Double counting is the risk that more than one individual measure is taken to deal with a particular aspect of the problem, but in apparent isolation from each other – with no clarity as to why they should be additive rather than alternatives. We see this as most problematic in the area of capital conservation and buffers – where a proliferation of different buffers and provisions Overall calibration is an even more difficult task and may only begin to be discussed when the results of the quantitative impact study are known.

The Committee rightly seeks to promote (paragraph 10) "a better balance between financial innovation, economic efficiency and sustainable growth over the long run". What CP 164 does not overtly recognise is that diminishing returns from higher prudential requirements set in very quickly – as recent research modelling in the UK confirms, the optimum balance is

soon reached and beyond that further tightening simply destroys welfare. Nor does the Committee recognise that its own members, as national supervisors, are themselves incentivised to overshoot when tightening prudential requirements – as they benefit directly from the lower risk of institution failures but the resulting costs of loss of economic output fall elsewhere.

Raising the quality, consistency and transparency of the capital base

The Committee states that the vast majority of internationally-active banks are structured as (proprietary) joint-stock companies, hence the focus on ordinary shares as the primary core tier 1 instrument. Footnote 19 on page 18 then suggests that the relevant criteria also apply to mutual and cooperatives taking into account their specific constitution and legal structure. In our view, while the criteria are no doubt satisfactory for proprietary companies, certain criteria are simply inappropriate for mutuals and cooperatives as (being based exclusively on the capitalistic “basic ownership” concept) they contradict the fundamental principles which distinguish them from proprietary firms. In particular, Criteria 2 and 5 are repugnant to the international cooperative principles of disinterested distribution and limited interest on capital. Nor has the Committee correlated the observed problem of over-distribution with the innate characteristics of the ordinary share as enjoined by Criterion 5.

Special consideration also has to be given to joint stock companies which are subsidiaries of mutuals or co-operatives. For example, in the UK, it is not possible for a co-operative (or certain other types of mutual) to operate a banking business other than through a joint stock company subsidiary (ie a non-mutual company), with the group as a whole run along mutual principles. Such subsidiaries should be afforded the same derogations as for non-joint stock companies including the possibility to issue capped instruments. National supervisors should be able to take account of the fact that shares held by the mutual/co-operative group in the bank fulfil a different function (including control rights) compared to external investments with limited voting rights. The reference in paragraph 87 to non-voting shares of banks being "identical to voting common shares of the issuing bank in all respects except the absence of voting rights" is unnecessarily restrictive, and would, for example, prevent subsidiary banks of mutuals or co-operatives from issuing capped instruments.

We note that the UK’s HM Treasury has warned in its response to the Commission Services document on further changes to the CRD that consideration will need to be given to how the criteria for core tier 1 capital can be achieved in light of the specific constitutions of different types of mutuals.

The other proposals on tier 1 capital illustrate the problem of several measures taken in apparent isolation – leading in this case to logical inconsistency, as evident in paragraph 62. The stated problem is that banks’ low level of core tier 1 net of regulatory adjustments was not reported. To remedy this, the consultation proposes both enhanced transparency – which would on its own solve the stated problem – and also applying regulatory adjustments to core tier 1 only. Separately, the quality of non-core tier 1 is to be enhanced – which begs the question why, once enhanced, these items cannot share in absorbing regulatory deductions.

While we can understand some of the arguments in favour of taking more deductions against core tier 1 rather than just tier 1, we think it is necessary to question whether the cumulative effect of this taken together with the other moves on both core and non-core tier 1 is really justified. The danger is to view each of these areas of change, which may – *ceteris paribus* - be justifiable in themselves, in isolation, and then to overlook their strong interactions with each other. So - in relation to capital, and taking together not only the proposed changes in CP 164 but also the changes that are in course of implementation from CRD 2 - we have:

- much stricter criteria for what counts as core tier 1.
- much stricter criteria for what counts as non-core tier 1 – especially on loss absorbency.
- much more onerous effect of deductions etc if taken against core tier 1.

To some extent the latter two pull in opposite directions. The effect of the CRD 2 changes, which are consolidated and taken further under these proposals, has already been to raise substantially the going-concern loss absorbency required of non-core tier 1, especially by the requirement for mechanisms such as conversion to core tier 1 , or write-down, under stress. The stated objective is to ensure that all going-concern tier 1 capital is of the highest quality ie permanent and suitably loss absorbent. That being so, what is the justification at the same time for insisting that these deductions etc are to be taken against core tier 1 only? If non-core tier 1 capital is in future to be of the highest quality why cannot deductions continue to be made, as at present, from total tier 1? This is illogical, and the gearing effect of requiring these deductions against core tier 1 only could be enormous.

We do not object to the inclusion of stock surpluses (share premium etc) only in the same bucket as the instruments to which they relate, so that share premiums on core tier 1 remain in core tier 1 but the equivalent on hybrids is included in the relevant hybrid bucket, or to the proposals on minority interests. On the prudential filters, we call for some articulation of the overall objective – otherwise it can be difficult to judge whether this is the right policy in the first place. Are the filters designed to give a truer picture of the capital position than accounting capital, or to smooth out unwanted fluctuations in accounting capital, or both, or neither (ie some other objective)?

We drew attention above to the emphasis on going even further than the CRD 2 amendments to make non-core tier 1 capital instruments of the highest quality. While this may have advantages, it is almost certain to raise the cost and reduce the availability of non-core tier 1 capital, as some investors in the limited and specialised market for this capital may not accept the higher-quality features, or may expect a substantially enhanced return. So we re-iterate the point made above, that if non-core tier 1 is indeed to be of the highest quality in future, then the capital rules should allow it to be fully used (but always subject to the 50 % or 35% quantitative limits) eg to absorb the effect of deductions. Otherwise requiring non-core tier 1 capital to be of the highest quality thereby making it scarcer and more expensive, is wasteful and inefficient. The same is true in relation to the denominator of any leverage ratio – if non-core tier 1 is of the highest quality it must be included in that denominator.

We believe that the elimination of “innovative” capital is an important example of our general point that hybrid capital will end up scarcer and more costly, and should therefore be capable of efficient use.

We support the position that the requirement for principal loss absorption through either conversion or formal write-down is limited to liability instruments only, and does not apply to equity instruments. This is particularly important as, in future, there will be a variety of instruments which qualify as equity under national law, but fail in one or other respect to qualify as core tier 1 capital. These equity instruments will, however, function perfectly well as hybrids without the addition of conversion or write down features – indeed they will be superior to debt hybrids. So we contest the need for such instruments to have mandatory conversion or write-down features.

Finally, we urge that the grandfathering of existing instruments should be no less favourable, whether in timing or extent, than that already established under CRD 2.

Leverage ratio

We agree that the idea has some merit; there ought to be a measure or mechanism to limit overtrading - blatant and unhealthy balance sheet growth – to which proprietary banks are incentivised. But a leverage ratio on the lines of the one discussed in the consultation risks damaging business and producing perverse results.

A leverage ratio as proposed will discriminate against low risk, high volume business models (of which mortgage lenders are an example). This will have severe repercussions in the mortgage markets, constraining the availability of credit, and increasing the costs associated

with mortgage lending. The restricted capacity to lend will be especially damaging in a post-crisis period when the demand for new loans is high and necessary to restart the economy.

A leverage ratio also creates perverse incentives to reduce the balance sheet by increasing the risk profile. Without differentiation based on risk, higher profits through riskier assets are not penalised, or even discouraged. With a limited amount of equity, it would not be surprising if institutions pursued higher risk business.

In conclusion, we understand the rationale behind the proposal to apply a backstop measure such as a leverage ratio but are concerned that it adds little further value if run in parallel with the existing risk-weighted asset methodology, and that it is too crude to be an alternative. But any measure that is capable of avoiding a repetition of the current contraction of liquidity and subsequent financial crisis deserves consideration. We therefore suggest that a leverage ratio could be incorporated under Pillar II. Under this framework the ratio can be used more constructively to detect and discipline those institutions that have increased leverage significantly over a short time and constitute an evident risk to the whole sector (without at the same time disadvantaging prudent firms). As others have suggested, the Committee of European Banking Supervisors could help by ensuring that domestic regulators have access to common toolkits and that convergent practices are adopted. It goes without saying that any such toolkits or practices should recognise the distinctive nature of mutual and co-operative institutions.

Procyclicality

It is clear that the procyclicality of Basel II needs to be addressed because of the impact it has had on financial institutions in this recession. In such circumstances, procyclicality acts to reduce the ability of these institutions to lend.

Procyclicality has a number of sources and there are consequently many ways to address it. Some of these solutions exist already, for example, capital buffers. In response to a recent FSA consultation on capital buffers, the BSA supported the implementation of such a buffer to mitigate unexpected losses which arise through the economic cycle. These should be regulatory counter-cyclical capital buffers outside the financial reporting framework that operates within the Pillar 2 process. It should not be re-invented in a new way, and/ or harm those institutions that already operate such a buffer and which are already managed prudently.

Care should be taken in the apparent rush to take firm action that there is no duplication of existing – and effective - regulatory tools. As others have pointed out, duplicated tools will lead only to double counting. At the very least it will hamper economic recovery, reduce the number of financial products and therefore limit consumer choice.

We do not support a move towards a single prescribed approach for capital assessment. There may be other approaches that reduce procyclicality and institutions should be allowed to choose – with supervisory agreement - the one(s) most suitable for them.

A further consideration is the need to avoid opening up inconsistencies between IFRS accounting treatment and any calculations of provisions / reserves which are developed and required by the regulatory authorities.

Liquidity

While the introduction of a liquidity coverage requirement appears to be an appropriate response to reduce bank failure and other problems thrown up by the financial crisis, its detail is restrictive. The unintended consequences could, moreover, lead to a situation – though different – as severe as the financial crisis the recurrence of which the requirement was set up to prevent.

The proposal is a 30-day liquidity ratio that assumes all wholesale funding, both secured and unsecured, is unable to roll over, there are calls on firms' off balance sheet commitments

(including as a result of ratings downgrades) and a reasonable level of deposit withdrawal. Only high-quality government debt may be included as a liquid asset. This requirement may result in severe market distortions which will hit all institutions, particularly smaller mutuals, very hard.

The narrow definition of the buffer will increase concentration in eligible assets, which in turn will create distortions in the market. With banks being forced to hold almost entirely government debt, there will be a large upward price pressure on government debt and a corresponding decline in yields. Lower profitability and reduced lending capacity will have a direct impact on the cost and availability of credit to consumers. Another unintended consequence of too costly liquidity requirements will be to push banks into higher risk business to compensate for holding low margin, or unprofitable assets, clearly not the intention of the proposed rules.

The Basel committee proposals ignore – in relation to wholly retail funded institutions - the immediately usable cash (not just liquidity insurance) that these institutions hold overnight or at call with their clearing banks. Affected institutions include smaller or specialist firms, such as many mutuals, which rely on clearing banks for operational cash management and transmission. (We recognise that the Basel committee's remit excludes such institutions but it is appropriate to highlight here the possible impact outside large internationally active institutions). A suitable modification would be for all smaller and purely domestic credit institutions – say with balance sheets below €5 billion – to be able to hold a proportion of their liquidity at call with banks that are part of the national funds clearing system.

A too narrow definition of the liquidity coverage requirement buffer will not only cause a flight to a very limited set of asset classes, but will also lead to overall illiquidity as holders will be reluctant to sell or trade in these assets once obtained. A related issue is that, in the event of a systemic crisis, all banks will be seeking to dispose of the same type of assets at the same time. This will drive down prices, thereby exacerbating the crisis.

We believe therefore that these proposals are in danger of over-compensating for past mistakes. Mutuals are expected by their wider stakeholders - including national governments - to continue to play their part in providing finance to citizens. A sharp hike in liquidity requirements risks prolonging the financial crisis by pushing mutuals to hoard liquidity, diverting funds available for lending.

Mutuals argue that ultra-high liquidity is not an efficient tool to deal with a retail run, where some form of liquidity insurance might be more cost-effective, especially for smaller mutuals, even if, for systemic reasons, liquidity insurance is not a useful approach for the largest banks.

The net stable funding requirement requires the haircut value of assets and a portion of off-balance sheet commitments (including those from credit rating downgrades) to be funded from stable sources. In short, stable funding consists of wholesale funding of greater than one year residual maturity and retail funds. In normal business times, the requirement will provide supervisors with a view of an institution's balance sheet compared to its peers.

We support a structural funding measure but suggest that in the net stable funding requirement, retail loans (such as mortgages) that may have a final maturity beyond one year, but are repaid by monthly (or more frequent) instalments, should be moved from the 100% requirement bucket to the 85% bucket. This will help to correct any unintended consequence of favouring short–term loans to citizens over longer-term loans which may be more suitable for their needs.

We also share concerns that the exclusion of assets such as covered bonds maturing within one year from the "stable funding available" calculation will hurt certain institutions and may produce a large, though artificial, gap between available and required funding. As others have pointed out, variable rate mortgages have become more popular in recent times with historically low interest rates, and these are the very assets underlying covered bonds with maturities of less than a year.

We are concerned by the calibration of the liquidity coverage requirement and the net stable funding requirement:

- The severity of the assumptions underpinning the factors - eg a three-notch downgrade in an institution's public credit rating
- The use of standardised factors applied to broad asset and liability classes

This means that firms specific factors (such as business model) and/or changes in a bank's behaviour made over the ratio horizons cannot be taken into account. On an individual institution basis, the proposed ratios produce a complicated set of calculations that appear to overstate the liquidity risk, distort markets and consequently reduce availability of finance to citizens and industry.

One warning we wish to sound concerns public disclosure. While we always support transparency, we believe that in this case disclosure of any changes in an institution's liquidity coverage requirement and/ or the liquidity buffer could be misunderstood by the market (and the public), thereby causing irreparable damage to an institution and possibly its sector. But we would support some form of aggregate sectoral measure, particularly if it were based over an extended time period and prevented identification of individual institutions.

16 April 2010