HM TREASURY

Building Society Capital and related issues:

a discussion paper

March 2010

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Contents

		Page
Chapter 1	Background	3
Chapter 2	The financial crisis and challenges for societies	7
Chapter 3	Adapting to the financial crisis	11
Chapter 4	Mutual capital	15
Chapter 5	International capital developments	19
Chapter 6	Responding to changes in capital requirements: New Instruments	21
Chapter 7	Outstanding issues and challenges	23
Annex A	The capital requirements framework	27

1 Background

How to respond

The window for responses closes on 22 June 2010.

Responses or enquiries should be sent to:

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1 Horse Guards Road
London, SW1A 2HQ

Alternatively, please feel free to email your response:

Building.Societies@hmtreasury.gsi.gov.uk

Introduction

1.1 In *Reforming financial markets (2009)*, the Government announced that it would convene an expert group of key stakeholders to advise on strategic issues affecting building societies. This work focused on four main workstreams: governance, shared operational services, pooled funding, and capital. The Government updated on the progress of the expert group in the 2009 Pre-Budget Report and since then work has continued to further explore particular challenges such as access to capital. This paper reflects on some of the challenges explored in the experts group relating to capital issues and explores some of the potential ways forward. The Government invites the views of building societies, investors, members and other interested parties on the range of issues discussed, and particularly on the specific questions set out at the end of chapter 7.

Building Societies as mutuals

1.2 Building societies are mutual organisations – autonomous associations of persons united voluntarily, whose primary purpose is to satisfy their common needs. Individuals with a savings account or mortgage with a building society are members of that society, and have rights to vote and receive information as well as to attend and speak at meetings; a building society is owned by its members collectively rather than by external shareholders. Each member has one vote, regardless of how much money they have invested or borrowed or how many accounts they may have. A board of directors is responsible for the affairs and strategy of the society. The directors have a fiduciary duty to act in the interests of the society and in doing so to balance the interests of different classes of members – although as there are no external shareholders, members' interests are likely to be less diverse than company shareholders' interests and there will be no pressure to pay a dividend to external investors (even though there may be pressure and/or obligations to pay coupons on deferred shares to members who hold these as well as to the lenders of subordinated debt).

1.3 Building Societies are incorporated under their own legislation, the Building Societies Act 1986, and are regulated by the Financial Services Authority (FSA). Their business operations are constrained by the statutory 'nature limits', which prohibit societies from raising more than 50 per cent of their funds from non-member deposits. Building societies are also required to have at least 75 per cent of their lending secured against residential properties.[1]

Business model

1.4 Although often competing in the same marketplace, building societies exhibit a different business model to banks, reflecting both their mutual ethos and specific legislative constraints. Unlike banks, building societies are not profit-maximising organisations but instead seek to return benefits directly to their members; for example, through offering higher savings rates and lower mortgage rates. Building societies are typically more risk-averse organisations that focus primarily on prime lending, and are funded largely through retail deposits. This has historically meant that societies could offer comparatively low but more stable returns on remunerated capital, and – because of the freedom afforded by their business model – societies have generally become well capitalised relative to the rest of the financial sector.

1.5 In addition to building societies, the financial mutual sector in the UK also comprises friendly societies, mutual insurers, cooperatives and credit unions. Financial mutuals play a strong role in local communities, with many smaller mutuals conducting the vast majority of their business in their local area. This enables them to build long-term relationships with their members. In addition, many financial mutuals have historically operated in areas of economic and social deprivation, helping to provide valuable services to those that might otherwise be financially excluded.

Evolution of the building society sector

1.6 The building society sector has evolved considerably since the first building societies were formed in the 18th century as 'terminating' societies - designed to be wound up once all their members had been housed. Permanent building societies began to spring up in the 19th century and by 1910 there were over 1,700 societies in existence with over 600,000 members and assets in excess of £75 million. Following a series of legislative changes, the shape of the UK financial sector changed considerably in the 1980s and 90s. This included the demutualisation of a number of larger societies between 1989 and 2000. This process began with the demutualisation of Abbey National in July 1989 and included the demutualisation of Cheltenham & Gloucester in 1995; National & Provincial in 1996; Alliance & Leicester, Halifax, Woolwich, and Northern Rock in 1997; Birmingham Midshires in 1999. The process concluded with Bradford & Bingley in 2000.

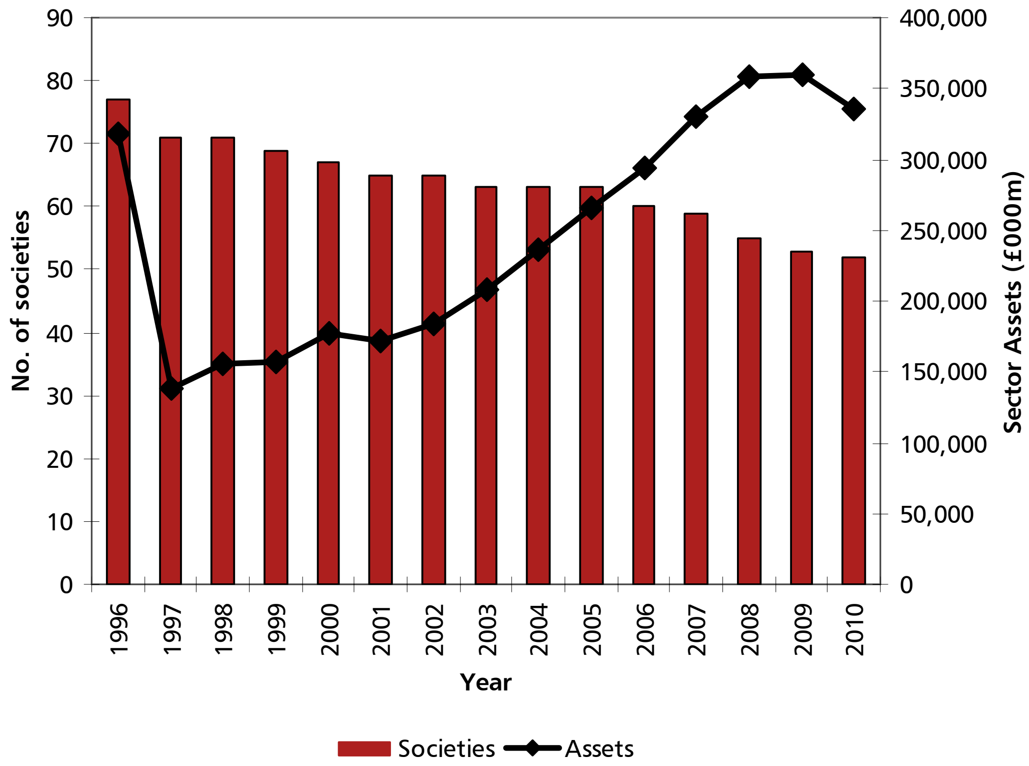
1.7 In addition, societies have had to adapt to an environment in which they face increased competition from other financial service providers such as specialist mortgage lenders. The range of services offered by building societies has expanded in response to changes in technology and customer demand, as well as competition and legislation, and a number of societies now offer a wide range of services, including current accounts and internet banking.

1.8 As a result of demutualisation the sector shrunk in size from £318bn of assets in 1996 to around £156bn in 1998, with the number of societies decreasing through consolidation as well as demutualisation, to stand at 59 in 2007 - down from 110 in 1989. Subsequent asset growth meant that by 2007 total assets in the sector were back up to around £330bn, although the

[1] The Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 contains a measure to increase the proportion of funding which building societies may raise in the wholesale markets, to 75 per cent, however the Government has decided that although it accepts the principle that building societies should have flexibility over their funding strategies it is not convinced of a need to implement this section in the current economic circumstances. The Government committed in January 2009 to reviewing the position in two years time. At that point, the Government will consider whether the current wholesale borrowing limit appears to be acting as a constraint on the ability of building societies to run their businesses effectively and, if so, whether the benefits of increasing the limit would outweigh any stability risks. The Act also contains a provision that would allow the Government to remove the subordination of retail deposits to wholesale deposits, and it is likely that the Government will consider removing such subordination within the context of the broader review of the role of wholesale funding for building societies.

sector by this time constituted a smaller part of the savings and mortgage markets than it did before 1997.

Chart 1.A: Impact of demutualisation on number of societies and sector assets



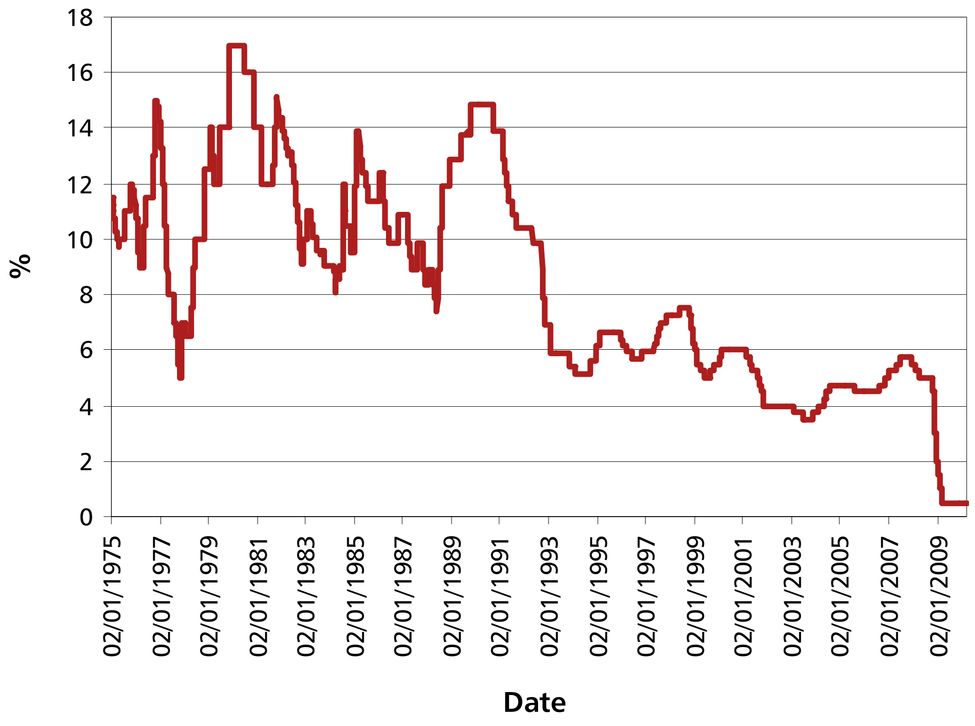
Source: BSA

2 The financial crisis and challenges for societies

2.1 The onset of the financial crisis has created a number of challenges for building societies, just as it has for other credit institutions around the world. These include:

1 Operating in a low interest rate environment: Official Bank Rate fell from 5 per cent at the beginning of October 2008 to 0.5 per cent on 5 March 2009, where it has remained until now. This is far below historical averages for Bank rate, even when considered in the context of the historically low Bank rates of the past ten years.

Chart 2.A: Bank of England base rates

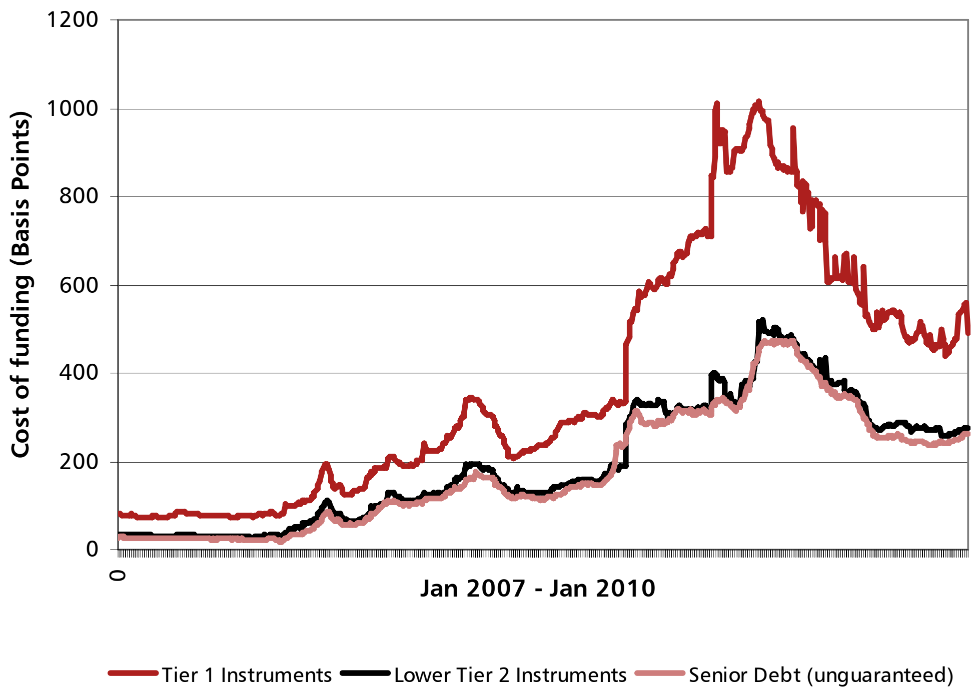


This low interest rate environment can put pressure on interest margins for organisations such as retail banks or building societies that earn income on the difference between the interest rate they borrow at from retail depositors and wholesale funding providers, and the interest rate they lend at for mortgages and other types of loan – particularly where those loans are tied to Bank rate. This exceptionally low rate has also meant that the interest building societies and other financial institutions earn on their liquid holdings such as Treasury Bills has declined at the same time as the amount of liquid assets held has increased, further depressing margins.

Whilst these challenges have affected a number of building societies, many retail-funded societies carrying out traditional activities have nevertheless remained profitable through the financial crisis.

2 **Increased costs of funding:** During the financial crisis the cost of wholesale funding for financial institutions increased significantly – and dislocated from Bank Rate. A reappraisal of building society credit by investors has contributed to increasing the cost to societies of accessing wholesale funding. Since the financial crisis, institutional investors have perceived building societies to be a higher risk and therefore expect a higher rate of return on their investments. Asset impairments suffered by a minority of societies have contributed to this reappraisal of building society credit, these are discussed in more detail in section 3.

Chart 2.B: Cost of wholesale funding



Source: Bank of England

This has impacted on the cost of funding for building societies in two ways: firstly it increased the cost of wholesale funding for those societies engaged in wholesale funding markets. Secondly, it led to increased competition for retail deposits, as banks and building societies sought to meet their financing needs by replacing wholesale funding with retail deposits, thereby increasing the cost of retail deposits relative to Bank Rate. This atmosphere of increased competition for funding is likely to remain as the banking sector exits from the extraordinary support operations introduced during the crisis – including the Special Liquidity and Credit Guarantee Schemes – and as it adjusts funding structures in response to changes in liquidity regulation.

3 **Asset impairments:** During the financial crisis and subsequent downturn, sharp increases in asset impairments have put direct pressure on the capital base of a minority of societies. This has been most pronounced where societies have strayed beyond traditional prime residential lending, a common factor amongst those societies which have either been merged within the sector, or resolved under the Special Resolution Regime. Dunfermline Building Society was deemed in breach of its threshold conditions in March 2009 and resolved under the Special Resolution Regime. Its collapse was caused in part by its substantial loss-making commercial property lending; it had also purchased self-certified mortgage books from Lehman Brothers and GMAC. However impairments in the sector are low when compared

with the wider banking sector, reflecting the focus of most societies on traditional prime residential lending.

4 **FSCS levies:** The cost of the failure of certain financial institutions in the UK is met by the Financial Services Compensation Scheme (FSCS). The current funding model for the FSCS was introduced in April 2008 following extensive consultation and building societies contribute in proportion to their covered deposits (in effect their retail deposit base). Contributions to the FSCS have increased in light of the financial crisis, and have impacted the profitability of those institutions with a high proportion of covered deposits relative to their size. The FSA committed itself to regular reviews of the annual levy limits for the different classes of levy payers and announced that the first such review would be before April 2011.

Impact on profitability and capital

2.2 These factors have contributed to a significant reduction of profitability in the sector, with profits for the sector as a whole decreasing from around £1.3bn in 2007 to less than £0.3bn in 2009.[1] Reduced profits – or losses in the case of some societies – limit the amount of retained earnings societies have available to increase their capital base, at a time of increasing focus on capital adequacy.

2.3 However, as noted above, many societies have remained profitable throughout the financial crisis, including a number of societies that have continued to concentrate on a traditional business model focussing on prime residential mortgage lending funded by retail deposits. In addition, many societies have strong capital ratios when compared with other credit institutions, which adds to their resilience in times of financial stress.

[1] Source: FSA

3 Adapting to the financial crisis

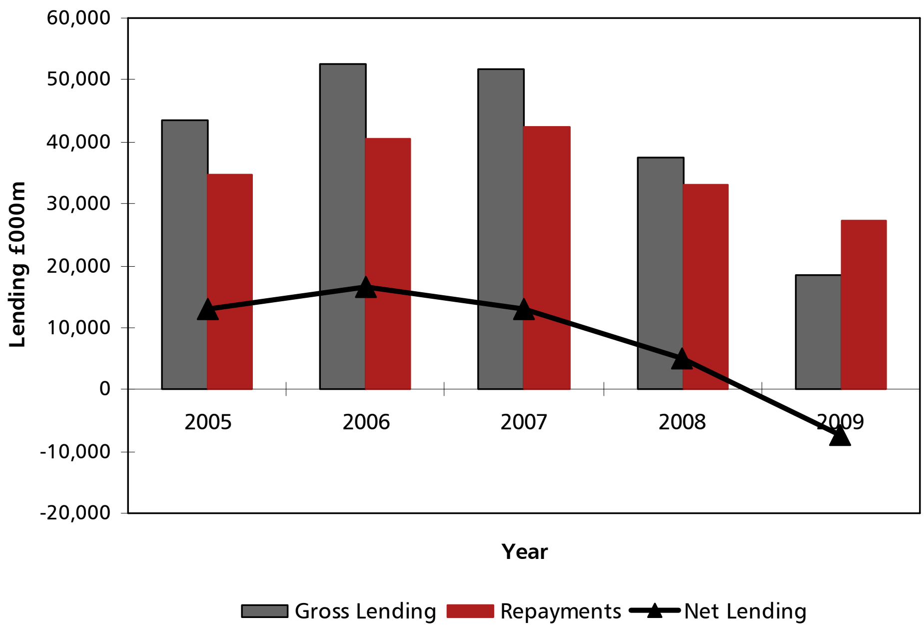
3.1 During the financial crisis the shape of the sector has continued to evolve as building societies reacted to the challenges of a tough economic climate.

3.2 Consolidation in the sector intensified during the financial crisis, with a series of mergers between building societies over the last few years, including:

- In 2008: Nationwide merging with Derbyshire and Cheshire; Yorkshire merging with Barnsley; and Chelsea merging with Catholic;
- In 2009: Co-Operative Bank's merger with Britannia Building Society (under new legislation facilitating the transfer of Building Societies into a group owned by an Industrial and Provident Society); Skipton merging with Scarborough; and Nationwide acquiring the deposits, branches and residential mortgages of Dunfermline; and
- In 2010: Societies announcing mergers (subject to member votes), Yorkshire and Chelsea (effective from 1 April 2010); Skipton and Chesham; and Coventry and Stroud & Swindon.

3.3 Many building societies have also shrunk balance sheets to deal with funding challenges by reducing new lending more quickly than repayments have decreased, resulting in negative net lending.

Chart 3.A: Building society sector lending



Source BSA

3.4 The change in economic climate has also driven some societies to adapt by seeking greater efficiencies and reducing costs within their business. In addition, some larger societies have actively sought to reduce their reliance on wholesale funding by re-focusing on attracting retail deposits.

3.5 Building societies, like other credit institutions, also benefited from unprecedented public sector intervention in the financial sector during the financial crisis, including access – subject to meeting scheme conditions – to schemes such as the Special Liquidity Scheme and Credit Guarantee Scheme. At the same time the Government has continued to review the legislative framework for building societies and other financial mutuals, with the Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 facilitating the transfer of a mutual, such as a building society, into groups owned by another mutual.

3.6 In *Reforming financial markets* (2009) the Government re-affirmed its support of the building society sector and commissioned an expert group of key stakeholders to advise on the strategic issues affecting building societies. The expert group included representatives from building societies, industry experts from professional services firms, plus the Building Societies Association and Tripartite Authorities (Bank of England, FSA and HM Treasury). The group was convened from September 2009 to discuss a number of issues including capital, pooled funding, governance and shared services, with the objective of understanding challenges and exploring potential developments in each area.

3.7 The group explored pooled funding models, whereby participating societies could gain access to new – or more affordable – sources of wholesale funding by, for example, issuing covered bonds through an issuing entity owned jointly by a number of societies. This would allow societies to aggregate their resources and potentially benefit from economies of scale which could reduce wholesale funding costs, resulting in improved Net Interest Margins, and in turn higher profitability, which could then be returned to members through more competitive savings and lending rates, and/or used to increase capital. Progress was made by the group on the design of a pooled funding model, and on identifying legislative changes that might be needed to enable it. However this has not led to further progress by societies in developing the proposals, perhaps reflecting how the set of building societies which expect to continue accessing wholesale funding is a relatively small subset of the sector, raising the question of whether the number of beneficiary institutions is too small to achieve the requisite scale for any funding vehicle. Whatever the business model, any such entity would need to be sector-led and not contain any explicit – or implicit – government guarantee. Given the potential benefits however, and the challenging funding environment building societies face, the Government encourages societies to continue to consider pooled funding structure further and welcomes input from societies' views on these proposals.

3.8 The group also encouraged societies to look at opportunities for sharing services and taking advantage of economies of scale. One issue raised on shared services by the building society sector was VAT. At Budget 2010 the Government announced it will work with affected sectors to consider options for implementing the EU cost sharing exemption. The Government encourages societies to continue to explore opportunities for further shared services that arise. Given the homogeneity of business models in the sector, this may be an effective way to reduce costs, again bolstering profitability and capital accretion.

3.9 The Experts Group also engaged with the challenges building societies face in raising capital. The group initally focused on identifying instruments that meet new, more stringent capital requirements. The progress and challenges are set out more fully in chapters 4 to 7.

3.10 Separate to this, The *Walker Review* (2009) highlighted the need to address the issue of corporate governance across the financial services industry. The expert group provided examples of best practice and participants highlighted innovative ways to engage with members, such as those included in the BSA *Conversations with members* report.[1] In the 2009 Pre Budget Report the Government proposed the introduction of a new governance code for building societies and other financial mutuals and the Government has since commissioned a working group led by the Financial Reporting Council to take this forward.

[1] See www.bsa.org.uk

4 Mutual capital

Introduction to building society capital

4.1 Whereas public limited companies seek to maximise profits and pay dividends to the external shareholders that own the business, mutual organisations (such as building societies) instead seek to generate benefits for members, for example, by providing more competitive rates on their savings and mortgages, and/or retain excess profits to strengthen their capital base.

4.2 As building societies do not face the same pressure as plc's to pay out dividends to shareholders and have fewer sources of external capital (as they do not issue common equity), retained earnings account for a larger proportion of building societies capital. Currently, around 85 per cent of the sector's capital is made up of retained earnings, while the use of inorganic capital is generally limited to larger institutions, with smaller regional building societies generally capitalised exclusively from retained earnings.

4.3 Since the concept of deferred shares was introduced in legislation in 1981, building societies have been able to increase their Tier 1 capital base through the issuance of deferred shares.[1] Under the current Building Societies (Deferred Shares) Order 1991, the terms of deferred shares must prohibit the society from repaying any principal amounts to the holders of deferred shares except where (a) the society is wound up and all other sums due to creditors, and other shareholding members, have been paid, or (b) the FSA grants relevant consent.[2]

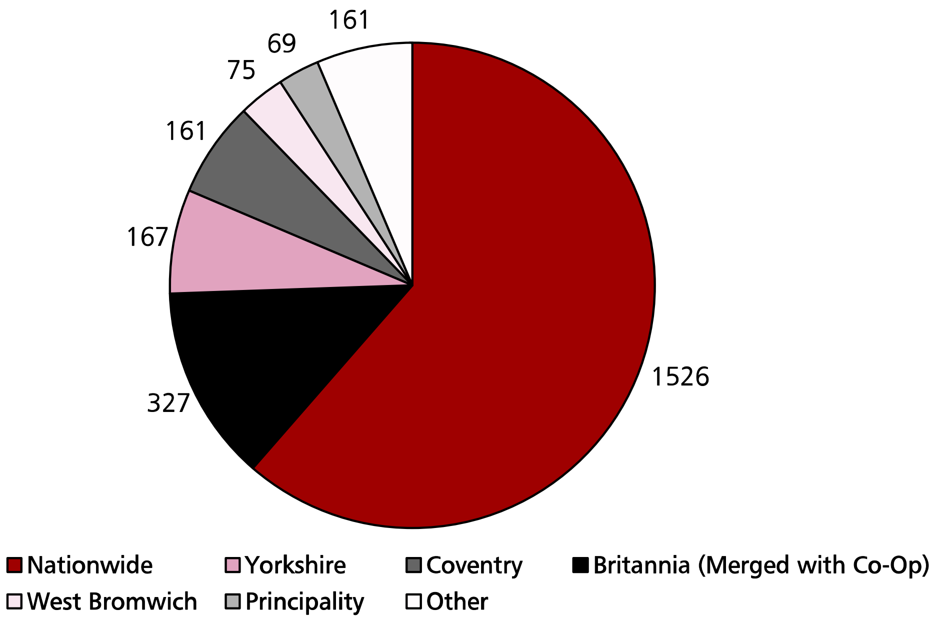
Permanent Interest Bearing Shares (PIBS)

4.4 Over £2bn of deferred shares have been issued in the form of Permanent Interest Bearing Shares (PIBS) – primarily by the largest societies.

[1] In the Building Societies (Authorisation) Regulations 1981. The current legislation is the Building Societies (Deferred Shares) Order 1991.

[2] "relevant consent" is the expression used in the 1991Order – it means that the consent of the FSA must not be applied for by virtue of any form of compulsion, sanction or incentive under the terms of the issue. See Wurtzburg and Mills, Building Society Law, 10.08.

Chart 4.A: PIBS Issuance (£mn)



Source: KPMG Building Societies Database 2009

4.5 PIBS generally carry a fixed coupon, which is non-cumulative – this means that if the society is unable to make a payment on a specified coupon payment date, it typically has no obligation to carry the payment over to subsequent years. However, other than West Bromwich Building Society, there have been no cases of building societies not paying coupons, even during the financial crisis. PIBS also have no fixed maturity date, although the issuing society may include specified call dates in the terms and conditions on which they can be redeemed. PIBS terms often include clauses to incentivise redemption, such as a step-up in the coupon rate after a number of years. The option to redeem is at the issuer's discretion, not the PIBS holder's. Existing PIBS in issuance are classed as non-core Tier 1 capital by the FSA under current FSA rules.[3] Unlike some of their counterparts in Europe, UK building societies have principally (although not exclusively) targeted capital issuance at wholesale investors rather than members.

Governance implications

4.6 The building society ownership structure and legislative framework creates unique governance challenges in the building society sector. As outlined above, members' reserves constitute practically all Core Tier 1 capital and approximately 85 per cent of total Tier 1 capital (the remainder coming almost entirely from PIBS). Members vote on a one member one vote basis, but have little or no incentive to monitor the condition of the building society, as their deposits are protected by the FSCS up to a limit of £50,000. Investors in instruments such as PIBS have limited voting capacity under the 'one member one vote' principle, unlike shareholders in a plc where voting power reflects the size of the investment. In the case of larger societies some oversight is provided by Credit Rating Agencies and wholesale funding providers, but the incentives for owners, and the ability of external investors, to hold management to account can be more limited than in plcs. These challenges are discussed more fully in chapter 7.

[3] However, in contrast to other PIBS, the profit-participating deferred shares (PPDS) issued by West Bromwich Building Society are treated as Core Tier 1 capital. This was achieved by a modification of FSA General Prudential Sourcebook rule, GENPRU 2.2.83R to allow deferred shares with the capital qualities of Core Tier 1 capital (i.e. PPDS) to be included within the building society's capital resources Core Tier 1 capital.

International examples of Mutual Capital

4.7 PIBS are a form of capital unique to the UK building society sector. However, mutual organisations across Europe raise capital in a variety of different ways. Some types of capital raised in Europe exhibit equity-like features and are available to institutional investors, whilst others are raised directly from members. Some of the different types of capital used by mutuals in other European countries are explored in Box 4.A.

Box 4.A: Capital raising by mutuals in other European countries

France – Mutuals in France are part owned by their members and have restrictions on raising external capital. The sector tends to operate at a local level (through 'Caisse locale'), whose members' collectively own regional banking institutions called 'Caisse regionale'. In the case of Credit Agricole, the Caisse Regionale own a 55 per cent equity stake of a listed national central body Credit Agricole SA, with the remaining shares owned by the public or Credit Agricole employees. The local institutions (Caisse locale) issue non-listed voting shares exclusively to their members. Regional Banks (Caisse regionale) can issue non-voting shares in two forms: listed shares available to any investor or unlisted shares available to members within Credite Agricole group. 15 out of the 39 regional Credit Agricole banks have issued listed shares. The national central body, Credite Agricole SA, is also listed and can issue shares to any investor. In France there is a cap on cooperative capital remuneration in national legislation. The cap is set annually by the Ministry of Finance and is based on the average return on "private sector obligations". Distributions are not paid up to the full amount of the cap and are variable.

Italy – The Italian mutual sector comprises two types of institution, Co-operatives ('Banca di Credito Cooperativi') and Popular Banks ('Banche Popolari'). Generally, cooperatives are small regional institutions and Banche Popolari operate on a larger national scale – together they have around a 20 per cent share of the Italian banking market. Cooperativi can issue quasi-equity shares with variable coupons, however, they still operate on a one member, one vote basis. They are also heavily overseen by the Bank of Italy, who hold the right to make a 'declaration of failure' in crisis scenarios and in doing so prevent any withdrawal of these shares to maintain capital levels. The Banche Popolari can either be listed or unlisted. Unlisted institutions raise capital in a similar way to cooperatives. Listed institutions raise capital through equity, which provides them with permanent capital, although again voting rights are limited and not proportionate to the level of investment.

Germany – The German financial landscape includes mutual institutions such as Cooperatives and mutual banks (e.g. Sparkassen). Mutual institutions use capital such as 'silent participations' (a non-voting stake in institutions) and cooperative shares to capitalise themselves. Cooperative shares have Tier One status.

Netherlands – Rabobank is one of the largest cooperatives in Europe. It comprises a network of independent banks that collectively form the Rabobank cooperative. Rabobank issues capital in a number of ways including through member certificates (capital issued exclusively to members). It also announced in March 2010, the proposed issuance of a new senior debt instrument, which acts like a normal bond, but is written down by 75 per cent – with the remaining 25 per cent returned to investors – if capital ratios fall below a pre-determined amount.

Spain – Spanish 'cajas' account for a significant 50 per cent of the retail market in Spain.Most rely on retained earnings and preference shares for capital. Since 2004, they have however also been able to issue 'cuotas participatives', a form of non-voting equity which are floated on the stock market.

4.8 The ability to raise capital from members and listings – with protections on member rights – elsewhere in Europe, raises the question of whether the use of member capital should be considered for the UK building society sector, and if so (i) what form this should take, and (ii) what legislative changes might be needed. It also raises the question of whether any of the specific capital instruments in issue in Europe could be adopted in the UK.

4.9 These questions will need to be considered in the context of wide ranging changes internationally to improve the quality and quantity of capital, explored further in Chapter 5.

5 International capital developments

5.1 In light of the financial crisis it became apparent that the quality and quantity of capital issued by financial institutions globally was insufficient to absorb losses of the scale seen. Capital which was ostensibly in place to absorb losses on a going concern basis proved ineffective at doing so.

5.2 Capital requirements for internationally active banks are agreed by the Basel Committee on Banking Supervision (BCBS), implemented into European Law for all credit institutions and investment firms through the Capital Requirements Directive (CRD) (subject to certain limited exceptions), and implemented in the UK by the FSA and HM Treasury. A summary of the process and organisations involved is included at Annex A.

Changes in the Quality of capital

CRD2 and CEBS consultation

5.3 The CRD2 amendments, adopted by the European Council and the European Parliament in 2009, introduce more stringent requirements for instruments to be classified as non-Core Tier one capital. This captures hybrid instruments such as PIBS, which are currently counted as non-Core Tier 1 capital. Under CRD2, non-Core Tier one capital must be fully loss absorbent with conversion or write-down features (or equivalent). The CRD2 amendments also set out grandfathering arrangements for applicable existing instruments.

5.4 The Committee of European Banking Supervisors (CEBS) published a consultation in December 2009 covering the criteria for Core Tier 1 capital instruments referred to in Article 57(A).[1] Core Tier 1 instruments represent the best quality capital so can be counted towards meeting capital requirements without limit. This sets out permanence, loss absorbency and flexibility of payments criteria as key features for such instruments. In addition, specific exceptions were noted for non-joint stock companies, such as allowing caps related to the payment on instruments if, resulting from a provision under national law, the cap is applicable to all instruments eligible under Article 57(a), so that it does not create privileges.

5.5 The FSA published a consultation paper in December 2009 setting out its proposals for implementing changes made through the CRD2 amendments in the UK.[2]

Basel and CRD4

5.6 In the light of the financial crisis, the G20 asked the Basel Committee on Banking Supervision (BCBS) to develop by the end of 2010 internationally agreed rules to improve both the quantity and quality of bank capital for internationally active banks.

5.7 The BCBS published a consultation document – *Strengthening the resilience of the banking sector* – in December 2009.[3] In February 2010, the European Commission published a working document; Possible further changes to the Capital Requirements Directive, seeking views on

[1] See http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:177:0001:0001:EN:PDF
[2] See http://www.fsa.gov.uk/pubs/cp/cp09_29.pdf
[3] See: http://www.bis.org/publ/bcbs164.pdf?noframes=1, for comment by 16 April 2010.

further changes to the CRD in light of the BCBS proposals.[4] Regarding non-joint stock companies, the CRD consultation notes that:

- the criteria also apply to non joint stock companies, such as mutuals, cooperatives or savings institutions, taking into account their specific constitution and legal structure;
- the application of the criteria for Core Tier one capital should preserve the quality of the instruments by requiring that they are deemed fully equivalent to common shares in terms of their capital qualities, in particular as regards loss absorption and do not possess features which could cause the condition of the bank to be weakened as a going concern during periods of market stress;
- supervisors will exchange information on how they apply the criteria to non joint stock companies in order to ensure consistent implementation; and
- non-common equity elements of capital to be included in tier one capital must also absorb losses while the institution remains a going concern and the institution must not over-rely on non-common equity elements of capital and so the extent to which these can be included in Tier 1 capital must be limited.

5.8 The Government welcomes the views of societies and other interested parties as these proposals are developed further in the coming months.

[4] See: http://ec.europa.eu/internal_market/consultations/docs/2010/crd4/consultation_paper_en.pdf, for comment by 16 April 2010

6 Responding to changes in capital requirements: New Instruments

6.1 Events in the financial sector over the past two years and the current period of low interest rates have put considerable pressure on the profitability of some building societies and other financial institutions globally. As a result building societies and other mutuals have needed to consider how to enhance their capital base with new instruments to ensure they can withstand stress. Instruments created to date include:

1. Profit Participating Deferred Shares (PPDS): In 2009 a new form of deferred share was introduced in the UK building society sector (taking the same legal form as PIBS), known as PPDS. These were used for the first time when The West Bromwich Building Society converted their subordinated debt into PPDS in June 2009. PPDS are perpetual instruments on which the issuer can pay the investors up to a specified percentage of profits in years in which the society is profitable. The payment amount is at the discretion of the issuer so there is no fixed payment. PPDS also feature a mechanism to enable the write down of the principal amount if the firm suffers losses, enhancing its loss absorbency. PPDS are categorised as Core Tier 1 capital by the FSA. To date no PPDS has been issued to new investors, and their use has been limited to exchanges for existing capital instruments. Whilst PPDS do provide uplift to a building society's Core Tier 1 capital they also present challenges, including in terms of (i) marketability: given that their features don't fit naturally with the mandates of the fixed income investor base that has been the principal investor in PIBS; and (ii) valuation: given the absence of a fixed coupon. The key challenge for building societies is to offer a product that suits the appetite of investors, complies with capital requirements, and allows the society to remain committed to the mutual model, protecting the interests of the members – who have historically been the beneficiaries of building society profits.

2. Contingent Convertible Notes: Another potential source of capital for building societies is the issuance of Contingent Convertible Notes. These notes could be issued as subordinated debt or senior debt, providing investors with a fixed coupon and a fixed maturity date. Therefore whilst the issuance of Contingent Convertible Notes would uplift the building society's overall capital level, they would not increase Core Tier 1 capital at the point they are issued. However, in the event of the issuing society's Core Tier 1 capital level falling below a specified threshold, the notes would be converted into PPDS. They would therefore provide access to Core Tier 1 capital in times of stress. The Yorkshire Building Society is due to issue £100m of Contingent Convertible Notes as part of their merger with the Chelsea Building Society. These notes will replace existing subordinated debt issued by Chelsea building society (so it is a conversion as opposed to a new issuance). There have not been any cases of new issuances of Contingent Convertible Notes by building societies to date.

3. Rabobank Contingent Notes: In March 2010, Rabobank announced its intention to issue EUR 1.25bn of Senior Contingent Notes, which would not count toward regulatory capital, but would be subject to write-down at a specified trigger, producing Core Tier 1 capital at the point of write-down. As with Convertible

Contingent Notes described in the previous section, these would act in the same way as normal bonds until a specified threshold is breached. Once the threshold is breached, instead of converting into an alternative instrument, the principal value of the notes would be written down by 75 per cent, with the remaining 25 per cent being returned to the investors. The 75 per cent write down of the principal will be retained by the issuer as Core Tier 1 capital. The level of investor interest reported in this new issuance demonstrates that there is investor appetite for new forms of contingent capital. One advantage that Rabobank has over other potential issuers is their resilience to stress – exemplified by their AAA credit rating – which greatly improves the attractiveness of these notes to investors when compared with those issued by most other mutual organisations.

6.2 Whilst these developments demonstrate the scope for innovation in developing new capital instruments to meet the evolving demands of capital requirements, investors and issuers; they also highlight some of the challenges building societies and other financial institutions face. These are explored more fully in Chapter 7.

7 Outstanding issues and challenges

7.1 The building societies' experts group has explored the challenges facing building societies in increasing their capital base, including examining whether there is a need to design new Core Tier 1 capital instruments or adapt existing lower-ranked capital to fit with the new regulatory environment. In parallel, international regulatory discussions on the future of capital have progressed further, and a number of new capital instruments have entered the marketplace.

7.2 The experts group and related discussions have concluded that the building society sector and Tripartite authorities (HM Treasury, FSA, Bank) face a number of important choices in deciding
how societies should work with investors to raise capital in future. Some of these choices are set out below.

7.3 In considering the framework for building society capital and capital raising, it is important that building societies are treated with 'parity of esteem' to banks. In practice, this means applying principles on capital quality to building societies in a way that is sensitive to the mutual business model, and not necessarily considering plc's and mutuals as the same in circumstances where the characteristics distinguishing the models need to be taken into account. For instance, because of their ownership structure, building societies cannot (and should not) issue common stock, and the lack of that investor base in the sector means societies will not be able to issue 'pure' equity capital with the same ease as banks.

Profit Participating Deferred Shares

7.4 For building societies, Profit Participating Deferred Shares' (PPDS) main benefit is their loss-bearing characteristic under stress, increasing societies' resilience through any periods in which a society makes losses. For societies facing a period of sharply decreased profitability and an erosion of their capital base through impairments on their asset base, PPDS offer an alternative route for building societies to replenish their Core Tier 1 capital base in a form that takes consideration of certain aspects of their business model (e.g. through an instrument that does not carry proportionate voting rights for its holders).

7.5 However, the fully variable coupon, in addition to other factors such as the absence of tax/regulatory calls as well as incentives to redeem, makes PPDS unattractive to the fixed income investor base that has traditionally bought PIBS. As a result of the mutual business model that building societies follow, societies would not be able to grant non-member investors into PPDS the control over the building society that investors in an equity instrument would normally acquire as a result of their equity investment. For these reasons, societies' use of PPDS has been confined to date to capital exchanges, and no society has issued this instrument to new investors in the months since the instrument was introduced.

Beyond PPDS – a new Core Tier 1 capital instrument?

7.6 As discussions of investor reaction to the introduction of PPDS have made clear, the new capital instrument has challenged building societies' traditional business model, despite taking consideration of certain aspects of that model as noted above. The introduction of PPDS was the first time institutional investors acquired rights to a proportion of a society's 'below the line' profits, curtailing the opportunity for members to directly benefit from building society profits.

7.7 In response to these challenges, societies might consider what the appropriate upper boundary for external investor profit participation might be, whilst ensuring that members have a priority share in their society's success. Societies may also need to consider how the building society business model might adapt to support new issuance. This may mean reconsidering the target investor base for any new instruments. For example, an instrument with a non-variable fixed return sold to a traditional fixed income investor base is unlikely to meet regulatory requirements for Core Tier 1 capital, particularly ensuring the full variability of coupon payments.

7.8 Similarly, in addition to the wholesale equity and fixed income investor markets, societies could consider how to target new investors for these (and other) instruments – including looking at the continental model of retail investors. If societies chose to target retail investors with relatively complex profit participation instruments, it would be important to ensure that adequate consumer protection safeguards were in place. Additionally, if societies mirrored the continental model for mutuals and involved members taking a compulsory financial stake in the issuing firm as a condition of membership, this could make societies less competitive.

7.9 These challenges have been borne out by the work of the experts group in exploring instruments that have included a mechanism to 'smooth' dividend payments through use of a reserve account that would hold extra profit in good times to ensure payment when a society makes losses, and would also require a cap on remuneration from capital to be introduced under national legislation. This has highlighted the challenges of creating an instrument that behaves in a way suitable for fixed income investors, when flexibility of payment is an important part of what makes capital Core Tier 1. Ultimately the decision on an instrument's capital classification is one for the FSA and any instruments designed to be counted as Core Tier 1 capital will need to satisfy the FSA that they meet European law in behaving as Core Tier 1 capital is required to behave, including variability of coupon payment and loss absorbency. The Government encourages the sector to continue working with the FSA to develop instruments that meet the needs of societies, and investors, whilst also complying with European law.

7.10 Separately, societies might also consider how their governance might respond to improve the marketability of a new instrument, for example by allowing institutional shareholders to represent their views directly to societies' management whilst ensuring mutual values remain paramount. For instance, Core Tier 1 capital instrument holders might be given the right to nominate a board member, but with the societies' members able to vote off those board members through the usual AGM process.

7.11 Finally, societies might give some consideration to developing a mechanism whereby members would be given the opportunity to increase their investment in the institution and receive a proportion of the profits that the institution achieved. Such a "members' reserve certificate" would work much the way that PPDS works, but it would have to be issued to members and held by members.

7.12 These changes would represent a significant evolution of the mutual model, and would challenge some of the core principles of mutuality. This could be read to imply that the building society capital model was somehow deficient in comparison to that of banks. It is the Government's strong view that this is not the case, and that this view fails to take account of the benefits building societies experience as a result of their business model. Building societies have a natural advantage to banks in being able to return a greater share of profits to their Core Tier 1 capital base than banks (as they have no implicit commercial responsibility to maximise dividends to shareholders), and societies arguably have a much greater capacity to generate low cost Core Tier 1 capital whilst profitable. Building societies need to build up capital buffers from profits in good times that can be used in bad times. The Government welcomes views on this.

An alternative model for capital issuance

7.13 As an alternative to pursuing significant business model changes that might enhance societies' appeal to investors, societies could focus on raising capital through new issuance of contingent convertible debt, that converts under stress e.g. on breach of a predetermined threshold of a society's Core Tier 1 capital ratio. This could involve a PIBS-like instrument (with modifications to recognise new requirements for Tier 1 hybrid capital) that would convert to an instrument behaving similar to PPDS – or an instrument that is automatically written down, as recently issued by Rabobank. Both of these instruments might be marketable to societies' traditional fixed-income investor base, and Government would welcome investors' views on this. This instrument may qualify as Tier 1 (rather than Core Tier 1) capital, but would provide a Core Tier 1 capital uplift (either through a profit through buyback or conversion to a Core Tier 1 capital instrument) under stress.

Government's role

7.14 The Government would welcome views on how building societies could raise new capital, both as a means of enhancing resilience to stress, and to support growth of the mutuals sector. The Government is also willing to consider any steps that might be necessary to safeguard the mutual model and to protect members' rights, including, if appropriate, through changes to legislation. The Government is aware that the tax treatment of any building society capital raising instrument is an important consideration on both the affordability of issuance and in assessing suitable investor demand, and will take account of this in its consideration of the options set out in this paper. Separately, the Government will use respondents' views in considering its approach to international negotiations on the future of mutuals' capital.

7.15 However, any support – such as introducing a cap on distributions from capital into legislation – would be self-defeating if it did not help improve the quality of capital held by mutuals, and Government supports the view that in principle Core Tier 1 capital must be designed to behave as such (for instance, Core Tier 1 capital must genuinely absorb losses when the issuing society is not profitable). This is why retained earnings remain of critical importance as the foundation of building societies' Core Tier 1 capital – particularly as the international economic recovery continues – and the source of capital for growth in good times (to a much greater extent than for plc's, who face pressure to make dividend payments to shareholders) which also provides a buffer to absorb losses in stressed conditions. However, this is also why there could be a central role for new forms of capital that might behave as Core Tier 1 capital under stress but would otherwise take the form of lower-quality capital or debt. Such an instrument could complement retained earnings in bearing losses when societies are not profitable.

7.16 In taking forward this work, the Government seeks investors', societies', members' and others' views on:

1. Prospects for new Core Tier 1 capital instruments – including (i) whether societies need new Core Tier 1 capital instruments; and (ii) any changes that may be required to societies' governance and investor base as a result;
2. Any modifications to PPDS that might help the instrument become more marketable (whether or not it is possible to make sufficient amendments to be suitable for new issuance);
3. The alternative of relying on contingent convertible instruments for new, inorganic capital issuance;
4. Government's role in supporting societies to raise capital for stability and growth;

5 Any changes to secondary or primary legislation which could (a) help societies to develop new capital instruments and/or (b) ensure that the mutual model, and members' rights, are safeguarded;

6 Whether instruments similar to any of the capital instruments used in other countries should be adopted in the UK, and if so what legislative and other changes would be needed to do so;

7 How these issues apply to other UK financial mutuals.

A The capital requirements framework

A.1 Capital requirements for internationally active banks are agreed by the Basel Committee on Banking Supervision (BCBS), implemented into European Law for all credit institutions and investment firms through the Capital Requirements Directive (CRD) (subject to certain limited exceptions), and implemented in the UK by the FSA and HM Treasury. A summary of the process and organisations involved is set out below:

1. Basel Committee on Banking Supervision (BCBS): For internationally active banks, minimum capital requirements are set by the BCBS. The BCBS is a committee of banking supervisory authorities, which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. It usually meets at the Bank for International Settlements (BIS) in Basel, Switzerland, where its permanent Secretariat is located. Basel 1 was introduced in 1988. Basel 2 updated this in 2006.

2. Capital Requirements Directive (CRD): For EU Member States, these capital requirements are then built upon and implemented into European law through the CRD. The CRD proposal is negotiated by the Finance Ministries of EU Member States and the Commission produces proposals for the directive, which are then considered by the European Council and Parliament. The CRD was introduced in 2006 and implemented the Basel 2 agreements. The CRD2 amendments will be implemented from 31 December 2010 and the CRD3 amendments from 1 January 2011. There will be a Commission proposal on the CRD4 amendments by the end of this year.

3. Committee of European Banking Supervisors (CEBS): CEBS advises the Commission on the interpretation of the CRD. It is made up of the supervisors of EU member states.

4. Financial Services Authority (FSA): The FSA is responsible for implementing the international capital requirements in the UK and enforcing them for UK banks as set out in the Financial Services and Markets Act (FSMA), 2000.

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