HM TREASURY

The future of building societies

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1 Introduction

Promoting mutuals

1.1 The Government's approach to financial mutuals is enshrined in its founding document, the Coalition Agreement, where it made a commitment to support diversity in the financial services sector and promote mutuals. A diversity of types of financial institution is essential to provide the consumer choice and the competitive pressure that the UK needs to sustain a vibrant and effective financial sector.

1.2 As the central mutually-owned institutions in deposit-taking and mortgage lending, building societies are key contributors to this diverse mix. In order to maintain their contribution to diversity it is important that building societies are given the conditions to allow them to thrive, while maintaining their unique identity and status.

1.3 The white paper[1] published on 14 June set out how the Government plans to implement the recommendations of the Independent Commission on Banking (ICB). This is part of a broad programme of reform, which represents the most far-reaching reforms to British banking in modern history. While the central focus of these reforms has necessarily been on the big, systemic institutions, which include Nationwide, the Government is determined to ensure that all building societies are well-placed to play a central role in the future of UK financial services.

Discussion document

1.4 The Government has therefore decided to set out its aspirations for the building societies sector, including the key role it sees for the sector as part of the future for UK financial services. The Government also wishes to set out its proposed approach to developing the legislative framework for building societies, so that they are capable of playing the role it sees for them.

1.5 However, the purpose of this document is not one-way. The Government would like to receive views from the sector, and other interested parties, on all of these issues. In terms of the future role of building societies, the Government would like to challenge the sector to set out its vision for how it intends to develop so that it can play the important role the Government sees for it. On the legislative framework, the Government would like to invite the sector to give its views on where things need to change and, just as importantly, where they need to be preserved, so that the building societies can continue to offer competitive services to their members, and serve their communities, while retaining their distinctiveness as mutual financial institutions.

1.6 This discussion document covers the following areas:

- Chapter 2 provides context on the building societies sector, setting out some of the history of the sector, and the shape of the sector today. It also sets out the Government's vision for the sector in the future world of UK financial services.

[1] *Banking reform: delivering stability and supporting a sustainable economy*, HM Treasury and the Department for Business, Innovation and Skills, June 2012

- Chapter 3 gives details of how the Government proposes to address the legislative framework for the sector, in accordance with its vision. First, it sets out how it proposes to apply the principles behind the ICB reforms to the building societies. Second it explains the Government's current attitude to other potential legislative developments of relevance to the sector.

- Chapter 4 gives details of how to reply to this document.

2 The building societies sector in context

The building societies sector today

2.1 The UK has a thriving building societies sector. There are currently 47 building societies, serving 25 million members[1] and employing 42,000 staff. Within the sector, the largest society, Nationwide, comprises 60 per cent of the sector by proportion of assets, with Yorkshire Building Society, the second largest, holding 13 per cent of the sector assets[2].

2.2 The principal purpose of a building society, as set out in the Building Societies Act 1986, is to make loans that are secured on residential property, substantially funded by members' deposits. They currently make up 17 per cent of the mortgage market (including their lending subsidiaries), and 19 per cent of the household savings market[3].

2.3 Building societies have strict legislative limits on their lending and funding activities, known as 'nature limits'. These limits mean that at least 75 per cent of trading assets must be loans secured on residential property, and that at least 50 per cent of total funding must come from their members in the form of retail deposits. In addition there are significant restrictions placed on the treasury activities of building societies. These enforced limits and restrictions help to create a distinctive identity for building societies, and also prevent them from taking excessive risks.

2.4 Building societies are mutually-owned institutions, which means that their purpose is to maximise benefits for their members, rather than profit for external shareholders. Building societies argue that this allows them to work to a longer term strategy, rather than focus on short-term profit and external shareholder gains.

2.5 Building societies are generally considered to offer good customer service. In a recent survey, 69 per cent of mortgage borrowers with mutuals reported being extremely or very satisfied with their customer service, compared to 57 per cent of mortgage holders with other lenders. Building societies also experience much lower levels of complaints, with just 3.5 per cent of complaints to the Financial Ombudsman Service, compared to 65.5 per cent for banks[4], which is significantly lower than their market share.

2.6 UK building societies are proud of their mutual status, and place great stock in their reputation of stability and trustworthiness. The presence of a mutually-owned option in the financial services sector provides greater diversity and competition for consumers.

History of the sector

2.7 Building societies have their roots in the 19th Century, and for many years they dominated the market for mortgage lending, which was their core purpose. The Building Societies Association set rates centrally across the whole sector. This monopoly persisted until the 1980s, when banks gained the ability to offer mortgages, and in 1984 the rates ceased to be set

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[1] *Mutuals Yearbook 2011*, Mutuo, October 2011

[2] bsa.org.uk

[3] bsa.org.uk

[4] Financial Research Survey: Customer Satisfaction Results, GfKNOP, January 2012

centrally. The banking sector has since become more dominant in the mortgage market, with a market share of around 60 per cent.

2.8 The number of building societies has reduced markedly in the last 100 years. In 1900, there were 2286 societies; 101 in 1990; and 47 today. There are two primary reasons for the reduction in numbers of recent years: demutualisation and consolidation.

2.9 Demutualisation was effectively an option only for the largest societies, because of the costs involved. Among the explanations given at the time for decisions to demutualise was the impact of an excessively restrictive legislative regime, particularly the funding limit, which was said to be restricting growth. Of course, there was also an incentive for members to vote for demutualisation, as members received a windfall, in the form of shares or cash, on demutualisation, as well as an element of conformism among the larger societies.

2.10 The first society to demutualise was Abbey National in 1989. Following this, it made a number of acquisitions, including Scottish Mutual and Scottish Provident, and National & Provincial. However, the company suffered from financial losses, and was eventually taken over by Santander.

2.11 Like Abbey National, the other large building societies that demutualised in the 1990s have all been taken over by other banks: Halifax (now part of Bank of Scotland, owned by Lloyds Banking Group), Alliance & Leicester (now part of Santander), Northern Rock (part of which is now Virgin Money) and The Woolwich (now part of Barclays). Of the building societies that demutualised, none are still operating as an individual entity.

2.12 However, the main cause of the reduction in the number of societies, both since 1900 and in the last 20 years, is consolidation by inter-society mergers. This has been the traditional process by which smaller societies are subsumed into larger counterparts, either when their business became non-viable or when the combination produced a stronger society: among recent mergers, for example, Nationwide took on Portman Building Society in 2007 and both Derbyshire and Cheshire Building Societies, Skipton Building Society took on Scarborough Building Society in 2009 and Yorkshire Building Society took on Chelsea Building Society in 2010 and Norwich and Peterborough Building Society in 2011. Larger societies can take advantage of economies of scale, such as with access to payments infrastructure and fixed costs associated with activities like raising funds. It is also possible for societies to share services or pool resources, rather than officially consolidate, but this has not to date proved to be an attractive business proposition.

2.13 In the years leading up to the recent financial crisis, there were problems with the way the financial system was regulated and governed. The banks became too large, too complex, and they took on risks they did not understand. When the bubble burst, huge global banks proved ‘too big to fail’, and the UK taxpayer was called upon for billions of pounds to prevent widespread collapse of the financial sector. While building societies did not cause this crisis, they were certainly not immune to its effects.

2.14 Building societies survived the financial crisis in better health than the UK banking industry as a whole[5]. This can largely be attributed to:

- their low-risk focus – driven by the lending and funding limits - on residential lending and customer deposit-based funding;
- the statutory restrictions on certain treasury activities;
- their strong brands and higher levels of capitalisation;

[5] *“Back to Basics” Banking Keeps U.K. Building Societies On Solid Ground*, Standard & Poor’s, April 2012

- their emphasis on longer-term planning rather than the pursuit of short term gains; and
- their focus on serving the interests of their members, rather than meeting external shareholder pressure.

The future: Government's vision for the sector

2.15 The Government believes that building societies have an important role to play in the future of UK financial services. They have been successful in delivering a range of services to a large proportion of the UK population, to a high degree of customer satisfaction. They have stayed faithful to a relatively low risk model, and have generally come through the financial crisis in good shape. Finally, they have offered a mutually-owned alternative to UK consumers, and contributed to diversity in the financial services sector.

2.16 The Government's vision for the building societies sector is of a thriving, independently-minded and sustainable sector that is able to continue offer consumers a mutually-owned option for their deposits and mortgage lending. It is of a sector that stays true to the best principles of its history, delivering excellent customer service and avoiding unsustainable, risky business models. And it is of an innovative, developing sector, which is constantly seeking out new ways to serve its members and communities, while remaining true to its mutual values.

2.17 At present there is a great diversity in size and approach of building societies, most clearly reflected in branch networks ranging in size from around 800 to some with just a single branch[6]. Whilst the Government wants to see the sector grow and develop, building societies will still offer a diversity of approaches. While some building societies will remain focused on serving local communities in the savings and mortgage markets, others will look to expand their business models further, including into areas such as SME lending.

2.18 In order to deliver this vision, the Government will adopt two high-level principles to shape its approach to the sector.

2.19 First, the sector must be able to compete fairly in the future world of financial services. The Government is determined to ensure that building societies have a legislative framework that enables them to flourish and play a central role in UK financial services. It will act to create and maintain a legislative environment that is supportive for building societies, and free from any inappropriate burdens. By allowing them to compete fairly in the financial services marketplace, building societies will be given the platform they need to reach their potential, delivering quality services to their members and serving their communities.

2.20 Second, the sector must continue to offer a distinctive approach. The sector provides a mutually-owned alternative for millions of consumers. It is set apart from external shareholder-owned financial institutions by its member-based ownership structure and its principal purpose of making loans secured on residential property, substantially funded by members. This has quite rightly led to the adoption of a lower-risk business model by building societies, which has served the sector well in difficult times. The Government will act to ensure that this distinctiveness is retained, in order to secure the contribution to diversity in UK financial services that is currently made by the sector and to continue to offer a genuine alternative proposition to consumers.

2.21 These high-level principles will guide the Government's approach to the legislative framework for building societies. Where legislation places barriers on building societies ability to compete and grow, the Government is committed to taking a hard look at whether those barriers can be lifted; where legislation is vital to maintaining the distinctive nature of building societies,

[6] bsa.org.uk

Government is committed to keeping it in place. Ultimately, the future of the building societies sector lies in the hands of the building societies themselves. The Government is committed, however, to ensuring that they have the environment they need to develop and flourish.

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

3 Reforming building societies legislation

3.1 An appropriate legislative framework for building societies is extremely important, as it will help them play the key role in UK financial services that the Government envisages for them. The white paper on banking reform sets out the most far-reaching reforms to the financial services industry in modern times, and balances financial stability with sustained economic growth. The Government wants to go beyond merely ensuring that the building societies sector is not disadvantaged by these changes, and is open to views on where this balance between stability and growth is not achieved in the current building societies legislation. It also wants to take this opportunity to consider the legislative framework for building societies more widely, in accordance with the vision and principles set out in the previous chapter.

3.2 This chapter, therefore, sets out the Government's proposed approach to the legislative framework for building societies. The Government is very keen to seek views from the sector, not only on the specific areas highlighted in this chapter, but also on any wider changes to the legislative framework for building societies that would be in accordance with promoting the Government's vision for the sector.

Building societies and the Independent Commission on Banking (ICB)

3.3 The recent financial crisis revealed several problems with the existing financial services sector. Financial institutions that provided key services to the population were not sufficiently insulated from financial shocks elsewhere in the system, nor were they adequately resolvable. The ICB set out to make recommendations that would solve these two problems, and the Government subsequently accepted its key recommendations.

3.4 Even a temporary disruption to the provision of such vital services as deposit-taking would have a significant impact on households and small and medium-sized enterprises (SMEs). Therefore ring-fencing aims to insulate these services from financial contagion elsewhere, and make it easier to maintain continuous services in the event of a financial institution needing to be run down. Structural reform will entail a separation of the retail and investment arms of large, systemic financial institutions, with laws on what activities must (mandated services) and must not (prohibited services) be undertaken within the ring-fence.

3.5 Deposit-taking from individuals (with exemptions for high net-worth individuals) and SMEs will be mandated activities within the ring-fence. As these are activities carried out by all building societies, they are all potentially within the scope of the ring-fencing restrictions.

3.6 The lack of loss-absorbency of the large financial institutions meant that investors believed that the Government would step in to save struggling banks and building societies. This gave a competitive advantage to larger institutions as they enjoyed a perceived 'implicit guarantee'. The Government intends that these loss-absorbency proposals, which include bail-inable debt, minimum primary loss-absorbing capacity and depositor preference, will apply to building societies as they do for banks.

Application of ring-fencing requirements to building societies

3.7 The white paper published on 14 June sets out the Government's plans to 'ring-fence' banking services whose temporary interruption would have a significant direct impact on the domestic economy, in particular on households and SMEs. The building societies sector already operates under legislative restrictions in the Building Societies Act, which have a significant overlap with the planned ring-fencing restrictions.

3.8 In line with the high level principles guiding its legislative approach, the Government intends to create a level-playing field by applying the same restrictions to building societies as it will be applying to ring-fenced banks. However, in order to maintain the distinctiveness and low-risk nature of the sector, the Government proposes to do this by carving the entire building societies sector out of the ring-fencing legislation. It will then bring building societies legislation into line with ring-fencing restrictions by, where necessary and in accordance with its high-level principles, making appropriate amendments to the Building Societies Act 1986. This is the simplest way to ensure that building societies do not have to face the unnecessary burden of complying with two different sets of legislative requirements operating in substantially the same area. This approach requires changes being made in secondary legislation, which the Government intends to do alongside, and to the same timetable as, the main ICB ring-fencing legislation.

3.9 As set out in the banking reform white paper, the Government has also decided to introduce a de minimis exemption from the ring-fence. Banks that fall below the de minimis limit will not be subject to the ring-fencing requirements. Given that the Government is bringing the Building Societies Act into line with the ring-fence, the Government has also considered whether a similar de minimis exemption should be introduced into the Building Societies Act (this would have the effect of removing small building societies from relevant provisions of the Building Societies Act).

3.10 The Government has concluded that, in order to maintain a single, coherent and safe approach for the building societies sector, it will not introduce a de minimis exemption into the Building Societies Act. The Building Societies Act provides the framework within which all building societies operate. Partially removing this framework would undermine the distinctiveness of the building societies sector which, as set out in Chapter 2, has been a key element of its success to date. The building societies sector has also been clear that it would not want the provisions of the Building Societies Act, which has worked well, to be removed.

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

3.11 The next four sections set out how the Government proposes to transpose the ring-fencing restrictions into the legislative regime for building societies, in the areas of:

- prohibited services;
- ancillary activities;
- financial institution restrictions; and,
- geographical restrictions.

Prohibited services

3.12 The white paper sets out how the ring-fencing model would prohibit those activities that undermine the resolvability or insulation of ring-fenced institutions. This covers both particular services and products.

3.13 As set out in the white paper, the Government believes that the following activities should certainly be prohibited activities:

- origination, trading, lending or making markets in securities (including structured investment products) or derivatives;
- secondary market purchases of loans and other financial instruments;

- conduit financing or securitisation of assets originated outside the ring-fenced bank;
- underwriting of securities issues; and
- holding derivatives, except for the purposes of balance sheet risk management.

3.14 The white paper also seeks views on proposals exempting the provision of certain derivatives to third parties from the general prohibition on trading in derivatives.

3.15 In accordance with its high-level principles, the Government intends to amend the Building Societies Act so that the prohibitions applied to ring-fenced banks will also be applied to building societies. This will mean building societies and ring-fenced banks have to comply with the same requirements.

3.16 In some cases the ring-fencing requirements would be more liberal than the Building Societies Act. In these cases, the Government proposes to take the best from both regimes, based on its high-level principles. It will therefore consider whether removing some additional restrictions in the Building Societies Act is consistent with maintaining the distinctiveness and appropriately low-risk approach of the sector.

3.17 First, the white paper proposes that ring-fenced banks should be able to provide simple derivatives products to their customers with appropriate safeguards. Building societies can already provide some simple derivative products to their customers (e.g. a hedge with respect to a loan from the society), and the Government would be open to broadening this to align with the provisions for ring-fenced banks, subject to the same safeguards. Allowing building societies to offer an expanded range of simple derivative products could support appropriate diversification of the building societies business model, for instance into lending to SMEs.

3.18 Second, a ring-fenced bank will be able to provide foreign currencies to its customers (building societies can currently only do so for transactions under £100,000 in value). The Government proposes aligning these restrictions fully, which would involve a relaxation from the legislation currently covering building societies.

3.19 Third, building societies currently are not allowed to issue floating charges. The Financial Services Bill contains a provision to amend the Building Societies Act so that societies can issue a floating charge in respect of payment systems, but there may be a case for making further exceptions, or even abolishing this restriction. However, before taking such a step, the Government would need to be convinced that this would be consistent with maintaining an appropriate approach to risk and members' rights.

3.20 There is also a case for considering whether there are areas where the corporate structure restrictions placed on building societies should be less than those applied to ring-fenced banks. The reason for this lies in the mutual model. To ensure that the principal of mutual ownership can be maintained, a building society must be at the top of any group structure. A building society cannot, therefore, create a holding company to own separate companies, one of which undertakes activities which would be allowed inside a ring-fence and another which undertakes activities that are required to be taken outside the ring-fence (as is the case for a bank).

3.21 As a result, it may be appropriate to consider whether there are any services that are not allowed inside a ring-fenced bank but which should be permitted for building societies. For example, the building societies sector has raised the issue of buying commercial options, as well as the ownership of non-core businesses, such as estate-agencies.

3.22 The Building Societies Sourcebook – which forms part of the FSA's Handbook – provides guidance to building societies as regards their treasury and lending activities. The aim of the detailed guidance is to ensure that a building society's risk appetite is aligned with its senior management skills and risk management capabilities. The Sourcebook pre-specifies the FSA's detailed expectations for lending and treasury operations at various levels of sophistication and provides a framework against which these operations can be discussed and assessed by the FSA. This approach seeks to ensure that the greater the level of sophistication and diversification from a traditional building society operating model as regards treasury and lending activities, the higher the level of senior management skills and risk management systems the FSA will demand from the building society. The Government understands that the Sourcebook will remain in place when prudential regulation moves from the FSA to the Prudential Regulation Authority in 2013.

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

Ancillary activities

3.23 As set out in the white paper, ring-fenced institutions will be able to buy and sell derivatives to manage their own balance sheet risk, although safeguards will apply.

3.24 The Building Societies Act, in section 9A, allows societies to use derivatives to hedge their own balance sheet risk. Societies can hedge against risk including that associated with foreign exchange, interest rates, property prices, security prices and inflation.

3.25 The Government will take the power in legislation to determine when a ring-fenced institution can invest as principal, and this will be clarified in secondary legislation. The Government proposes to align the legislative approach for balance sheet management for ring-fenced banks and building societies, where doing so would not undermine the distinctiveness and low-risk approach of the building societies sector.

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

Financial institution restrictions

3.26 The white paper outlines proposals to limit a key source of contagion by restricting ring-fenced banks' exposures to non-ring-fenced banks (or banks that engage in prohibited activities), investment firms, funds and fund management companies, and insurance companies. These exposure limits will not apply to ring-fenced banks' lending to building societies.

3.27 The Building Societies Act already contains a restriction on equity ownership in firms undertaking activities prohibited within the Building Societies Act, although on debt exposures there are no restrictions in legislation

3.28 In line with the Government's proposed approach to aligning the treatment of banks and building societies, the Government proposes to place the same restrictions on building societies as will be placed on ring-fenced banks.

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

Geographical restrictions

3.29 The building societies sector has previously expressed concerns that geographical restrictions for ring-fenced institutions would place building societies at an unfair disadvantage as they would not be able to create a non-ring-fenced offshoot to take deposits or lend in Guernsey, Jersey and the Isle of Man.

3.30 The Government is working with the authorities of Guernsey, Jersey and the Isle of Man to establish the conditions under which branches or subsidiaries in those jurisdictions would be consistent with the objectives of ring-fencing, so that ring-fenced banks can maintain operations there. In line with its high-level principles the Government intends to take the same approach to building societies as it takes to ring-fenced banks.

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

Further reforms to the Building Societies Act

3.31 Ensuring that the application of ring-fencing principles to building societies is appropriate and proportionate is important in allowing building societies to compete on a level playing-field with banks, and therefore contribute to the diversity in financial services that the Government wants to promote. However, going beyond this, the Government is keen to hear views from the building societies sector on whether any other legislative changes would remove limitations or barriers to growth, while retaining societies' core identity as stable institutions serving their members and communities.

Lending and funding limits

3.32 The Building Societies Act specifies that at least 50 per cent of a society's funding has to be in the form of retail deposits. The definition of retail deposits does not include deposits from SMEs, for historic reasons, as building societies have traditionally served individuals wanting to deposit their savings.

3.33 The Act also specifies that at least 75 per cent of a building society's lending must be secured on residential property.

3.34 The Government supports the existence of these limits, as they help to define what a building society is, and they also act as safeguards, as building societies cannot diversify away from their focus on lower-risk activities that would endanger their own stability.

3.35 However, building societies may decide that a natural extension to their business model is serving businesses as well as individuals in their communities, including supporting growth by lending to SMEs. If this was part of the sector's strategy, then the Government would be supportive of this development, and would be open to removing any constraints posed by legislation.

3.36 As the lending and funding limits set out in legislation do not currently bind on any society, the Government does not propose amending them at this time. However, the Government is open to reconsidering the limits as this becomes a practical issue, and welcomes views on whether the current limits are appropriate.

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

Building societies and capital

3.37 As building societies are owned by their members rather than external shareholders, the most natural way for them to raise capital is through retained profits. However, this can restrict growth (both organic and through acquisition), and as regulatory capital requirements have increased both domestically and internationally, the sector has worked to develop capital instruments that can be sold to investors in financial markets. The sector has developed and issued capital instruments in the past, however under Basel III these will cease over time to count as core capital.

3.38 The Government has worked closely with the sector to ensure that Capital Requirements Directive IV allows building societies to issue new capital instruments, and is open to legislative changes that would help to support the sector's efforts to design a viable instrument that genuinely acts as a loss-absorbing buffer in stress scenarios, while still being consistent with the mutual model.

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

Summary financial statements

3.39 The Government is also aware of the cost burdens imposed by requirements for summary financial statements. On opening a new account, a society must provide information to the new member that reflects their new status as an owner of the society. However, it is possible that the information requirements are too onerous and detailed to be effective. The Government would welcome views on whether these requirements should be amended, as well as suggestions for what precisely could be changed to reduce the burden on societies and increase the effectiveness of their communications to their members.

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

Further changes

3.40 The Government welcomes views on where the Building Societies Act should be changed, over and above those changes mentioned above. This legislation is a defining force in shaping the sector, and the Government invites building societies to take this opportunity to share their views on how the development of the sector can be supported by its legislative framework.

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

Loss-absorbency

3.41 By making systemically important institutions more loss-absorbent, the Government will be making them more resilient in the face of shocks, and it should also be easier to resolve banks or building societies that do get into trouble. Ultimately this will help to avoid future taxpayer bail-outs, and address the perceived implicit government guarantee that gives an unfair advantage to large systemically important institutions.

3.42 The ICB recommended various tools to increase loss-absorbency for ring-fenced banks including a minimum amount of 'primary loss-absorbing capacity' (PLAC), a leverage ratio, bail-inable debt, and depositor preference. This section sets out how the Government intends to apply these tools to building societies. It is important to note, however, that policy on loss-absorbency will need to be considered in the context of the Recovery and Resolution Directive and the eventual outcome of Capital Requirements Directive IV.

Primary loss-absorbing capacity (PLAC)

3.43 The white paper confirms the Government's view that primary loss-absorbing capacity of 17 per cent of risk-weighted assets is the appropriate level for the largest ring-fenced institutions, as recommended by the ICB. This 17 per cent could consist of Common Equity Tier 1, Additional Tier 1, and Tier 2 (collectively referred to as capital) as well as long-term debt clearly subject to a statutory bail-in power.

3.44 The arguments for adequate loss-absorbency hold for the mutual model as well as for the banks. Large systemically important building societies should be able to absorb losses like their bank counterparts.

3.45 The Government does not believe that building societies should have different loss-absorbency requirements to banks, and proposes to include building societies in any of the general loss-absorbency measures that apply to banks of a similar profile.

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

Leverage ratio

3.46 The leverage ratio is a minimum limit on the proportion of capital to total assets. It is designed to ensure a minimum level of capital adequacy that is independent of risk-weights, whose performance during the crisis came into question. The Basel III accord proposed that institutions first be benchmarked against a 3 per cent ratio (with the design and calibration of the ratio to be reviewed in 2017), with the view to introduce a binding minimum leverage ratio from 2018.

3.47 The ICB recommended that the structural minimum leverage ratio should be increased to 4.06 per cent for large ring-fenced banks. However, this limit would become a binding constraint to business models with low-risk-weighted lending (and particularly building societies with their high level of secured residential mortgage lending as a proportion of their balance sheet), rather than a backstop provision as anticipated; therefore the Government does not see a case for the structural or 'micro-prudential' minimum leverage ratio to be increased beyond the international standard.

3.48 The Government notes in this context the interim Financial Policy Committee's (FPC) recommendation that a leverage ratio tool should form part of the permanent FPC's initial macro-prudential toolkit. The Government will consult on its proposals for the FPC's toolkit during the passage of the Financial Services Bill.

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

Bail-in tool

3.49 The section of the Government's white paper on the statutory bail-in tool will apply to building societies as it will to banks. There may be some differences in the bail-in process, to reflect the fact that building societies do not have equity shares owned by shareholders. This detail will be consulted on as the process of European legislation develops.

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

Depositor preference

3.50 The white paper sets out that Government supports (as far as permitted by EU law) "insured" depositor preference, i.e. changing the creditor hierarchy so that depositors eligible for protection under the financial services compensation scheme (FSCS) are preferred in insolvency to the claims of other senior unsecured creditors. The Government believes that consistency across banks and building societies is important for creating a level playing-field, and therefore proposes to implement insured depositor preference for both.

3.51 In building societies, unsecured creditors are currently ranked above retail depositors in the creditor hierarchy, so they bear losses after retail depositors in the event of collapse. To achieve full consistency, given insured depositor preference, the Government would need to exercise its power under Section 2 of the Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 (known as the "Butterfill Act"), followed by applying the same changes as will be made for banks, to align the creditor hierarchy to achieve consistency for banks and building societies.

3.52 Regardless of whether depositor preference is introduced, it will still be important to align the creditor hierarchies for banks and building societies. Therefore, the Government intends to exercise the power in the Butterfill Act, and any additional changes required to equalise the creditor hierarchies, when the final position for banks is clear.

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

4 Views requested and how to respond

Summary of views requested

4.1 The Government would welcome written submissions on this document in general and on the following requests for views and information:

- The Government welcomes views on its vision for the building societies sector and proposed approach to the legislative framework.
- The Government welcomes views on whether the Building Societies Act should be amended to broadly reflect the ring-fencing requirements, with no de minimis exemption.
- The Government welcomes views on its proposed approach to aligning the Building Societies Act with the prohibited services proposals for ring-fenced banks and on whether there are any services that should be allowed for building societies even though they are prohibited for ring-fenced banks.
- The Government welcomes views on whether section 9A of the Building Societies Act should be amended to mirror the restrictions on ancillary services in the ring-fencing legislation.
- The Government welcomes views on whether the proposed restrictions on exposures to financial institutions for ring-fenced banks should also be applied to building societies.
- The Government welcomes views on its proposed approach to geographical restrictions.
- The Government welcomes views on the level and method of calculation of the funding and lending limits.
- The Government welcomes your views on whether, and how, the Building Societies Act should be updated to support the issuance of a new, loss-absorbent capital instrument.
- The Government welcomes your views on whether, and if so how, the requirements for summary financial statements should be changed.
- The Government welcomes your views on whether any other elements of the building societies legislation should be updated.
- The Government welcomes your views on the application of PLAC requirements to building societies.
- The Government welcomes views on leverage ratio, and would encourage the building societies sector to submit their views in response to the white paper.

- The Government welcomes views on the statutory bail-in tool, and would encourage the building societies sector to submit their views in response to the white paper.
- The Government welcomes your views on its proposed approach to building society creditor hierarchies.

How to respond

4.2 Responses to this discussion document should be sent to HM Treasury by 6 September 2012. Please address to Dan Turnbull, Banking and Credit Team, HM Treasury, 1 Horse Guards Rd, London, SW1A 2HQ or email building.societies@hmtreasury.gsi.gov.uk.

4.3 Information provided in response to this discussion document, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

4.4 If you want the information that you provide to be treated as confidential, which public authorities must comply and which deals with, among other things, obligations of confidence. In view of this, please be aware that, under the FOIA, there is a statutory Code of Practice with would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury.

4.5 HM Treasury will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

HM Treasury contacts

This document can be found in full on our website: http://www.hm-treasury.gov.uk

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

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