Building Societies Association

York House
23 Kingsway
London
WC2B 6UJ

Telephone: 020 7520 5900
Fax: 020 7240 5290
www.bsa.org.uk

COMMITTEE OF EUROPEAN BANKING SUPERVISORS

CONSULTATION PAPER CP 33 ON IMPLEMENTATION GUIDELINES REGARDING INSTRUMENTS REFERRED TO IN ARTICLE 57(A) OF THE CAPITAL REQUIREMENTS DIRECTIVE

RESPONSE BY THE BUILDING SOCIETIES ASSOCIATION

Introduction

The Building Societies Association (BSA) is pleased to submit its response to the Committee's consultation. We represent mutual lenders and deposit takers in the UK including all 52 UK building societies. Mutual lenders and deposit takers have total assets of almost £375 billion and, together with their subsidiaries, hold residential mortgages of almost £240 billion, 19% of the total outstanding in the UK. They hold over £245 billion of retail deposits, accounting for just under 22% of all such deposits in the UK. Mutual deposit takers account for about 36% of cash ISA balances. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

Summary

Our greatest concern is that policy making on the definition of capital, based on the proprietary company model as supposedly normative, may fail to deliver appropriate provisions and outcomes for deposit-takers across the European Union that are organised, like our own members, on a mutual or cooperative basis. This would be clearly against the interests of the citizens and businesses of Europe, given the very important role that mutual and cooperative banks play in the banking markets of many member states. We are therefore pleased to be working with the European Association of Co-operative Banks (EACB) to articulate the mutual and cooperative case on definition of capital to the Committee and in other fora, and we support in general terms the response to CP 33 from the EACB.

In relation to CP 33, we firstly welcome the Committee's clear attempt to make provision within the draft guidelines for mutual and cooperative banks in Europe. We encourage the Committee to continue down this route, and we trust that the detailed analysis and arguments in this response will prove of assistance. We explain below why the modifications necessary for mutual or cooperative banks do not constitute regrettable peculiarities, but on the contrary, express fundamental principles relevant to the European Social Economy and for which clear European legislative precedent exists. Nor do these modifications in any way weaken the case for the full application of the proposed criteria to the generality of proprietary banks for which they were designed. We therefore urge the Committee to remain true to these insights, and to develop and clarify the provisions for mutual and cooperative banks as requested below. We also underline the importance of the observation in Recital 4 to the CRD (and recognised at paragraph 33 of the draft guidelines) that the focus for the deemed equivalence to ordinary shares of article 57(a) instruments issued by mutuals or cooperatives must be their loss absorbency , and not other, unrelated, and irrelevant, features of the proprietary company model.

Detail

We address specific issues in CP 33 in the order in which they appear in the paper.

Impact assessment

As mentioned above, we welcomed the Committee's having taken into account the specificities of cooperatives and mutuals. Without such separate provision, the impact on our members (and in turn on the consumers they serve, and on competition in the markets in which they operate) would have been highly deleterious. For our own members, the key issue is the capping of dividends rather than the right of redemption. Nevertheless, there may be a need to adapt legislation in this area so that it is in harmony with the final CEBS guidelines. Moreover, without the further developments and clarifications proposed later in this response, there may still be significant costs- the proposals would not, in that context, quite reach the desirable objective stated in paragraph 11 of imposing minimal costs.

Public consultation

We welcomed the opportunity to attend and speak at the Committee's public hearing on 23 February, and found the presentation by the Committee and the ensuing discussion informative and constructive. We agree with the Committee's emphasis, expressed at the public hearing, on **simplicity**. Our members do not seek a proliferation of complex structures that try to game the rules for commercial advantage. On the contrary, all that is required is for our members to have a fairly simple and standardised instrument that meets their need for access to issued core tier 1 capital in accordance with their principles.

Section A : Definition of capital in the sense of Article 57(a) and Recital 4

Whilst appreciative of the Committee's efforts to cater for the specificities of mutuals and cooperatives, we emphasise again the importance of scrupulously observing the clear link that Recital 4 makes between deemed equivalence to ordinary shares and loss-absorbency. This means not making ordinary shares into a universal yardstick, and thereby –perhaps inadvertently- seeking to apply to mutuals or cooperatives features of ordinary shares which may be fundamental to the capitalistic model but are not relevant to going-concern loss absorbency (in particular whether or not dividends are unlimited or capped; and whether members participate in the residual surplus or not) and indeed may not be universally desirable.

We observe in passing that, in the real world, the actual functioning of bank ordinary shares hardly justifies the theoretical pedestal on which they are placed. We cite three separate instances in support of this point:

> (i) first, even in good times, proprietary banks have over-distributed. Analysis carried out in the UK by the Bank of England[1] shows that a more conservative distribution policy over the past decade, together with fewer of the mega-bonuses for which proprietary banks became notorious, would have retained more than enough extra capital to enable the proprietary banks to ride out the recent crisis without having to be recapitalised at the Government's / taxpayers' expense. Nor is this entirely a recent phenomenon : as the Bank[2] has pointed out : *"payout ratios to shareholders from banks' profits have consistently been high. Since the mid-1960s, the payout ratio has generally exceeded 50%. At times in the distant past it has been higher still: the average payout ratio to Bank of Scotland shareholders over the period 1800 to 1995 was around 70%. "*
>
> (ii) second, when banks faced difficulties, the theory that they would cut their dividends to conserve capital was not evident in practice. The most egregious example, of course, was Northern Rock, which insisted on paying an interim dividend in late 2007 although close to collapse. But the problem was widespread - as the Bank of England

---

[1] speech by Andy Haldane, Executive Director for Financial Stability on 27 January 2010 - see page 11 of speech text at http://www.bankofengland.co.uk/publications/speeches/2010/speech422.pdf

[2] ibid, page 10

has recently remarked[3] : "*Global banks have recently received just such a profit windfall, as full-year results for the main banks are beginning to attest. There is a strong case for banks, in the UK and internationally, pocketing this windfall rather than distributing it to either staff or shareholders. This would allow banks' balance sheets to be repaired while supporting lending to the real economy. It is prudential opportunism. So far during this crisis, there has been little evidence of such prudential opportunism. Among global banks, net income fell by over 20% between 2006 and 2007. Over the same period, dividends grew by 20%. In 2008, global banks made losses totalling $60 billion, but on average still made dividend payouts of over $60 billion. Although it sounds peculiar, this behaviour appears to be deeply rooted.* "

(iii) third, the availability of bank ordinary shares as a tool for speculation proved to have introduced a new and very damaging source of instability to proprietary banks.

Taken together, these effects rather undermine the claimed benefits of the ordinary share as the "gold standard" of issued capital. Building society deferred shares, which have been article 57(A) instruments ever since the original provisions corresponding to that article were introduced under the Own Funds Directive, do not suffer from these evident drawbacks.

Moreover, much of the thinking in the Basel proposals, carried across regrettably into some of the draft guidelines, is too closely based on the "basic ownership" concept that is applicable only to the proprietary company model. While this concept may assist in analysing the relative economic interests of different layers of capital providers in a proprietary company, it has no direct application to mutuals or cooperatives, and therefore no necessary connection with the loss absorbency or otherwise of their capital instruments. The Committee's draft guidelines, however, still tend to treat this concept as the norm, or normative, and the derogations then needed for mutuals and cooperatives as catering for isolated peculiarities, that may have become enshrined in law by local accidents of history. **We argue, to the contrary, that these specificities reflect a coherent body of principles of universal application, and moreover, they are now clearly recognised in European law.**

In rejecting the presupposition of the capitalistic "basic ownership" concept, we affirm that policy- making, whether at European or national level, should afford parity of esteem to the mutual and cooperative model alongside the proprietary model. This should then lead to equivalence of treatment, meaning neither uniformity (that ignores essential differences) nor treating the proprietary model as normative and the mutual/cooperative model as an unwelcome deviant, for which minor derogation is grudgingly conceded.

What is distinctive about mutuals and cooperatives is not the exact corporate form, but their guiding principle – **that the purpose of their economic activity is to benefit their members, typically through the members' transaction of business with the institution, rather than the extraction of profit to reward external providers of capital.** For cooperatives, this was articulated in the Rochdale Principles of 1937 which have been revised and updated as the Statement on the Cooperative Identity of the International Co-operative Alliance. We mention these principles both because of the clear connection with the matters on which the Committee has recognised the need for modification of its guidelines, and because they are explicitly recognised in the Recitals to the Council Regulation (EC) No. 1435/2003 of 22 July 2003 on the statute for a European Cooperative Society from which we quote in the paragraphs below. (The text of the Recitals to the Regulation is also reproduced for ease of reference at Annex 1 to this response.)

There are three principles of particular relevance to the definition of capital: open membership, limited interest on capital and disinterested distribution.

[3] ibid , page 10.

Open membership means that a citizen may join, and leave, a mutual or cooperative that provides relevant services: mutuals and cooperatives are not closed, privileged organisations from which citizens are excluded. (In the words of the Regulation *"there should be no artificial restrictions on membership"*.) On joining the member may subscribe for shares, and on leaving those shares may be redeemed by the mutual or cooperative. Although this particular principle operates in a different way for building societies, we agree in general terms with the analysis of the EACB as to the prudential adequacy of co-operative shares.

Limited interest on capital is the principle that is most at stake for building societies in the context of own funds. The Regulation states *"there should be limited interest on loan and share capital"* and *"profits should be distributed according to business done [with the SCE] or retained to meet the needs of members"*. This latter observation exactly describes the operation of a building society. The society takes in the cash savings of its members and lends the money on mortgage to other members to finance their homes. The benefit of the mutual enterprise is passed on to members by more favourable interest rates on their savings or loans. The society makes a modest surplus which is added to its reserves to maintain the capital strength of the society in the interests of the members. In line with the Regulation, societies reject the alienation of their profits from the members in favour of external capital providers. The socio-economic philosophy behind this principle is well described in the relevant paragraphs (set out in Annex 2 to this response) of the 1966 report of the International Co-operative Alliance on the review of the 1937 Rochdale Principles. Therefore Criterion 7, if applied to mutuals or cooperatives without modification, is repugnant to this principle and to the Regulation.

Disinterested distribution is endorsed in the Regulation as follows *"Net assets and reserves should be distributed on a winding up according to the principle of disinterested distribution, that is to say to another cooperative body pursuing similar aims or general interest purposes"* because *"members cannot exercise any rights over the assets of the cooperative"*. Criterion 9, is therefore also repugnant to this principle and to the Regulation if applied to mutuals or cooperatives without modification.

Question 1.1 : we are content with the wording of Criteria 1,2 and 3. We suggest that the text of paragraph 34 is amended as follows :

"While CEBS considers that ordinary shares may provide the benchmark for loss absorbency as specifically called for in Recital 4, CEBS also respects the principles in accordance with which mutual and cooperative societies' instruments are issued and held and makes clear that such instruments need not mimic ordinary shares in features unrelated to going-concern loss absorbency."

Section B : Permanence.

As stated above, we support the arguments of the EACB in relation to co-operative shares and redemption from individual members.

Section C : Flexibility of payments.

Based on the analysis of mutual and cooperative principles above, we conclude that Criterion 7 is repugnant to the principle of limited interest on capital and therefore to the Regulation, unless modified in its application to mutuals and cooperatives along the lines of paragraph 71, but with further elaboration and clarification. As a general statement, we also find paragraph 66 runs the risk of seeking to mandate mutual or cooperative instruments to mimic other aspects of the behaviour of ordinary shares (beyond loss absorbency) , thereby exceeding the authority conferred by Recital 4. And we re-iterate the arguments made above demonstrating that the actual behaviour of ordinary shares in relation to their distributions falls far short of the desirable theory on which the criteria are based.

Given that the instances of national law that provide for capped (but otherwise fully discretionary) coupons are expressions of the fundamental principle of limited interest on capital, and that in other member states the practice of mutual and cooperative banks abides by this principle without any provision in national law, **we argue that the derogation in paragraph 71 should be available to all mutuals and cooperatives that observe through their constitutions the principle of limited interest on capital**. For instance, in the UK this principle remains for the time being mandated by national law for credit unions[4] (that are pure cooperatives) and has been mandated by national law for building societies until the provision was inadvertently allowed to lapse by the regulator – although the principle continues to be observed. Moreover, on a purely technical level, the formulation of paragraph 71 may prove defective since it would not cover an SCE – as the provision limiting interest on capital is set out in the Regulation, which is directly applicable European law rather than national law.

We note that there could well be special situations in future – similar to those experienced during the recent crisis – where banks of any type may need to be recapitalised by their national Government / taxpayers – in which case the use of new capital with what may appear to be "privileges" could be desirable as a means of enforcing discipline and protecting taxpayers.

We also argue that, in order to respect fully both the overriding principle, and the practicalities of catering for diverse national traditions and circumstances, paragraph 71 needs to be developed further in the following areas:

(i) the "provision under national law" (which concept we believe should also extend to cases where the national law permits, but does not expressly provide for or require) may provide for a limit on dividends but need not specify what that limit is – this need not be the same for all institutions at all times or for all instruments issued by a particular institution.

(ii) any "provision under national law" may make different provision for different types of mutuals within the same member state.

(iii) the limit must be capable of being expressed as a percentage of the principal amount paid in or the nominal amount of the instrument.

(iv) the derogation should extend to all entities within a group headed by a mutual or cooperative society, regardless of the individual entity's corporate form, as the principle is clearly to be observed by the whole group.

(v) the wording on privileges needs to be refined to make it clear that instruments which comply with items (i) to (iv) above do not, by virtue of such compliance, create privileges and that, where the entity is a subsidiary of a mutual, it should be permissible for the capital held by other members of its group not to be subject to limitations on distributions but that the principle should apply to all other instruments held by external investors (with a saving for any instruments already in issue to external investors).

We propose the following alternative text for paragraphs 66 and 71 which would achieve the further development needed for mutuals and cooperatives:

Paragraph 66 : **When instruments other than ordinary shares are also eligible, the dividends on these instruments should replicate the behaviour of dividends on ordinary shares in relation to loss absorbency in a manner acceptable to the national supervisor. However, this shall not oblige mutual or cooperative banks (or proprietary bank subsidiaries of mutual or cooperative groups) to depart from the established principle of limited interest on capital.**

[4] British credit unions' dividend on their cooperative shares could not under existing national law (though this is subject to change) exceed 8% pa –and this provision has never (contrary to what is suggested in paragraph 71) operated to set a market expectation of what will be paid – this disproves the assertion that " A cap ….. can be viewed by the market as an obligation to pay this capped amount."

Paragraph 71 : **A cap relating to the payment on the instruments is not acceptable for joint-stock / proprietary companies, as it can be viewed by the market as an obligation to pay this capped amount. However, in the case of mutual and cooperative societies, CEBS respects the principle of limited interest on capital as re-stated in Recital 10 of Council Regulation (EC) no. 1435/2003 of 22 July 2003. Accordingly, such societies, and any other entities in their groups, may apply limitations to such fully discretionary payments, each expressed as a percentage of the principal or nominal amount but set at a level to provide a fair return to the holders based on market circumstances at the time of issue. This may either follow an explicit provision in national law, or be permitted by national law and accepted by the national supervisor, or may follow the general principle re-stated in the Regulation, but in either case payments on all instruments of that society eligible under Article 57(a) shall be subject to limitation (that is, the society shall not also issue instruments without such limitation) so as not to create privileges. The only exception to this should be that, where the entity in question is a subsidiary of a mutual or cooperative, it should be permissible for the capital held by the group not to be subject to such limitation but the principle should apply to all instruments held by external investors (with a saving for any instruments already in issue).**

Section D: Loss Absorbency

We welcome the Committee's efforts (particularly in paragraphs 77 and 80) to cater for mutual and cooperative banks and the explicit recognition in paragraph 77 of the principle of disinterested distribution. We also welcome the understanding, expressed in paragraph 76, that initial loss absorption falls to the institution's reserves, and that Article 57(a) instruments may absorb losses by supporting negative reserves. The deferred shares in a building society provide going concern loss absorbency in exactly this manner – though this has in the past not been properly understood by regulators.

We support in general terms the response on section D from the EACB.

31 March 2010

ANNEX 1 : **Recitals 7 to 10 to Council Regulation[5] (EC) No. 1435/2003 of 22 July 2003 on the statute for a European Cooperative Society**

(7) Cooperatives are primarily groups of persons or legal entities with particular operating principles that are different from those of other economic agents. These include the principles of democratic structure and control and the distribution of the net profit for the financial year on an equitable basis.

(8) These particular principles include notably the principle of the primacy of the individual which is reflected in the specific rules on membership, resignation and expulsion, where the 'one man, one vote' rule is laid down and the right to vote is vested in the individual, with the implication that members cannot exercise any rights over the assets of the cooperative.

(9) Cooperatives have a share capital and their members may be either individuals or enterprises. These members may consist wholly or partly of customers, employees or suppliers. Where a cooperative is constituted of members who are themselves cooperative enterprises, it is known as a 'secondary' or 'second-degree' cooperative. In some circumstances cooperatives may also have among their members a specified proportion of investor members who do not use their services, or of third parties who benefit by their activities or carry out work on their behalf.

(10) A European cooperative society (hereinafter referred to as 'SCE') should have as its principal object the satisfaction of its members' needs and/or the development of their economic and/or social activities, in compliance with the following principles:

— its activities should be conducted for the mutual benefit of the members so that each member benefits from the activities of the SCE in accordance with his/her participation,

— members of the SCE should also be customers, employees or suppliers or should be otherwise involved in the activities of the SCE,

— control should be vested equally in members, although weighted voting may be allowed, in order to reflect each member's contribution to the SCE,

— there should be limited interest on loan and share capital,

— profits should be distributed according to business done with the SCE or retained to meet the needs of members,

— there should be no artificial restrictions on membership,

— net assets and reserves should be distributed on winding-up according to the principle of disinterested distribution, that is to say to another cooperative body pursuing similar aims or general interest purposes.

[5] http://eur-lex.europa.eu/lexuriserv/lexuriserv.do?uri=oj:l:2003:207:0001:0024:en:pdf

ANNEX 2 : **extract from 1966 Report[6] of the Commission on Cooperative Principles established by the International Cooperative Alliance to review the 1937 Rochdale Principles**

LIMITED INTEREST ON CAPITAL

The Co-operative economic system has broken with the practice of ordinary profit-seeking enterprise, not only through its rules of association and democratic administration, already discussed, but also through the rules which determine the allocation and division of savings and other financial benefits successful co-operatives yield to their members. This has its origin notably in the resentment with which many working people regarding the distribution of property and income in 19th century society, because in their eyes it was both unequal and unjust. While the immediate goal of co-operative effort among them might be to cheapen the necessaries of life for consumers or to provide a decent living for producers, the ultimate aim was to establish a new social order characterised by what they called `Equity' in the distribution of wealth and income. The new industrial techniques, then as today, had an insatiable appetite for capital. People who possessed or commanded money for investment wielded a bargaining power which enabled them to obtain, at the expense of the other factors of production, high dividends and an accretion of capital values representing something much more than interest - the lion's share of the profits of industry as well.

The Rochdale Pioneers realised that, for their immediate plan of opening a store and likewise for their ultimate plan of establishing a community, capital was indispensable. They recognised the added productivity which the use of capital gave to labour as a reason for remunerating those who supplied it. Their idea, however, was labour working with capital, not labour working for capital or its possessor. They therefore rejected the claim of the owners to any part of whatever surplus remained after the other factors of production had been remunerated at market rates, although admitting their claim to interest at fair rates. Here it is desired to emphasise that co-operative rules regarding interest and the division and use of surplus are the twofold result of a firm resolve to establish and extend a more equitable division of the product of economic organisation than is commonly found in the profit-dominated business world.

The men of Rochdale, poor though some of them were, decided to provide the initial capital for their venture from their own personal savings. As the venture was successful they were able to add co-operative savings, notably in the forms of reserves and depreciation of their society's real property, to their individual contributions of capital. Self-financing by these two methods became customary and widespread among old Co-operative Movements, whether of producers or consumers, because of its obvious advantages of economy and security. Provided that capital is forthcoming in adequate amounts when required, self-financing is an added guarantee, in a competitive economy, of a co- operative society's independence and freedom to solve its problems of growth and development through the untrammelled application of co-operative principles. Moreover, individual savings in the form of share capital are a pledge of the members' support. The fact that their own money is risked gives powerful inducements to exercise prudence and foresight when playing their part in their society's administration. Naturally, self-financing is not so easy in the younger organisations of the newly- developing countries but it can be recognised as a desirable objective to work for and attain in time. Meanwhile the members ought to be obliged, as a matter of principle, to contribute at all times as much capital as they reasonably can, however little. In the old-established Co-operative Movements, with their powerful central institutions for trade,

[6] http://www.ica.coop/coop/1966-01.html#interest

banking and insurance, the rule of self-finance must receive, under contemporary conditions, a broader formulation. Self-financing tends to become ever harder and may end by becoming impossible for primary societies. The time may even come when, under the stress of competition and the urgent need to extend their structures and renew their equipment, the national movements will be unable to finance their operations without attracting capital from outside. Cases may even occur when the necessity of competing successfully for the favour of people with savings to invest against savings banks and the securities dealt in on the stock exchanges may tend to restrict the freedom of co-operative organisations to fix their interest rates according to their own principles. All the more reason, therefore, why Co-operators should clearly understand what their own principles require in this connection.

The capital structures of the different national Co- operative Movements are not uniform. Three main categories may be distinguished in most of them, but in proportions which may vary widely from country to country and from one branch of the Movement to another. These are: the members' share capital; capital owned by the societies in the form of reserves and special funds on which the individual members have no claim; loan capital, which includes all external borrowings, as may be from banks or governments or other co-operative institutions, as well as all kinds of loans made or savings deposited by members over and above their share-holdings. Of these three categories, no interest is payable by the society on the second, although it may calculate interest for the purposes of internal accounting. On the third, the interest rates are not likely to exceed the rates prevailing in the external money and capital markets or fixed by authority in a centrally-planned economy for equivalent kinds of investment. Clearly then, it is the first category, the share capital - subscription of which is an attribute of membership and which is closely associated with risk-bearing - which is subject to fixed and limited rates of interest.