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Response to Committee of European Banking Supervisors

Consultation Paper CP27 on implementation guidelines regarding hybrid capital instruments

The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK including all 52 UK building societies. Building societies have total assets of over £370 billion and, together with their subsidiaries, hold residential mortgages of over £245 billion, more than 20% of the total outstanding in the UK. Societies hold nearly £240 billion of retail deposits, accounting for more than 20% of all such deposits in the UK. Building societies also account for about 36% of all cash ISA balances. Building societies employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

In this response, we address those issues that we believe have particular relevance to UK building societies, whose capital structure we explain below, and other financial mutuals. Building societies do not in general use hybrid instruments, but may wish to do so in future, and wish to preserve access to hybrid capital on a similar basis to banks. The BSA therefore supports the general objectives of the CEBS consultation in CP27, but also looks forward to the separate document mentioned in footnote 5 on page 1 of CP27 in which guidelines regarding Article 57(a) instruments will be elaborated, as building societies already have such Article 57(a) instruments in issue.

Building societies are incorporated mutual societies that provide savings and mortgage loans to their members, and form a part of the European Social Economy. Their constitution, and therefore capital structure, is quite distinct from that of proprietary banks, and this has been a source of misunderstanding – including hitherto with CEBS. In accordance with established Social Economy principles, building societies are owned and democratically controlled by their customer-members and do not make profits primarily for distribution to external capital providers. Instead, surpluses are retained within the society for the benefit of the customer-members, and such reserves form the predominant component of the capital resources of building societies. The same is generally true of other financial mutuals.

Capital needed for the foundation of a new building society, or to augment the society's reserves, can be raised by deferred shares, called permanent interest-bearing shares (PIBS), which were created by UK legislation in 1991 as part of the implementation of the Own Funds directive. PIBS are equity capital under national law and in other respects fully qualify under what is now article 57(a) of the CRD, as they were designed to do. This was clearly stated by the UK competent authorities in 1991, and this Association has recently revisited the matter in the light of amendments to the CRD. On authoritative legal advice, we are clear that PIBS conforming to the original specification remain Article 57(a) instruments. We respectfully point out that the reference to PIBS in paragraph 8 of the CEBS proposal of 26 March 2008 for a common EU definition of Tier 1 hybrids is therefore strictly incorrect, as PIBS are original Article 57(a) instruments and so are not hybrids[1]. So we look forward to the further document containing proposed guidelines on Article 57(a) instruments.

In the meantime, we suggest that the CRD articles and CEBS guidelines on hybrids could usefully be illustrated by a "decision tree" for the classification of any instrument – which

[1] Although the footnote to that paragraph 8 in the 2008 document correctly states that PIBS are the most deeply subordinated capital instrument as building societies do not have [company-type] ordinary shares.

would help to make clear, and underline, that Article 57(a) instruments should be identified first, and that hybrids are a sub-set of instruments that do not qualify under Article 57(a).

In this context we note with interest the principle mentioned at paragraph 17 of the 2008 proposal, that regulation of hybrids should not be more onerous than the rules on ordinary share capital.

We have often seen ordinary share capital on the proprietary company model held up as an exemplar of the highest quality of capital, notwithstanding features that can compromise both permanence and loss absorbency. Proprietary companies that are banks can buy back their ordinary shares at any time, with no need for explicit call features, and moreover they may have constant incentives to do so whenever the combination of dividends and share price appreciation demanded by capitalist investors cannot be sustained : this adds up to an implicit "American" call option. As with incentives to redeem hybrids, the exercise of this option weakens the capital base.

Nor has the ability of ordinary shares to absorb losses been universally demonstrated during the recent crisis. In the most high-profile instance, the board of the UK mortgage bank Northern Rock refused to cancel its 2007 interim dividend notwithstanding the horrendous losses that were emerging, and the massive state support it had already received, and had to be compelled to do so by the regulator.

So we caution against a too ready acceptance that ordinary shares are the paragon of tier 1 capital as real-life experience does not bear this out. Instead, as CP27 generally recognises, guidance should be based on principles, not assumptions taken from the narrow proprietary company model.

In this context we also welcome, and endorse, the observations made by the European Association of Co-operative Banks in their open letter[2] to the G20 summit outlining the concerns of European co-operative banks. We draw CEBS' attention to the following statement in that letter :

> *"Co-operative shares are and must remain Tier 1 capital. Indeed, the features of cooperative banks and especially of co-operative shares are in many ways different from those of listed companies, but certainly of equal quality. The current crisis has provided further evidence of this. It will therefore be important that the Basel Committee carefully considers the particularities of co-operative shares when defining the prudential aspects of core capital. "*

We also welcome and endorse the recent remarks attributed to the Vice President of the Deutsche Bundesbank to the effect that proprietary share capital should not be treated more favourably than other forms of equity, such as co-operatives' equity.

Question 1 : "incentives to redeem"

We find the guidelines sufficiently clear, but have two reservations. The final three sentences of paragraph 53 introduce uncertainty, and are too wide ranging. And we oppose paragraph 58 which states that instruments which originally possessed an incentive to redeem continue in the 15% bucket even after any incentive has been passed or expired. We see no logical reason for this, and it serves no prudential purpose.

Question 2 : buy backs

We note CEBS' view that buybacks are economically and prudentially equivalent to a call or redemption (paragraph 72), and we pointed out above that institutions which are proprietary companies have unfettered ability to buy back their ordinary shares. We see this not as necessarily an argument against restricting buybacks of hybrids, but in support of our

[2] http://www.eurocoopbanks.coop/GetDocument.aspx?id=1d9a0049-4a8f-42e6-8d0c-b6df814d1a12

contention that ordinary shares' permanence is also compromised. Nevertheless we are broadly sympathetic to CEBS' desire to restrict early buybacks of hybrids.

Question 3 : Flexibility of payments -dividend pushers/ stoppers

These tools are mainly of relevance to proprietary companies, as they are a means of protecting hybrid holders from capricious exercise of payment flexibility on hybrids when holders of ordinary shares (who are more junior in ranking but have votes and can therefore ultimately mandate the institution's policy) are not being denied their dividends. Again, we observe that the need for these tools illustrates our point that ordinary shares do not - in practice, as opposed to theory – necessarily absorb losses so readily.

We do not agree with paragraph 78 that payments of coupons or dividends on hybrids can only be made from distributable reserves.

Question 4 : ACSM

We agree with the general principle that ACSM which has the same economic effect as coupon cancellation – i.e. no decrease in capital – is acceptable, and that the institution must have no further obligation e.g. to place the resulting ACSM instruments.

Question 5 : Loss absorbency

Paragraph 106 is a useful summary of the necessary loss absorption conditions. We do not agree with the suggestion that principal write-down or conversion features are necessary or desirable for recapitalisation, and we think that the requirement for a positive feature that makes recapitalisation more likely is not the same as requiring the absence of features that may hinder recapitalisation (which is what the Directive requires) - so in this respect CEBS is exceeding its mandate. We note that principal write-down or other features are not required for ordinary shares in proprietary companies, although – given their voting power, resistance to dilution and need for approval of new capital structures –ordinary shareholders can easily, and in practice do[3], *hinder* (whether or not they also ultimately prevent) recapitalisations that give a good return to providers of new capital, at their expense. Again, we make this observation to illustrate the relative shortcomings of proprietary companies' ordinary shares as loss absorbers.

Question 6 : limits

We think these are sufficiently clear.

Question 7 : indirect issues through SPV

We are broadly content with the proposals. Our members do not currently use such vehicles.

[3] a good example may be found among the successive recapitalisations of Eurotunnel PLC