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Introduction

The Building Societies Association represents mutual lenders and deposit takers in the UK including all 47 UK building societies. Mutual lenders and deposit takers have total assets of over £375 billion and, together with their subsidiaries, hold residential mortgages of over £235 billion, 19% of the total outstanding in the UK. They hold more than £250 billion of retail deposits, accounting for 22% of all such deposits in the UK. Mutual deposit takers account for 34% of cash ISA balances. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

Summary

We are pleased to be able to comment on the consultation and discussion papers on recovery and resolution plans. We should also like to thank the FSA for arranging a seminar in September that was focused on building societies' requirements. We set out first a high-level summary of our response, before addressing individual chapters of the CP/DP and their specific questions. Where relevant, points made in our summary are repeated in the response to particular chapters or questions.

Generally speaking, we agree that the UK Authorities need to have detailed knowledge and understanding of a deposit-taker's business to exercise the Special Resolution Regime tools and enable the orderly resolution of a failed firm without relying on taxpayer support. The support provided to UK banks following the financial crisis of 2008 should never need to be repeated. But we think that detailed knowledge is needed for systemically-important firms only.

Much of the content of the consultation and discussion papers is focused on the prospective resolution of large, complex, even global banks. Our members, on the other hand, are almost entirely domestic in scope, and concentrate on the traditional banking activities of deposit taking, lending and (in a few cases) money transmission services. So the businesses of BSA members are much simpler, generally smaller and domestic, therefore nowhere near as complex as high street or universal banks. In our response, therefore, we argue for a better approach to our members, in particular our smaller members, whose business is essentially simple and homogeneous, and which lack the resources of large banks to undertake extensive RRP activity. The FSA has said that the RRP material is "naturally" proportionate, and we appreciate that FSA has tried to make it so, but that is not how our members experience it. They find it hard to apply material necessarily designed for large, complex and international banks to their own straightforward, domestic businesses.

Calls for a proportionate approach have come from media commentators as well as the BSA. The *Independent on Sunday* describes[1] the proposals as a "burdensome piece of legislation *designed for the big institutions that caused the financial crisis*". The newspaper reports that experts think that requiring RRPs for as many as 200 institutions will needlessly drain small deposit-takers' resources.

We can see that preparing the material consulted on in the consultation paper is indeed a difficult task, as the FSA rules and guidance must cater at one extreme with one or more globally systemic banks displaying the characteristics of size, complexity, interconnectedness, lack of substitutability and cross-jurisdictional activity. At the other extreme, the great majority of our members do not remotely score against any of these indicators. We feel that the menu selection approach, where each mutual works out for itself

[1] IoS 23 October 2011

which items - from a complete menu designed for a globally systemic bank - do or do not apply to it, is neither proportionate nor efficient.

On **recovery plans**, our key point here is that building societies, given the statutory constraints within which they operate, already have a much narrower range of options for the recovery phase. For this reason, it is likely that their recovery plans will be extremely similar. As building societies their two basic businesses – personal savings and mortgage lending – are mandated by law, so neither can be discontinued nor wholly disposed of. As mutuals they pay neither plc-type dividends nor City-style bonuses, so elimination of these does not help.

The main credible option will be sale of the whole firm to a third party. This, of course, corresponds of course to a well-established exit route for the occasional smaller building society that gets into difficulties: merger with a larger, stronger society. This involves a statutory process overseen by the FSA.

Once a smaller building society needs to go beyond the stress responses of, for example, curtailing new lending to conserve both liquidity and capital, and in the absence of discrete business units that could be sold as part of recovery, merger is the principal remaining option. But the conventional merger process can take many months, with considerable uncertainty and execution risk, since it requires production of detailed information to members and then the passing of a special resolution at a general meeting. The FSA has power to expedite this by directing that the society can dispense with the general meeting and proceed by board resolution instead. This shortens the process from months to weeks and reduces uncertainty and execution risk. But at the stage of recovery planning, it remains a "known unknown". Arguably, the FSA's most helpful contribution to smaller mutuals' recovery planning would be to make clear the circumstances under which it is ready to use this power.

Turning to resolution plans, we understand that for the majority of our members - even though deposit-taking is always a "critical function" *per se* - it is unlikely that the test of necessity under the Banking Act 2009 for the use of the stabilisation options will be met. Therefore if a resolution tool is needed it will have to be the bank/building society insolvency procedure with rapid payout of protected deposits by the FSCS. So the top priority is for the FSCS to ensure faster payout to depositors based on single customer view information, and for the bank then to be placed into the bank insolvency procedure – as was seen earlier in the summer with the Southsea Mortgage and Investment Co. The overriding focus for "resolution" of a smaller firm should therefore be the ability to provide FSCS immediately with the information needed.

Since the stabilisation options such as partial transfer are not being contemplated in such cases, the advance preparation needed for their implementation is not needed either. But here again, mutuals face a "known unknown" – are they below the financial stability threshold, so FSCS plus BIP is the correct planning assumption? Who decides that, and can it be known in advance?

In conclusion, we have two main worries:

- that our smaller members' own scarce staff resources should be used efficiently in relation to RRPs; and
- those same members should not be at risk of a hard sell from external consultants telling them how to develop full scale RRPs that may not prove necessary.

The strong consensus from our members is that more focused and adapted guidance from FSA is required – for all the reasons outlined above. As the FSA will know from feedback to its September event and from our letter of 28 September 2011, our members are keen to help to adapt the guidance for smaller mutuals. The BSA has offered to facilitate this. A particularly useful ingredient of this collaboration could be a case study based on an imaginary small building society for which the RRP options are (ultimately) rescue merger (for recovery) and FSCS plus BIP (for resolution). BSA members can then be clear whether they broadly map onto the case study, and can generate truly proportionate RRPs accordingly without each reinventing the wheel. We look forward to hearing from the FSA on that offer.

Q1: Does the detailed guide to the preparation of RRPs, set out in the RRP guide, give adequate instruction and assistance to prepare an RRP? Are there areas which require further explanation?

Until firms start working on their own RRPs, it is hard to conclude how far the guide will be of help. The modular format in the RRP guidance pack is clear to a point although a "walkthrough" guide for the mainly larger firms that will use this, and a much pared down version for smaller firms, would have been more useful. Certainly we can find no fault with the aims outlined at chapter 1.14; the question is, will firms be able to produce the sort of information the regulator thinks it needs?

As we say throughout this response, we question the application of such an intensive and invasive regime to non-systemic firms. The RRP guidance was developed with globally systemic firms in mind so it will be challenging to say the least for other firms to apply it in full to themselves. At the FSA building societies' event in September 2011, the guidance was called "naturally" proportionate. That has not been our experience.

Much of it irrelevant to them, the guidance would be far more helpful if the regulator could signpost the parts that relate to the various categories, for example, to (smaller) mutuals. Not only would it save very small teams, sometimes – in a small building society - one person who will have other responsibilities, from having to go through documentation that largely does not relate to them, but also from being diverted from more important, day-to-day business. Our smaller members simply lack the resources of global universal banks.

In chapter 1.16, the FSA says: "We are required, as a minimum, to make RRP provisions that apply to UK incorporated deposit-takers covered by the FS Act 2010." Section 139B(1) - rules about recovery plans and section 139C(1) – rules about resolution plans, of that Act actually say that "The Authority must exercise its power to make general rules so as to make rules requiring each authorised person (*or each authorised person of a specified description*) to prepare, and keep up-to-date, a recovery (139B)/ resolution (139C) plan. We believe the result, and the intention, of this piece of statute is that the FSA has the discretion over who needs to prepare these plans. This seems the aim in the explanatory notes:

"…. **this requirement can apply to all authorised persons or the FSA can exercise discretion over which authorised persons are required to produce a recovery/ resolution plan by specifying the firms to which the rules apply**. This will allow for gradual implementation, focusing on the largest, most complex and systemically significant firms in the first instance."

There appears to be no legal impediment to stop the FSA being properly proportionate and recognising that substantive RRPs for smaller firms may prove largely a waste of everybody's time and resource. Nor is it at all obvious why the smallest building societies need RRPs any more than the largest credit unions – which, while authorised persons and (like building societies) deposit-takers, appear to be carved out of the RRP requirements altogether.

We believe the FSA is also somewhat hasty in setting out its requirements when the EU crisis management directive has not yet been published. Commentators have suggested that it will contain material divergences in some areas necessitating a change in the proposed FSA rules. Moreover, the EU's technical consultation early in 2011 underlines the point we have made above – that for non-systemic firms, the default option is insolvency with payout under the national deposit guarantee scheme – and that this, for smaller institutions with no cross-border operations, would in effect be the resolution plan[2].

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[2] ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf

Q2: Please give your views on the recovery plan proposals for:

- **governance;**
- **key recovery plan options; and**
- **assessment criteria**

Governance

We have no argument with the governance procedure described in chapter 3.8 though are concerned that RRPs overlap with other FSA requirements such as stress testing, contingency funding planning and ICAAPs. There is a danger that firms will be producing the same information in different formats. We also wonder why the FSA's data warehouse cannot be used to produce some of the information in the recovery plan.

We agree that the recovery plan should be regularly reviewed and updated. We also agree that there should be sound processes in place to monitor early warning signs and triggers and for timely decision-making and implementation of the plan by senior management and boards.

Should a recovery plan need to be executed, we agree that the regulator should be involved at an early stage.

Key recovery plan options

We agree that "credible options" should be constructed for the most severe circumstances where a firm is fighting for its survival. We also agree that the firm must ensure the continuity of key internal operational processes (IT, availability of staff). But the "credible options" for mutuals are more limited, unlike for plcs. Building societies have two basic businesses – personal savings and mortgage lending – which are mandated by law, so neither can be discontinued nor wholly disposed of.

Most of our members are unable to sell off discrete businesses or lines. They cannot raise plc-type equity capital, cut ordinary share dividends or sell overseas operations. Most smaller building societies do not have medium or long term debt in issue (whether subordinated or senior) that could be the subject of exchanges or liability management actions. The final option in the list – sale of the whole firm to a third party – corresponds, of course, to a well-established exit route for the occasional smaller building society that gets into difficulties: merger with (more formally, transfer of engagements to) a larger, stronger society.

But the conventional merger process can take many months, with considerable uncertainty and execution risk, since it requires production of a detailed information memorandum to members and then the passing of a special resolution by savers at a general meeting. This involves a statutory process overseen by the FSA. Section 42B (3) of the Building Societies Act allows the FSA where "it considers it expedient to do so in order to protect the investments of shareholders or depositors" by directing that the society can dispense with the general meeting and proceed by board resolution instead. This removes almost all the uncertainty and execution risk and shortens the process to weeks. But at the stage of recovery planning – in the context of paragraphs 3.24 and 3.25 - it remains a "known unknown".

Arguably, FSA's most helpful contribution to smaller societies' recovery planning would be to make clear the circumstances under which it is ready to use the section 42B (3) power.

While we consider merger to be the only credible option for the smaller mutual that may get into trouble, we do not think that a single potential partner for crisis times (a "white knight") should be named in a recovery and resolution plan. Theoretically, a white knight needs to have the option to say no – and, if it wants to say yes, will want first of all to carry out some form of due diligence. Not only will this be a drain on the white knight's resources, but it could provide the knight with the ammunition to make an unwelcome approach for the mutual..

To get round this conundrum, we suggest smaller mutuals list 2-4 larger mutuals they might approach in a time of crisis, or merely state they will approach one of the three largest mutuals of the day. It also does not seem prudent to us to name a single mutual that could itself experience a change of circumstances and therefore not be suitable.

Chapter 3.11 does acknowledge that the options for smaller firms are limited but omits that there are generally even fewer for our members. In summary, once a smaller mutual needs to go beyond the stress responses of, for example, curtailing new lending to conserve both liquidity and capital, and in the absence of discrete business units that could be sold as part of recovery, merger is the principal remaining option.

Assessment criteria

Mutuals hit an immediate problem with the proposed requirement that the benefits have to be capable of being realised within an acceptable timeframe of six months or less (see above). To effect a swift merger with a stressed building society in a crisis situation the FSA would have to take the action described above, using section 42B (3).

A merger clearly meets the requirement of being credible to key stakeholders of the stressed mutual. For it to be successful, a coherent communications strategy, as outlined in chapter 3.25, is essential to maintain public (and where applicable, market) confidence. This is particularly pertinent in the mutual sector where contagion is always a factor. But how confidence would be maintained should several deposit-takers face difficulties at the same time is a matter for the Authorities.

Q3: Please give your views on the proposals for the recovery plan trigger framework.

The consultation paper envisages unambiguous triggers which, when breached, will create a strong presumption that the plan will be activated. The FSA says that having clear triggers is necessary to support timely and decisive action by a firm's senior management. We believe the accent here should be on "support"; firms should not be required mechanically to take action on a trigger alone.

The FSA writes that "the firm should consider indicators that measure the adequacy of its financial resources and its distance from failure". The guidance pack adds that firms should add specific examples, with metrics. This suggests that triggers are mainly quantitative. We consider some might be qualitative such as a crisis at a competitor. Chapter 3.34 discusses early warning signals that can serve as the starting point for the firm to review its recovery plan options. We note that two of the four examples given (negative market sentiment and a drop in a firm's credit rating) do not apply to smaller mutuals at all. This is yet another example that the RRP requirement has been written with plc global banks in mind.

We do not disagree with the FSA's proposal that firms will be required to develop their own triggers and to set these at appropriate levels. But we would like confirmation that the regulator will not try to force all firms, particularly those in the same sector, to adopt the same indicators. There may be good reason why different firms have different tolerances.

A key component of the RRP framework is the determination of <u>when</u> the firm will implement aspects of its recovery plan. Clearly, this will need to be early enough to give the firm time for the plan to have an effect. Whether formal triggers are the answer, however, is debatable. Even the FSA does not seem sure: chapter 3.30 says that a firm should be prepared to activate its recovery plan if it is determined that its viability is at risk, even though none of the triggers have been met. This suggests the FSA may bypass them. We question therefore the need to rely on formal triggers.

Q4: Do you agree it is appropriate for the FSA/ PRA to collect interbank exposure as outlined? What changes, if any, would you suggest to the data template?

We understand why the FSA wishes to understand interconnections between banks when assessing the implications of bank and building society failure. We agree this is especially relevant when trying to assess the risk of contagion spreading through the financial market. But we question the need for yet another return, particularly for smaller firms such as mutuals. The FSA says that neither the current requirements nor the new large exposure requirements to be introduced as part of the Common Reporting framework provide enough detail.

It is unfortunate that the current LE return is deemed insufficient; we would like an explanation of why the current suite of returns cannot be refined to give the FSA the information it says it needs. Our understanding of COREP is that none of its templates have been agreed, and will not be for some time. A real danger of this proposed new return is that it may have to change again in the future. In chapter 4.23, the FSA acknowledges this itself: "A more streamlined solution will be investigated after the regulatory reform changes have been implemented and various relevant international data initiatives are complete." Even a more streamlined solution comes at a cost to firms, and presumably to the FSA as well. The return is also being introduced ahead of the RRPs in March 2012 so there is no time to assess its effectiveness.

The FSA says in chapter 4.22 that information for the new return should be readily available from risk management systems. Even if it is, there are resource costs in producing, reviewing and approving such information.

The FSA says it will ask **all** relevant firms to submit details of their 20 largest interbank exposures using a template for either high and medium-high impact or medium-low and low impact firms. It adds it will take a proportionate approach so that the level of detail expected from each firm will depend on the size of the firm. Without further details of how "proportionate" will be interpreted, it is hard to comment authoritatively but for smaller mutuals such a return will not yield startling information – the **total** number of exposures will be in single figures. We therefore suggest the FSA's approach is made truly proportionate by eliminating the need for a new LE return for the majority of mutuals.

Q5: Please give your views on the suggested information requirements for both derivatives and securities financing, the ability of firms to produce the information quickly (recognising that some modifications to systems may be needed) and comments on whether it would be possible to achieve the same ends through alternative means.

BSA members have little involvement here – others are better placed to respond.

Q6: Please give your views on the list of economic functions list. For example, have we failed to identify any important economic functions?

We consider the economic functions listed at chapter 4.35 and in module 4 of the RRP guidance pack are comprehensive. Economic functions for BSA members are, of course, far more limited than this list would suggest.

Some of the figures produced by the metrics, for example, total liabilities and total accounts, may vary considerably throughout the year so care must be taken when using them. The FSA says that a firm should consider at least three metrics for each economic function – we consider that to be excessive. Forcing firms to do this, particularly if no appropriate metric can be found, could lead to a reliance on less relevant data.

Q7: Resolution planning: give your views on the proposals for the provision of information and analysis on:

- **group structure and legal entities;**
- **economic functions; and**
- **barriers to resolution.**

We do not propose to comment on the first bullet point, group structure and legal entities: Building societies typically have very simple group structures and the society itself must always be at the head of the group.

On the second bullet point, economic functions, we feel that the number could be amended to suit the mutual sector/ smaller firms. Throughout there is an erroneous assumption that the impact on the markets is paramount – for example, in number 4.1.2 of the matrix, "Management view of the *impact on the markets* and customers etc in the UK." And, as we say earlier, requiring three metrics for each function appears excessive and possibly counter-productive.

We are pleased to note that values used in the metrics do not need to be reconciled to the statutory accounts or regulatory returns. The information should be accurate but not to the point where considerable amounts of management time has to be devoted to its production. At a meeting with trade bodies, officials mentioned the data should be "best estimate"; we think that point should be explicit.

We note that the FSA says its approach to implementation will be "iterative and proportional". It will be iterative in that it expects to establish a firm's critical economic functions before asking for more information on those functions, including where necessary plans to alter firms' business operations or structure to address inadequacies in the resolution packs. This sounds like a complex and resource-consuming process, particularly for a sector as homogenous as mutuals. We believe the solution for mutuals will be much more straightforward.

Turning to the final point, barriers to resolution, we were pleased to note from the FSA's seminars (though not in the consultation paper itself) that resolution by the use of one of the stabilisation options - such as partial transfer - for which the more detailed planning is then necessary, is not contemplated for failing firms that do not pose a risk to financial stability. For firms below this threshold, even though deposit-taking is always a "critical function" *per se*, the correct procedure is for the FSCS to ensure faster payout to depositors based on single customer view information, and for the bank to be placed into the bank insolvency procedure – as was seen earlier in the summer with Southsea.

The overriding focus for "resolution" of a smaller bank or society should therefore be the ability to provide FSCS immediately with the information needed. Since the stabilisation options such as partial transfer are not being contemplated, the preparation needed for their implementation is not needed either. But here again, societies face a "known unknown" – are they below the financial stability threshold, so FSCS plus BIP is the correct planning assumption? Who decides that, and can it be known in advance?

Q8: Do you support the proposal to assign responsibility for RRPs to an executive director of the firm?

We agree that firms should nominate an executive director to have responsibility for their RRP. As this director will already be an FSA Approved Person, we are slightly confused as to why his/ her nomination needs to be discussed with the firm's supervisor.

Q9: Do you agree with the approach set out in Chapter 5 for the preparation of RRPs for internationally active firms?

Not of relevance to BSA members.

Discussion paper questions

Overview

The following paragraphs respond selectively to issues raised in the discussion paper sections of CP 11/16, chapters 7-11 and annexes 5 to 8 (the DP). Our preliminary comment is that much of the content of the DP is necessarily, and understandably, focused on the prospective resolution of large, complex, even global banks. BSA members are almost entirely domestic in scope, and concentrate on the traditional banking activities of deposit-taking, lending and (in a few cases) money transmission services. Moreover, for the majority of our members, it is unlikely that the test of necessity under the Banking Act 2009 for the use of the stabilisation options will be met, therefore if a resolution tool is needed it will have to be the bank/building society insolvency procedure with rapid payout of protected deposits by the FSCS.

Accordingly, we focus our discussion paper response on issues with particular relevance to our members' situation: chapter 11 (bail-in) and annex 7 (payments, clearing and settlement systems). We also refer briefly to the other matters in the paper.

Chapters 8-10

Our only comment on chapters 8 and 9 is to emphasise the need to make clear distinctions between the resolvability of larger, complex, even global banks where use of stabilisation options is necessary, and the resolution – generally under the straightforward bank/ building society insolvency procedure – of simpler domestic institutions such as most BSA members. **Any requests from the FSA as contemplated by paragraphs 8.12 to 8.18 should be clearly related to the actual resolution route contemplated for a particular institution.**

Turning to chapter 9, the barriers to resolution mentioned there (trading books, complex organisational structures, operational and financial dependencies, and booking practices) generally do not apply to BSA members. For instance, a building society must always be at the apex of its group (if indeed it has any material subsidiaries at all – many do not), so the issue of a non-bank holding company does not arise. The restrictions on financial trading in section 9A of the Building Societies Act mean that no "substantial derivatives or securities financing" trading books exist.

One set of issues raised in chapter 9 - access to payments, clearing and settlement systems – is, however, important to all BSA members – not in relation to their own resolution, but because of their reliance on network providers. We address this below. Since the trading book problem as described does not affect BSA members, we offer no comments on Chapter 10. Since BSA members do not have the kind of complex, typically global operational dependencies contemplated in Annex 6, we also offer no comments on questions 14-16.

Chapter 11 – Bail-in

The BSA understands the need for some additional loss absorbency to facilitate formal resolution of systemic banks where capital has been, or will be, exhausted, but - since this need is concentrated in systemic institutions - we do not agree with the proposal for statutory bail-in that would apply to all deposit-takers regardless of whether they are systemic or whether stabilisation options could realistically be used.

Bail-in, as a form of internal recapitalisation, is, by definition, not needed where a smaller bank or building society is "resolved" by FSCS payout and the bank or building society insolvency procedure.

We also note that this debate has been taken forward by the final report of the Independent Commission on Banking. The ICB identified the need for additional primary loss absorbing capacity *only* at UK G-SIBs and "large" ring fenced retail banks regarded as domestically systemic (RWAs at least 1% of UK GDP).

We do not in this response debate the detail of the calibration of the ICB's proposals, but instead draw attention to the principle – that **substantial additional primary loss absorbing capacity is needed at systemic banks only**. In our view this undermines the argument for a universal statutory bail in regime that would turn all senior debt into subordinated debt. Instead, what is needed is the contractual approach helpfully proposed as one option by the European Commission in its technical consultation earlier in 2011. The EC explained that a targeted, contractual approach could ensure that the bulk of issuance (and thereby the extra costs) could be restricted solely to SIFIs. Going beyond this and imposing a statutory bail-in regime will impose costs, but yield no direct benefits, to non-systemic deposit-takers – so this incremental step would fail any cost-benefit analysis.

Chapter 11.6 of the discussion paper suggests that the contractual and statutory approaches are not mutually exclusive. That may be so, but completely misses the point. If the contractual/ targeted approach can deliver the vast majority of the benefit of extra primary loss absorbing capacity for systemic deposit-takers, the case for going further and imposing statutory bail-in on all deposit takers is not made.

It is also necessary to consider other, related proposals in a joined-up manner. The ICB report proposes a measure of retail depositor preference. The BSA supports this, provided its implementation is wisely handled. But we then can see no need for further subordination (via statutory bail-in) of specific creditor classes such as long term unsecured debt. Effectively subordinating all currently senior long term debt risks displacing most bank funding activity into secured instruments such as covered bonds, a result which viewed overall is wholly counterproductive.

The discussion in chapter11.13 – arguing that bail-in should be considered for all firms, not only systemic ones – is unconvincing and inconsistent. It claims that bail-in will redress the perceived advantage that investors in systemic firms may only face going concern losses, while investors in non systemic firms would face gone concern losses. But this is exactly the result that the Banking Act Special Resolution Regime, and the proposals both from the FSB and the EC, unavoidably lead to.

Where the default option for non systemic banks is payout under a deposit guarantee scheme together with whole firm liquidation, bail-in does not arise, and that bank's uninsured creditors - by design- are exposed to gone concern losses. Imposing statutory bail-in for cases where it is almost certain that "resolution" would be by way of FSCS plus BIP cannot change that fact – all it can do is to make that deposit-taker's funding substantially more expensive to no benefit. Worse, applying statutory bail-in creates a false expectation that stabilisation powers would in fact be used in such a case.

Q19: Bail-in

- **Do you believe that bail-in could be an effective tool in helping to recapitalise a firm that is either at the point of or is failing, in order to avoid a public injection of funds?**
- **What are the pros and cons of using the various tools: private sector contingent capital, contractual resolution bail-in and statutory resolution bail-in?**
- **Are the various tools best used separately or in tandem?**
- **Do you think it will be necessary to regulate the quantum and the maturity profile of bail-in-able instruments if use of the resolution bail-in tools is to be successful?**
- **Do you see any alternatives to provision of liquidity assistance to a recently bailed-in firm by the public sector?**

- **Do you think that, as a result of the bail-in arrangements, the cost of capital for banks will increase, or decrease, in a material way? And, what will be the effect on the capital structure?**

Our analysis leads to the following responses to the specific questions grouped under question 19:

- Targeted, contractual bail-in on its own would be an effective tool to recapitalise a failing systemic bank to avoid a public injection of funds.
- Contingent capital also provides primary loss absorbing capacity, and may do so in a recovery rather than only a resolution situation.
- Bail-in is not necessary for non systemic banks, so a targeted contractual resolution bail-in is the right answer. The wider scope of statutory resolution bail-in is not justified on cost benefit grounds.
- Therefore we do not agree that both contractual and statutory bail-in are needed.
- The quantum of bail-in instruments needs to be considered, based on some metric of systemic significance such as (but not necessarily the same as) that proposed by the ICB.
- Public sector liquidity provision is already on super-senior terms as it is provided only against eligible collateral of the highest quality.
- Bail-in is unlikely to have a material effect on the cost of regulatory capital for BSA members. Contractual bail-in bonds would probably be priced similarly to current subordinated debt. Statutory bail in would make all senior debt of all deposit takers substantially more expensive, as its price would rise towards that of subordinated debt. No corresponding reduction in the cost of other liabilities will be observed, so there will be a net cost, not a zero-sum.

Annex 5: structural barriers and "co-mingling of economic functions"

We explained above that BSA members, being simpler domestic deposit-takers, do not have complex organisational structures of the kind contemplated in Chapter 9 and Annex 5. However we do need to draw attention to an obvious instance of "co-mingling of economic functions" that of necessity takes place at all our members. Paragraph 4.42 identifies both customer deposit-taking and mortgage lending as critical economic functions, and all BSA members undertake both.

They are inescapably "co-mingled" within a single legal entity, as the deposit-taking provides the funding for the mortgage lending. Moreover, for a building society this co-mingling is mandated by law as the Building Societies Act requires a society to fund its mortgage lending from retail savings. So the BSA needs to make clear that there can be no question of prior placing of these critical functions in separate legal entities (as paragraphs 13-15 of Annex 5 appear to contemplate) – this would be foolish and (for a building society) illegal.

Annex 7 – payments, clearing and settlement systems.

All BSA members rely heavily on the UK payments infrastructure to make or receive payments large and small. Our two largest members, Nationwide Building Society and the Co-operative Banking Group, are direct participants in the principal retail payment networks – BACS, CCCS. All other BSA members rely on agency arrangements with a direct participant in the networks. Several more building societies are also members of the ATM network LINK. The BSA does not have sufficient expertise to engage with the technical issues described in the discussion paper, so we limit our response to a few observations from the perspective of BSA members reliant on agency arrangements.

Some of our members already operate what the discussion paper describes as "client-led contingency arrangements" by maintaining accounts with a second network member. But we question the practicality of immediately redirecting a large volume of payments from a failing network member to another member. While this builds operational resilience in case of localised outages, we do not think it is a satisfactory solution to the failure of a network member.

Although BSA members make limited securities transactions compared with large universal banks with trading books, they do nevertheless need continuous access to clearing and settlement systems, again through agency arrangements.

Q20: Do you have any comments on the cost benefit analysis?

General

We agree that when markets do not expect banks to be bailed out by taxpayers, plc-shareholders and debt-holders' incentives to monitor banks' management to act prudently are likely to be higher than where bail-out is expected.

We are not sure, however, if RRPs even in concert with other measures, will help firms, particularly non-systemic firms. The FSA opines that a system of regulated recovery plans is superior to a voluntary one as the former *has the potential* to mitigate herding behaviour should, for example, firms decide to exercise asset sales as a recovery option in a systemic stress. In such a stressed situation, there is no way of predicting behaviour and it seems erroneous – even when tempering the statement with the word "potential" – to claim that a costly, invasive and disproportionate piece of regulation, particularly for smaller firms, will stop or slow down events.

Where systemic firms are concerned, we believe the resolution plan data and analysis requirement does go some way to address an obstacle to the effective use of the current Special Resolution Regime – that the authorities are under-informed about the barriers to resolution and the systemic nature of individual economic functions. The collapse of Lehman Brothers illustrates neatly that this absence of key information can lead to inefficient decisions being made by authorities in a resolution and increase their unwillingness to let firms fail, thus amplifying moral hazard.

We also agree that systemic firms may have little incentive to have a resolvable legal and operational structure because such a structure may potentially increase the exposure of creditors and to some extent shareholders to the consequences of failure, thereby increasing their funding cost.

Yet another example of plc-fixation may be found in the CBA annex. Paragraphs 16-18 talk about shareholder behaviour in relation to extreme financial stress events. No mention is made of mutuals though, of course, this could imply that the FSA does not consider mutuals will ever be subject to such circumstances.

Cost of compliance

An indication of the large costs to individual firms of the RRP exercise may be inferred from the low response to the FSA's cost estimate survey. Only nine of the 32 firms approached were able to provide estimates of the costs of producing the RRP by module and of additional costs such as cost of board sign-off. Module 5 appeared to be the most expensive one to complete.

Even with a lack of depth of data, the on-off costs, such as investment in IT, staff training for high impact firms ranged from £20,000 to £24 million per firm. For medium high, medium low and low impact firms (the latter two categories taking in the majority of building societies), the one-off costs for producing modules 1 to 5, range from £120,000 to £20,000, and for module 6, £10,000 to £3,000[3].

Estimates for ongoing costs of producing the pack for medium-low and low impact firms range from £8,000 to £200,000.

[3] Insufficient data available to break down module costs for high impact firms.

Even at the lowest end, these figures will make a serious dent in mutuals' surplus. Unless a truly proportionate approach is taken, this regulatory excess will constitute a clear and culpable waste of resource that could be better used elsewhere. We cite again in support the *Independent on Sunday*'s recent coverage which calls the proposals a "burdensome piece of legislation *designed for the big institutions that caused the financial crisis*" pointing out that experts think that RRPs for as many as 200 institutions needlessly drain small organisations' resources.

We note the proposals to extend the use of skilled persons' reports under s166 FSMA 2000. Paragraph 57 says: "...depending on how good or poor the data and information provided by firms will turn out to be, we may have to use the power requiring a firm to appoint a skilled person to collect data, and this will impose costs on firms." This will undoubtedly lead to costs, in fact double costs: firms pay towards the FSA's costs and now they pay again for external consultants to do the same work. The same consultants, it should be added, that will be approaching firms to help them with their RRPs.

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