



**RESPONSE TO THE COMMITTEE OF BANKING SUPERVISORS' DRAFT
PROPOSAL FOR A COMMON EU DEFINITION OF TIER 1 HYBRIDS**

Introduction

1. The Building Societies Association represents all 59 building societies in the United Kingdom. Building societies have total assets of just under £325 billion and, with their subsidiaries, hold residential mortgages of over £250 billion, approximately 20% of the total outstanding in the UK. Societies hold just under £210 billion of retail deposits, accounting for about 20% of all such deposits in the UK. Building societies also account for over 37% of all cash ISA balances. Building societies employ over 50,000 full and part-time staff and operate through more than 2,100 branches.

Background of CEBS proposal

2. Following a request from the European Commission in 2005, the Committee of Banking Supervisors agreed to provide technical advice on own funds. Included in this advice was a pan-EU quantitative analysis of all types of eligible capital instruments, with a special subset – an analysis of hybrid capital instruments.
3. One of CEBS' key findings was the significant volume of "hybrid" instruments, which represented around 11.5% of total eligible own funds as of 31 December 2006 and the various regulatory treatments to which these instruments were subject.
4. Against the background of the CEBS' findings and the lack of EU legislation on the treatment of hybrid instruments, the Commission invited CEBS to consider whether convergence in this area could be achieved.
5. The Basel Committee on Banking Supervision has set out the conditions for hybrid instruments to be considered as Tier 1 capital in the Sydney Press Release of 27 October 1998 as well as imposing limits on their inclusion.
6. The BSA understands that the objective of CEBS is not to create a brand new definition for Tier 1 hybrids but to provide guidelines for a common and clear interpretation and implementation across the EU of the eligibility criteria that hybrids must meet using, as the starting point, the Sydney Press Release.

http://www.c-ebs.org/press/documents/CP17_draft%20proposal%20on%20hybrids.pdf

Summary

7. The Building Societies Association welcomes CEBS' proposals to harmonise the definition of hybrid Tier 1 capital across Europe and broadly agrees with the concept of three clear principles to define eligibility as hybrid Tier 1 capital.

8. But we should like to point out the impact that the proposals, as drafted, will have on building societies. They do not take into account the unique capital structure of mutual organisations, and as a result, will be difficult for societies to comply with.

9. It is important for CEBS to recognise that building societies are unable to raise common equity.

10. Permanent interest bearing shares ("PIBS") were the first and only form of external instrument introduced in the UK to count as Tier 1 capital for building societies under the terms of the Own Funds Directive. PIBS are perpetual and usually pay a fixed rate coupon, although in recent years building societies have issued them with step ups which may give the societies an incentive to repay. They rank on liquidation as the most deeply subordinated instrument in the capital structure. Payments cannot be made if this causes an issuer to become insolvent.

11. For these reasons, we suggest that PIBS are allowed to continue to qualify outside the innovative Tier 1 limit when including a step-up in the interest rate and/or an alternative coupon settlement mechanism.

Discussion

12. We encourage CEBS to consider the following:

- ***Building societies are mutual organisations:*** Any framework must take into account the structural differences inherent in building societies when compared to joint stock company based financial institutions (building societies are unable to raise common equity).
- ***The nature of PIBS:*** PIBS are a statute based instrument and the only kind of issued membership capital available to absorb losses for UK building societies. The required features are that they are undated/ permanent with non cumulative interest payments. In respect of these elements, PIBS conform to CEBS proposals.
- ***Appropriate limits:*** the FSA's General Prudential Sourcebook requires that 50% of Tier 1 must be core capital (ie reserves for building societies), which is consistent with CRD requirements. We acknowledge the proposal for 70% of minimum Tier 1 capital has to be in this format, but we strongly believe that applying the 15% innovative limit for banks to building societies is unduly prohibitive.

PIBS are building societies' only source of Tier 1 capital outside reserves, since societies are unable to access the equity markets. Of those societies that have issued PIBS, the average "step-up" PIBS/Tier 1 ratio (based on most recent publicly available figures) is approximately 17%.

Since the Sydney Press Release, almost all PIBS have been issued with incentives to redeem. There would be no market capacity for PIBS issues without such incentives, which would result in building societies being restricted to issuing PIBS with incentives and hence 15%, if they are included within the innovative limit. Banks, on the other hand, have greater flexibility to manage their capital structures. They are able to issue hybrid securities, with or without incentives to

redeem, and ordinary shares, which can be dynamically managed via buyback transactions. PIBS should be treated as the building society equivalent of ordinary shares for these purposes.

There should, therefore, be no innovative limits on PIBS issuance.

- **Grandfathering:** We agree that grandfathering will help to achieve a smooth transition. But for those building societies that have PIBS without call dates (which are truly loss absorbent on a permanent basis), the proposed tiered transition will effectively turn irredeemable core capital into prohibitively expensive Tier 2 capital in the long-term.

We therefore suggest that all such PIBS issues are grandfathered to maturity.

- **Prudent management of liquidity:** In the current difficult market conditions, capitalisation assumes even greater focus. Due to a predominantly sterling asset base, building societies have access only to sterling-based UK investors for capital, a relatively small and illiquid market. The new regime is likely to create pressure on firms to issue new capital in order to manage future capital positions. But investor confusion created by the new framework, in an already illiquid market, will hinder new issuance. Societies' only alternative is to increase earnings to raise core Tier 1 capital, but this is only practical over the longer term. This may in turn raise issues about competition and customer fairness as societies look to widen their margins. The use of securitisation as a tool to release capital, while having less impact under Basel II, is also not a viable option for many smaller societies on the grounds of costs and legal considerations.