Impact of CRR /CRD 4 on financing the economy

Response to DG FISMA consultation paper

07 October 2015

Building Societies Association

Introduction

We welcome this initiative from Commissioner Hill and his team at the new DG FISMA, going beyond the narrow remit in CRD 4, asking the right questions, setting the right tone of enquiry and openness, not imprisoned by past decisions. We particularly welcome the material on proportionality and simplification (question sets 13 and 14 at the end). We would be very happy to contribute to the ongoing debate on these matters.

The Building Societies Association (BSA) represents all 44 UK building societies – specialist mutual savings and mortgage institutions. Building societies have total assets of over £330 billion and, together with their subsidiaries, hold residential mortgages of over £250 billion, 19% of the total outstanding in the UK. They hold almost £240 billion of retail deposits, accounting for 19% of all such deposits in the UK. They employ approximately 39,000 full and part-time staff and operate through approximately 1,550 branches

The BSA belongs to the European Association of Cooperative Banks, and we support the wider EACB response to this consultation. In our own response, we concentrate on issues of direct relevance to our building society members, and draw on actual experience over the implementation of CRD 4. We do not cover SME or infrastructure lending.

General observations

The BSA and its members support sensible and appropriate capital rules. Like cooperative banks across Europe, building societies did not cause the financial crisis, and proved generally more resilient. But our members have paid directly and heavily through the UK's Deposit Guarantee Scheme for the costs of resolving failed UK banks (Bradford & Bingley, Icelandic subsidiaries, etc). Some "prudential repair" was necessary. But we saw early on the risk that the cumulative impact of post-crisis measures could reach, and go beyond, a "tipping point" where the net benefit of tougher regulation in terms of economic welfare falls to zero and then goes negative. We therefore welcome the Commission's recognition of this issue in relation to the impact of CRD 4 on bank lending – but this is only part of the whole picture.

Background and scope

The first sentence in this section of the paper illustrates the problem – ***"The CRR implemented the most up to date version of international prudential standards*** [i.e. Basel III] ***into EU law"*** – but Basel III was drawn up for large internationally active banks. EU law then applies it to all EU credit institutions under the Single Rule Book and any further attempts at proportionality are stymied by the Level 1 text. Whereas other major jurisdictions, notably the USA, can and do choose only to apply Basel rules to "Basel banks". Small EU credit institutions are therefore uniquely disadvantaged. Contrary to the implicit view in the paper, this is actually bad for competition, as it always favours large incumbents wherever the rules involve complexity. So this model of agreeing Basel rules for large banks, and then rolling out within the EU to all banks however small, is fundamentally misguided. We comment below on better approaches.

Capitalisation (QQ 1-3)

The actual CRR provisions and the transitionals were mostly reasonable. But they were accompanied by rhetoric from a sub-set of national regulators (the capital extremists, described in the UK as "Capital Taliban") indulging in a competitive "race to the top" which was highly damaging. The benefit of transitionals was negatived by regulators demanding that banks immediately use "end point" capital definitions in stress testing etc – this meant ignoring the carefully crafted transitionals on for instance the phasing out of legacy capital instruments, and the application of deductions against CET 1 – all forms of "front-running". Nor was the long drawn out process of defining enhanced loss absorbency at point of non-viability helpful, as banks had to wait a long time for certainty before issuing new capital. This rhetoric was picked up by the markets, and overall undermined the intention of a "soft landing".

We discerned a particularly unhelpful iteration between regulators and markets – on of the regulators' excuses for their "race to the top" and "front-running" was that this was "what markets would demand". But the regulators' actions of course taught and encouraged markets to ignore transitionals. This was then cited as ex post justification for the "front running".

One consequence of this was that much of the "recapitalisation" appears to have been achieved simply by rapid deleveraging, rather than by phased new capital issuance – see further remarks below. Nor was it ever likely that the capital markets could supply in time all the new capital that would have been required consequent upon the regulators' "front running" if deleveraging had not occurred.

The basic concept of the CRD 4 buffers is sensible, and welcome, but the proliferation of different buffers starts to be confusing. The gradual introduction at least of the key Capital Conservation Buffer is sensible.

Regulation (QQ 4-7)

In the UK residential mortgage market, we certainly observed a massive decrease in net lending by the major banks, many of which needed to be substantially recapitalised and/or build up capital and/or deleverage to meet expected G-SIB or D-SIB levels. So much so that UK building societies, which entered the crisis relatively well capitalised, but have an asset market share of around 20% on residential mortgages, provided at certain stages more than 100% of UK net mortgage lending. We cannot trace the exact causation of this definitively to the CRR regulation

(as domestic initiatives such as pre-empting the leverage ratio may also have played a part) but we think it is likely to have been a major factor. It correlates with the wider observation above of the role of deleveraging.

We do not believe that the effects of higher capital requirements are purely temporary, as there is a well known relationship between bank profitability, the required level of capital, and the maximum rate of asset growth compatible with maintenance of that level of capital through profit retention, in the absence of new issuance. If capital requirements are pushed up to a new plateau, then (ceteris paribus) a lending bank will either have to grow more slowly at the same level of retained profit, or widen its profit margins if it wishes to grow faster. This is particularly true of building societies and mutual and cooperative banks which tend to rely on internally generated capital to a greater extent. In theory there should be some offsetting effect from reduction in the cost of funds to a better-capitalised bank, but we doubt if any sensible conclusions can be drawn about this given the massive shifts in funding patterns, and the impact of other measures such as BRRD which through bail-in has made unsecured bank debt riskier than before, even if the banks are also better capitalised. It is also too early, we suspect, to draw any conclusions about the longer-term movement in the cost of bank capital – given the massive issuance needs of banks all over Europe, demand and supply of bank capital will not reach equilibrium for some time. Our perception is that the cost of bank capital has increased since before the crisis and remains high. While it is desirable that the cost of future bank failures should not fall on EU governments and taxpayers, allocating such losses more explicitly (as BRRD does) to capital investors (first) and also to creditors would be bound to make bank capital a higher-risk, higher-return product.

Proportionality, and scope for simplification (QQ 13-14)

The paper mentions some instances of proportionality in CRD 4, but these are occasional examples, not a systematic approach – indeed, the paper states that ***"It should also be noted that the standards set by the BCBS, which the CRR was to a large extent based on, were designed to apply to internationally active institutions only. A conscious decision was made to make the requirements of the CRR and CRD IV apply more widely."*** As we outlined above, we think this decision was the wrong policy choice, and the whole approach needs to be redesigned.

The BSA also welcomes the important contribution[1] to the proportionality debate from the German savings banks, presented to the EBA's proportionality workshop on 3 July 2015 by Sparkasse Aachen. We agree that a two tier approach to regulation should be considered, which distinguishes highly interconnected international banks from local plain vanilla "community banking". Most building societies by their nature fall within the scope of local "community banking" as described by Sparkasse Aachen. It may also be necessary to have three tiers – (i) G – or D- SIBs, (ii) intermediate large banks, and (iii) smaller "community banks".

The BSA considers that there is considerable scope for simplification, along the lines set out above. One particular area is regulatory reporting. The imposition of Common Reporting (COREP) on all UK building societies has proved to be an expensive nightmare with no apparent benefit. The UK regulator estimated the implementation cost of COREP and FINREP for our member building societies at £278 million – more than 50% of that year's aggregate retained

[1] "A petition for more proportionality in the supervisory process" : http://www.eba.europa.eu/documents/10180/1044289/Session+4.+Demonstrating+the+case++-+Dr+Christian+Burmester.pdf

surplus – yet it delivers no perceptible benefit whatsoever- and indeed has remained plagued with delays, errors and malfunctions.

Another example where necessary proportionality has been frustrated, in this case by Commission interpretations, relates to variable remuneration under CRD 4. We have not observed any substantial changes in CRD 4 compared to CRD 3, which would justify ignoring of the principle of proportionality. CRD 4 equally incorporates the principle of proportionality which allows for proportionate ('neutralized') application of the remuneration-related provisions. More specifically, recital 66 of the Directive 2013/36/EU envisages that the provisions on remuneration should "reflect differences between different types of institutions in a proportionate manner, taking into account their size, their internal organization and nature, scope and complexity of their activities." Nevertheless, following intervention by the Commission, the sensible disapplication of certain provisions cannot proceed – resulting in ridiculous requirements applying to small institutions and to individuals receiving small amounts of variable remuneration. This episode has not been a good advertisement for sensible regulation at European level.

A further example of a failure of proportionality, outside the CRD 4 context, but within DG FISMA's remit, arises under EMIR. As we have pointed out at some length, and with evidence, in our response to the Commission's review of EMIR, the original EU decision to impose mandatory central clearing on all financial institutions regardless of size or systemic impact was clearly a mistake – and one not followed in other advanced jurisdictions. That decision is now proving utterly counterproductive – another bad advertisement for European regulation.

Single rule book (Q 15)

As our own chief executive Robin Fieth explained at the July 2015 EBA workshop, the starting challenge to the Commission, and other regulators, is to **"think small first"**. That is, to consider the appropriateness of any new regulation to small simple banks first, and not as an afterthought (as is currently the case with the "just roll out Basel" approach). This may lead to the realisation that unthinking adherence to a "single rule book" is neither necessary nor desirable, and may indeed prove anti-competitive as between large and small banks.

We explain below why a single invariant rule book may not actually lead to a level playing field. The key is complexity, and the relative management, staff and financial resources available to large and small banks to handle regulatory implementation and compliance matters. In brief, a complex set of rules takes up a far bigger share of these resources at a small bank than at a large bank (even if the absolute costs to the latter are much greater). That leaves, in general, less resources to run the business. This is a feature regularly reported to us by our medium and smaller member societies - the share of their total resources being consumed by regulation rises almost inexorably. So the effect of one size fits all complex rule making always tends to favour the large incumbents. This is the anti-competitive effect we identify.

Conclusions

The BSA welcomes the excellent work by Commissioner Hill and his team in questioning old thinking and introducing, and being open to, fresh ideas on proportionality, simplicity and diversity. Our overall challenge to the Commission is to "think small first" and at least consider two tier regulation, or even three tiers. The BSA looks forward to making further contributions to this ongoing debate.

Jeremy Palmer
Head of Financial Policy
jeremy.palmer@bsa.org.uk
+44 (0)20 7520 5912

York House
23 Kingsway
London WC2B 6LU

+44 (0)20 7520 5900
@BSABuildingSocs
www.bsa.org.uk

BSA EU Transparency Register No: 9: 24933110421-64

www.bsa.org.uk

The Building Societies Association (BSA) is the voice of the UK's building societies.

We fulfil two key roles. We provide our members with information to help them run their businesses. We also represent their interests to audiences including the Financial Conduct Authority, Prudential Regulation Authority and other regulators, the government and parliament, the Bank of England, the media and other opinion formers, and the general public.

Our members have total assets of over £330 billion, and account for approximately 20% of both the UK mortgage and savings markets