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HM Treasury
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By post and by email (building.societies@hmtreasury.gsi.gov.uk)

14 September 2012

Dear Sir,

Re: The Future of Building Societies

The City of London Law Society ("CLLS") represents approximately 15,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees. This response in respect of The Future of Building Societies consultation has been prepared by the CLLS Financial law Committee.

We are pleased to have the opportunity to respond to this consultation. We will respond in general terms and cross refer to our response to the consultation on Banking Reform with regard to a number of the issues raised.

Building societies are mutuals whose core activities include the taking of deposits and making of loans, primarily to individuals, with relatively very small involvement in business and corporate lending. Traditionally building societies are lenders to house buyers on the security of first mortgage and provide attractive savings products for savers and these activities remain at the heart of their business.

In many ways building societies mirror the activities of retail banks and in principle we are of the view that any regulation of conduct and activity restrictions should apply

equally to building societies and retail banks, with appropriate differentiation to reflect existing "nature limits" and the mutual structure.

It follows that if ring-fencing of retail activities of UK regulated banking groups is introduced building societies should be subject to broadly the same rules as are applicable to ring-fenced banks.

As regards what both building societies and ring fenced UK regulated banks should be allowed to do, we refer you to our response to the HMT consultation on banking reform and the paper submitted by the Law Society of England and Wales which we supported in that submission. We believe in summary:

- Restrictions should be purposive and not formal, so as to prevent a "tick-box mentality" without proper risk assessment. In this regard "nature limits" placed on building societies are more suitable than the proposed cataloguing of bright line restrictions for ring-fenced banks on where they may trade and who they may deal with for what purposes.
- Absolute restrictions on dealing with certain counterparties are likely to be impractical and will produce complex legislation to no good purpose. They also may make it difficult to meet customer needs.
- The proposed restrictions on ancillary activities may interfere with the ability of banks and building societies to meet customer needs. More work is needed to identify customer needs and to ensure that they can easily be met at a reasonable cost under the proposed regime. Only when this has been done can any ancillary restrictions be properly framed and consulted on.

  We agree that both banks and building societies need to be able to use derivatives to hedge their own balance sheet risk and to manage their exposure in providing services to customers in relation to, for example, foreign exchange and fixed interest products and as to the value of assets taken as security (e.g. property).
- Restrictions on dealing with foreign institutions and using foreign laws are likely to inhibit the provision of services required by customers, particularly those who use their building society for current account banking, debit and credit card services and business customers, especially when trading in non-EEA countries. Again, as the Law Society suggests, detailed studies based on customer needs have to be made to ensure that any legislation in this area is soundly based and in accord with EU law and UK Treaty obligations to States outside the EU.
- Restrictions on the use of non-EEA law are in any event misconceived (see Law Society Paper for detailed discussion) and likely to have unintended consequences. We urge that these are abandoned.
- We believe that proposals at both EU and UK level for bail-in to extend to non-FSCS deposits and some commercial obligations are misconceived.

  Deposits and loans need to be recognised as the core commercial assets of a bank or building society: just like the order book and component supply contracts of a manufacturing company or the service contracts of a service supply company and its contracts with suppliers to it. As such, these assets are as unsuitable for "bail in", just as the trading obligations of a manufacturing or service company are unsuitable for inclusion in most consensual schemes of arrangement under the

Companies Act entered into to resolve the difficulties of ailing commercial businesses without an insolvency process.

Counterparties need absolute confidence deposits will be repaid in full and obligations to pay for supplies and to lend met in full by a bank or building society (or a successor institution) subject to the resolution regime otherwise they will only make short term deposits and there will be a "run" at the first hint of difficulty, so damaging the prospects of these important financial institutions and their customers.

The risk of further bail-in affecting these categories of assets would also make it very difficult for a reconstructed business (whether the whole business or a bridge taking on part of the business on a going concern basis) to trade through. We therefore believe that bail-in should only be applied to equity and classes of loan capital that have clearly been ear-marked in advance as available for this purpose.

The risk of bail-in would, by worsening the ability of building societies to obtain longer term deposits, lead to an exaggerated "borrow short and lend long" profile, since their mortgage lending is necessarily long term and they do not have share capital, as such.

- We also believe that proposals to use bail in in relation to a bank or building society which is wholly placed in administration, or as regards claims which will remain against an entity in administration. In those circumstances, the ultimate application of insolvency law will ensure an appropriate distribution between affected creditors. It would be pointless to apply bail-in, and then try to apply the "no worse off than in insolvency" rule to try to get back to what would have happened without bail-in. It would only cause confusion and disputes and be likely to reduce recovery by creditors.
- The deposits of building society members with an entitlement to vote fulfil the role of equity to some extent. They are rightly treated as debt for the purposes of the FSCS guarantee: there are good social reasons to do this, since they may represent the life savings of individuals with modest incomes. However, they are rightly deferred to ordinary debt creditors in ranking, given their quasi-equity nature. To enhance the status of these deposits to that of ordinary debt, would be to recognise that building societies effectively operated without any at-risk members' capital: that is not a decision that we believe should be taken without examination of whether it is a justified violation of the mutual concept. Maybe it would be better if more were done to attract members whose deposits will be above FCSC limits, or to allow members which are not of a nature protected by the FCSC guarantee.
- We agree with the Law Society that the case for depositor preference is not made out for banks and the same applies even more to deposits of building society members which entitle them to vote.

We should be happy to discuss these views further. Please contact the Chairman of the Financial Law Committee, Dorothy Livingston at Herbert Smith LLP (dorothy.livingston@herbertsmith.com) if you would like to do this.

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Yours faithfully

Dorothy Livingston
Chair, Financial Law Committee

(The names of the members of the CLLS Financial Law Committee are available on the CLLS website. Sarah Paterson of Slaughter and May did not participate in this submission.)