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Written evidence to the PCBS panel on tax, audit and accounting

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 £245 billion, 20% 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 31% of cash ISA balances. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

Executive summary

While we acknowledge many of the questions are focused solely on shareholder driven, plc banks, the consequences of any resulting changes could also – unintentionally - affect mutual deposit takers. In most cases, this would be wholly inappropriate as mutuals have a different capital structure, are risk-averse and enjoy a distinct, co-operative culture.

Given the short response time, our comments are, of necessity, high level and brief.

Questions

1. *How, if at all, does the tax system encourage leverage in banks? What is the effect of having tax relief for debt interest but not for dividends on equity? What effect does this have on the stability of the banking system?*

Mutual deposit takers have a different capital structure to conventional shareholder-driven, plc banks. Their capital comes in the main from accumulated, internally-generated reserves, not external issues of shares. The question of lack of tax relief for dividends on equity therefore does not currently affect them.

They tend to hold more capital because it has to be generated internally over time, not raised in large external transactions. Thus the average core tier 1 ratio across the largest mutuals was 12.2% in 2011/12, far above the 7% under Basel III requirements. In addition, members who have savings accounts with mutuals (in building societies, for example, savers outnumber borrowers by approximately eight to one) would not benefit from any upside to greater risk-taking, but would suffer the downside consequences. They therefore tend to have a very risk-averse outlook. This is in marked contrast to the incentives for risk taking, chasing higher returns, in plc banks.

Mutual deposit takers therefore follow more prudent strategies than plc banks, as indicated by the lower level of arrears on their mortgage books, which run at approximately two thirds of the level across the market as a whole.

Under new European rules, mutuals will be able to issue core tier 1 capital instruments, known as core capital deferred shares, that will *inter alia* be taxed as equity. But these new instruments are not envisaged to be used as much as banks' share capital.

2. *What are your views on alternative systems to level the playing field?*

No comment. For the reasons given above, we do not believe there is an issue for mutuals.

3. *Do banks' attitudes to tax planning affect banking standards and culture, and does this have any effect on the wider economy?*

Building societies operate straightforward savings and mortgage accounts. A minimum of 75% of their lending must be in residential mortgages. Building society law forbids them to take risk positions in commodities, currencies or derivatives. Their business models therefore tend to be simple and their members, in many cases, local. They are not in the business of offering complex structured transactions such as inheritance tax planning or involve themselves in opaque tax-avoiding remuneration practices.

4. *Do you have any views on the role and purpose of structured capital markets teams in banks? Does the volume and type of structured tax transactions have any effect on bank stability, and did this play a part in the banking crisis?*

No comment. As explained above, the question does not apply to mutuals,

5. *What are your views on the effectiveness of the Code of Practice on Taxation for banks? Would the Code benefit from having sanctions and if so what should these be?*

It is worth making clear from the start that mutuals have no wish to promote or defend tax avoidance. We therefore understand why the government wants to find solutions to change behaviour in those major banks or other institutions that do engage in this activity, and we support such action. But we have reservations about the code's ability to do this. More importantly, we have grave reservations about extending the applicability of a *banking* code of practice to the building society sector.

We consider that, viewed as a sector, the "behaviour"' of building societies as regards their tax obligations is exemplary and, given the nature of societies and their "ownership" structure, much less prone to the aggressive type of behaviour that feeds the tax avoidance industry.

Our understanding is that the government intends the code to be adopted by all banks operating in the UK, including branches of foreign banks. The code has clearly been written with large, international banks in mind; it assumes they are all handled by HMRC's large business service and therefore have a customer relationship manager. There was no mention in the consultation or code of building societies, other mutuals or any other form of financial institution or explanation as to why they should, in principle, be treated as if they were large plc banks.

In December 2009, a voluntary pared-down version was introduced and building societies were (and are still being) encouraged to sign up to it. Although shorter, we believe that the pared-down version is still as inappropriate for smaller building societies as the full one is for the very largest. One worrying trend is that participation is meant to be voluntary but those building societies that have not signed are still coming under pressure to do so.

6. *How effective has the Senior Accounting Officer legislation been with particular regard to banking standards and culture?*

No comment. The SAO regime applies only to very large companies incorporated under the Companies Act, so building societies and industrial and provident societies are expressly excluded from its scope, as HMRC's guidance makes clear. Nor do we see any need for the SAO regime to be extended.

7. *Do we need a special tax regime for banks? If so, what would this look like and what would be priorities for change? Should tax continue to follow accounting with respect to banks? Should the tax system actively seek to influence banking standards and culture?*

We do not consider there is a need for a special tax regime for the banking sector. Preferable is proper, consistent and transparent application of the current system, not just for banks but for all businesses. We wish to see an end to the "sweetheart" deals, not available to ordinary people and domestic businesses but seemingly offered by HMRC to large global entities such as Goldman Sachs and Vodafone.

8. Are banks exploiting regulatory and information arbitrage between FSA, HMRC and auditors? If so, what is needed to address this?

We cannot comment on this: as explained above, mutuals do not engage in the aggressive tax-related actvities that tend to involve such arbitrage.

9. *Should there be a 'safe environment' in which the tax authority, regulator and auditors can share confidential information and concerns, possibly on varying levels of seniority?*

Channels are already open between the FSA and auditors. Under the section "Auditors", SUP 3.8R of the FSA Handbook states: "Auditors must cooperate with the FSA in the discharge of their duties." Additionally, in response to the financial crisis the regulator introduced a code of practice for the relationship between the external auditor and the supervisor in 2011. This is intended to set out principles to guide interactions between supervisors and auditors. For example, it indicates a minimum level of bilateral and trilateral meetings that should take place for high impact firms.

There is less formality between auditors and HMRC; for mutuals, we argue that this is not necessary. As we say elsewhere, the majority of mutuals operate straightforward savings and mortgage accounts. Their business models are therefore simple and their members often local. They are not in the business of offering complex structured transactions such as inheritance tax planning or involve themselves in opaque remuneration practices.

Disclosure by a regulator of firm-specific confidential information is strictly controlled by European law, from which the UK cannot derogate. The provisions are to be re-enacted as Articles 54 to 62 of the revised Capital Requirements Directive. But even Article 60, which allows limited scope for disclosure to other government departments for certain purposes, does not cover tax authorities. So the "safe environment" concept may prove illegal under EU law.

10. *What was the role of accounting standards and reliance on fair value principles in the banking crisis? What does a 'true and fair view' really represent to the market?*

The causes of the banking crisis are manifold but most experts agree the root problem was a lack of liquidity. It is clear, however, that fair value accounting did have a role to play. The volatility it introduces is unhelpful in terms of financial stability. When the markets first froze in 2008, prices of assets such as mortgages, corporate bonds, and structured debts fell below their true value – even though they were still performing. Marking to market may have pushed some banks toward insolvency and forced them to unload assets at fire-sale prices, which then caused values to fall even further.

Mutuals were affected by this development but far less so than shareholder driven banks as they do not trade in financial instruments.

One important point to make is what "market" means to mutuals. It is quite different to that for plc banks. Our "market" is primarily our customer-members – individual savers and mortgage borrowers. Some larger societies also see the "market" as institutional investors but more narrowly than plc banks – our wholesale investors tend to specialise in long term fixed instruments. There is no counterpart for mutuals to equity shareholders, market makers and analysts that make up the "market" for plc banks.

11. *What are your views on the current incurred-loss impairment model and its role in the banking crisis? Do you consider that proposals to move to an expected-loss model will address criticisms of the current accounting rules?*

We believe that a move away from the current incurred loss impairment model is a move in the right direction but on its own is unable to address criticisms of current accounting rules.

The majority of UK mutuals are on the standardised approach under Basel II/ CRD. This means they do not have formal predictive models with regard to loss assumptions in the same way as those mainly larger institutions on the internal ratings approach may have *although we understand that certain such large institutions may not have all the data to build these models*. Estimates of credit losses will have little objective supporting evidence, representing a challenge for the relationship between mutuals and external auditors. Potential adverse outcomes from this are:

- insufficient recognition of future credit losses as a result of a lack of objective evidence to convince external audit; or
- potential inconsistency in value of recognised future credit losses due to lack of objective evidence and auditors' inability to challenge in the absence of formal models, a position no different to general loss provisions at the moment.

We believe a more acceptable alternative is to build on existing domestic practice and devise a more qualitative solution that could be used across the sector. Suitable credit risk disclosures, including basic indicators on arrears, could then be drawn from these estimates.

12. *What is the best method of accounting for profits and losses in trading instruments? Are there any alternatives to mark-to-market or mark-to-model that might better represent a 'true and fair view'?*

We do not comment on the "trading book", as our members do not trade in financial instruments. And as we say elsewhere, the volatility mark-to-market and mark-to-model may also introduce into the "banking book" is unhelpful in terms of financial stability.

13. *Did IFRS accounting standards contribute to a box-ticking culture to the exclusion of promoting transparency and a 'true and fair view' of the business?*

We offer no comment on a box ticking culture but observe that IFRS has made large building society accounts longer and more complex. They have also probably made them less accessible to their principal users *(but see our response to question 16).*

14. *Do we need a special accounting regime for banks? If so, what should it look like?*

We think this is unnecessary. Banking institutions are already subject to additional requirements such as Pillar 3 disclosures under Basel II/ CRD, which will be further enhanced under Basel III/ CRD 4. While it would affect our sector less, other parts of the banking sector might be severely impacted by the inability of institutional investors to compare them with other business sectors if the accounting were different. There is of course the likelihood that banking institutions' financial statements would become even longer and arguably less effective.

15. *Are there any interim measures (such as mandatory disclosure) which could be introduced in the meantime?*

See above.

16. *What are your views on current proposals for improving disclosure and dialogue (with particular reference to discussion papers issued by FSA/FRC)?*

We believe that any further mandatory disclosures should be proportionate where mutuals are concerned. "Users" of mutuals' accounts differ from banks. For a building society, for example, the most common user is the ordinary member who receives every year a summary financial statement, which sets out the financial position under prescribed headings. While investors and ratings agencies may use these accounts, few members request the annual report and accounts.

It should also be borne in mind that in preparing their annual accounts and reports, building societies are additionally bound by the requirements of the Building Societies Act 1986 and the Building Societies (Accounts and Related Provisions) Regulations 1998. Much of the requirements apply only to those on UK GAAP but some still apply to those on IFRS.

17. Is there a problem arising from the difficulty of qualifying the accounts of a bank? Should auditors be able to 'grade' accounts – from AAA down? What would be the effect of this?

We do not support the grading idea: it is not clear whom such a grading would benefit, particularly with regard to mutuals. Ordinary members are more interested in knowing if a mutual is covered by the FSCS than its accounting policies and methodologies.

In addition, we see problems in setting and policing parameters for the various grades. Who, for example, would do the grading? The firm's auditors or a different set? Many banks in the UK use one of four large audit firms giving them relatively little choice. Adding another aspect to the audit would surely disadvantage smaller firms of auditors who would be unable to expand and/ or sustain their skill sets so comprehensively. This could further reduce choice for those banking institutions that do not use the Big 4. Then there is the question of who will audit the auditors?

Auditors may wish to steer clear from banking institutions with low rankings in case they too are perceived as low ranking, further reducing choice for institutions. On the other hand, auditors may use a low ranking to formally increase fees.

The final effect is the one on costs. Banking institutions would be subject to higher audit fees, thus reducing profits which, in the case of mutual, would then be passed on to the ordinary customer/ member. For mutuals this might lead to higher lending costs and lower savings rates.

18. *Should the scope of audit be widened so that auditors can better express a broader view of the business? For example should auditors comment specifically on issues such as remuneration policy, valuation models or risk?*

The examples provided – remuneration policy, valuation models and risk – go well beyond the normal boundaries of an audit, the purpose of which is to provide a view, and a check, on the accuracy and reliability of the financial statements. Once again, we question who would benefit from such an expansion of the financial statements and who would pay. We are concerned at this "mission creep".

As we argue elsewhere, mutuals follow more prudent strategies than banks, as indicated by the lower level of arrears on their mortgage books. The majority of building societies operate straightforward savings and mortgage accounts. A minimum of 75% of their lending must be in residential mortgages. Building society law forbids them to take risk positions in commodities, currencies or derivatives. They are not in the business of offering complex structured transactions such as inheritance tax planning, running sophisticated valuation models or indulging in opaque remuneration practices.

19. *What would be the effect of using return on assets as a performance measure in banks, as opposed to return on equity?*

Return on equity is less meaningful for a mutual than for a plc bank.
Building society legislation already requires societies to provide certain percentages[1] in their annual business statements, including both profit and management expenses as a percentage of mean total assets. This information is also available to all members in the summary financial statement. The directors' report must also list key performance indicators. They may not embrace all aspects of a shareholder driven bank's activities – no indication of trading risk for example - but we consider that, taken together, these requirements provide a suitably high level of disclosure and

- [1] Lending limit and funding limit
- as a % of shares and borrowings: gross capital, free capital and liquid assets.
- as a & of mean total assets: profit and management expenses.

comparability for mutuals. No further requirements are therefore needed for mutuals.

20. *Are the amendments to the Financial Services and Markets Act 2000 regarding dialogue between regulator and auditor sufficient, or does further work need to be done in this area?*

We do not consider further work is necessary yet but suggest the position is reviewed in the future.

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