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Our response to the supplementary FRC consultation paper: Guidance for Directors of Banks on Solvency and Liquidity Risk Management and the Going Concern Basis of Accounting

Introduction

The Building Societies Association represents mutual lenders and deposit takers in the UK including all 45 UK building societies. Mutual lenders and deposit takers have total assets of over £330 billion and, together with their subsidiaries, hold residential mortgages of over £230 billion, 18% of the total outstanding in the UK. They hold over £230 billion of retail deposits, accounting for 19% of all such deposits in the UK. Mutual deposit takers account for over 30% of cash ISA balances. They employ approximately 39,000 full and part-time staff and operate through approximately 1,600 branches.

Executive summary

We agree with the interpretation in the integrated code guidance and in the supplementary guidance that reliance on central bank and government liquidity assistance does not necessarily mean that the bank should fail to adopt the going concern basis of accounting or that a material uncertainty should be disclosed.

Background

The UK Corporate Governance Code (the "UK Code") is addressed to publicly quoted companies but building societies are encouraged by the Prudential Regulation Authority "to have regard to" the Code. We have provided our members with guidance to help them "have regard to" the Code.

In November 2013, the FRC published draft guidance that aimed to provide revised guidance for directors of companies that are required to, or choose to, apply the UK Code. It will integrate the FRC current guidance on going concern and risk management and internal control and also makes some consequential revisions to the UK Code and auditing standards. The draft guidance will replace 2005 and 2009 guidance and it, along with changes to the UK Code, will be applicable for periods commencing on or after 1 October 2014.

The draft guidance addresses *inter alia* the board's responsibilities for managing the principal risks facing the company (including risks to its solvency and liquidity and how risks are assessed). It also addresses the design and process for reviewing the company's risk management and internal control system which is largely unchanged from the current guidance. The FRC recommends that boards state clearly "what actions have been or are being taken to remedy any significant failings of weaknesses identified from that review". We have no comment on this aspect of the proposals.

Of interest to our sector, however, is the fact that the assessment period appears to not be necessarily fixed at 12 months. The draft guidance requires "consideration of solvency and liquidity *over longer periods* having regard to the evolution of the company's own business cycles and the economic cycle". Clarification as to what this might mean in practice would be most helpful.

While institutional investors may value the enhancements to reporting, their benefit is less obvious to individual members of building societies. Our hope is that the changes make reports more useful and do not result in lengthy or boilerplate disclosures.

At the same time as the principal consultation, the FRC issued separate supplementary guidance, particularly in the context of the going concern assessment and related disclosure, for the banking sector. It is this supplementary guidance that this response relates to principally.

SUPPLEMENTARY GUIDANCE

The additional guidance applies directly to banks or building societies that either are required to follow the code, or have chosen voluntarily to do so.

We agree that the supplementary guidance provides a useful explanation of the solvency and liquidity risk assessments for the banking sector. The sector's most common business model set around maturity transformation means it faces more intense liquidity and solvency risks and greater vulnerability. Confidence in the institution's solvency is what sustains the business model. Without it, the institution is likely to fail and in the process endanger others in the sector. Additional guidance for the sector is therefore sensible and welcome. We agree the guidance will help building society and bank directors meet their financial reporting responsibilities as well as their further solvency and liquidity risk management, internal control and related reporting responsibilities under the UK Code.

Transparency helps achieve market efficiency. Timing is, however, key to any public disclosure of the Bank of England's provision of different liquidity insurance facilities to mitigate the temporary effects of liquidity shocks experienced by solvent and viable banks and building societies. As the FRC points out, the BoE's public interest responsibilities of financial stability and transparency are potentially in conflict in certain circumstances.

Many commentators believe that premature disclosure of the actual or expected need for central bank liquidity insurance facility usage will almost inevitably give rise to a self fulfilling prophecy and lead to a run on the bank/ building society. That prospect will simply force the hand of the authorities to refer the bank into the Special Resolution Regime. This will happen even in circumstances where referral could have been avoided through deploying the liquidity insurance facilities available to a solvent bank (or building society).

The integrated code guidance and the supplementary guidance make clear that use of central bank liquidity insurance may be a normal source of funding for a solvent bank (or building society). The need to use those facilities does not necessarily mean that the bank (or building society) is unable to continue as a going concern or that there are material uncertainties that need to be publicly disclosed by the bank and emphasised by its auditor.

We strongly support the above conclusion; from our experience, the risks from disclosures that can be readily misunderstood, taken out of context or mischievously sensationalised are likely to outweigh any marginal benefit from greater transparency.

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