

PO-CH/NL/0172

PART A

Part A.

CONFIDENTIAL
(Circulate under cover and

Begins: 5/7/88
Ends: 16/10/89.

COMMERCIAL - IN - CONFIDENCE


PO -CH /NL/0172

PART A

Chancellor's (Lawson) Papers:

ALLIANCE AND LEICESTER
BUILDING SOCIETY
POSSIBLE ACQUISITION OF
GIROBANK

Disposal Directions: 25 Years

Phelan

5/9/95.

PO -CH /NL/0172
PART A

COMMERCIAL IN CONFIDENCE

FROM: MRS R LOMAX
DATE: 5 July 1988

ECONOMIC SECRETARY

cc. Mr Scholar
Mr Dickson

BUILDING SOCIETIES AND GIROBANK

You might like to be aware that four building societies have registered an interest in buying Girobank: the Abbey, the Alliance and Leicester, the Birmingham Midshires and the Norwich and Peterborough. There may be others: although the deadline for applications has officially passed, interest has not been such that late entrants will be turned away.

2. It is not yet clear whether there is a really serious proposition on the table from any of the above societies. The Midshires, for example, were clearly responding to an idea put to them by their merchant bank, Morgan Grenfell. The Alliance may be more serious. In any event, a couple of societies have been in to see the Commission, and the Commission have already had one general discussion of the issues involved, and plan another later this week. Mr Watson will be minuting you with their considered views, probably next week. This note is for information only.

3. While there are a raft of obvious problems in a building society acquiring Girobank, and I am personally pretty sceptical, I have encouraged the Commission to give the idea proper consideration. Acquisition would not be possible under existing powers, but that could be remedied fairly easily by the Commission making a designation order. More intractable are the points of principle that would arise; for example, could we contemplate a society owning an institution which does business outside the scope of even the new expanded Schedule 8 powers? Would Giro still be an attractive proposition if it were required to divest itself of such activities? (Girobank appears to have a significant business in overnight corporate deposits).

4. Even if the Commission were to recommend that societies be allowed to bid for Giro, there is no guarantee that the Bank of England would be happy with a building society purchaser - or that the society would be able to satisfy the Bank and the BSC that it had sufficient capital to stand behind Girobank. And while I am sure that DTI will be primarily interested in securing a good price, there may be some political awkwardness in amending societies' powers at this stage specifically to enable one of them to buy Girobank.

5. Still it is an interesting idea.

RL

MRS R LOMAX

FROM: G R WESTHEAD
DATE: 6 July 1988

MRS LOMAX

cc Mr Scholar
Mr Dickson

BUILDING SOCIETIES AND GIROBANK

The Economic Secretary has seen and was grateful for your minute of 5 July.

Guy Westhead

GUY WESTHEAD
Assistant Private Secretary

MP

COMMERCIAL IN CONFIDENCE

- 1. MRS LOMAX
 - 2. ECONOMIC SECRETARY
- I suspect the Board would have found a building society bid - now - for time very difficult to handle. I am sure this is the right decision.*

Re. 13/7.

From: P C Diggle
Date: 12 July 1988

- cc: PS/Chancellor)
 Mr Scholar)
 Mrs Brown) HMT
 Mr Dickson)
 Miss Noble - O/R)
 Mr Bridgeman)
 Mr Watson) BSC
 Mr Fleet)

BUILDING SOCIETIES: GIROBANK

You may like to know of building societies interest in the current offer for sale of Girobank PLC.

2. At least four building societies have indicated to Schrodgers (acting for the Post Office) that they may want to make offers. Two of these are medium to small societies acting as part of consortia. As such it is unlikely that they would be able to meet the prudential requirements of the Bank as Girobank's supervisor, particularly as to management and control. The other two societies are significantly larger than Girobank. Both are planning conversion within the next year or so.

3. It would not be possible for a building society to purchase or invest in a deposit-taker without a designation order under section 18(3) of the Building Societies Act 1986. The Commission has therefore considered whether such an order would be consistent with the framework of the Act as redefined by the new Schedule 8 orders. It decided against because Girobank's viability clearly depends on commercial business accounting for more than half its profit, gross revenue and lending, and almost half customers' balances. This range of business falls alongway outside the area defined by the Act in section 5(1) ie investment and mortgage lending services to members as individuals.

4. This does not rule out any building society bid for Girobank. But completion would have to take place after conversion, perhaps by arranging for Girobank to be held by a third party until after conversion. We believe that there would be no vires difficulty about building societies doing preparatory work on such a bid now, since it could be viewed as part of the preparation for conversion and thus authorised by the conversion orders.

5. I have now told the four societies concerned of the decision against making a designation order, so preventing purchase of Girobank by a building society. Two societies had already cooled. One of the others thought it unlikely that it would decide to proceed. The remaining ^{one} which plans to convert very soon, ~~one~~ remains very interested, primarily because acquiring Girobank would speed expansion of its non-personal business after conversion. This society accepts that any bid it may make next on the strength of the prospectus would have to be for purchase after conversion. It also appreciates that the transfer documentation it will give to its members when seeking agreement to conversion will need to spell out its intentions about Girobank should its offer be favourably received.

C. Peter

for P C DIGGLE

COMMERCIAL-IN-CONFIDENCE

FROM: G R WESTHEAD
DATE: 18 JULY 1988

MRS DIGGLE - BSC

cc: PS/Chancellor
Mr Scholar
Mrs Brown
Mr Noble or
Mr Dickson

Mr Bridgeman BSC
Mr Watson BSC
Mr Fleet BSC

BUILDING SOCIETIES: GIROBANK

The Economic Secretary has seen and was grateful for your minute of 12 July about Building Societies' interest in the current offer for sale of Girobank plc.

2. The Economic Secretary notes the suggestion in your paragraph 4, that a Building Society could bid for Girobank, but that the completion would not take place until after conversion. He notes that it might be possible for a society to perhaps arrange for Girobank to be held by a third party until after conversion. He wonders whether this would be a feasible option for the societies who intend to convert?

3. The Economic Secretary is surprised by your reference, in paragraph 3, to Girobank's viability depending on "commercial business". He wonders what you mean by this? It implies Girobank do not have personal customers.

fw

fw

GUY WESTHEAD
Assistant Private Secretary

to 21.0m. On page 20 question
looks at the figures, along with
results from Black Arrow and
Porter Chadburn.

Wall St down

TRADING on Wall Street saw the Dow Jones close down 24.01 points at 2086.59. In New York the pound ended at \$1.7280, up 2.3 cents. The long bond lost 5.4 cents to close at \$98.50, pushing the yield up to 9.259 p.c.



Interim down

ANGLO American's Transvaal mines produced substantial profit increases in the second quarter but interim dividends, as expected, are down.

Vaal Reefs is paying 800 cents per share, compared with 950 cents, a little below expectations, while Western Deep Levels did better than forecasts with a dividend of 260 cents as against 290 cents last time. Elandsrand declared 50 cents as before.

Increased production and a higher average Rand gold price helped profits.

TOURIST RATES

Australia	2.11 dollars
Austria	21.80 schillings
Belgium	65.90 francs
Canada	2.03 dollars
Cyprus	*0.81 pounds
Denmark	11.94 kroner
Finland	7.48 markkaa
France	10.50 francs
Germany	3.1150 marks
Greece	*245 drachmae
Holland	3.5250 guilders
Iceland	*70.00 kronur
Ireland	1.1570 pints
Israel	2.75 shekels
Italy	*2310 lire
Japan	228 yen
Malta	*0.57 pounds
New Zealand	2.55 dollars
Norway	11.41 kroner
Portugal	252.75 escudos
South Africa	*4.10 rand
Spain	204.25 pesetas
Sweden	10.81 kronor
Switzerland	2.59 francs
Turkey	2300 lire
United States	1.7150 dollars
Yugoslavia	*3950 dinars

Rates indicate approximate foreign currency bank notes obtainable for sterling in Britain.

*Subject to limit. †Not available.

Bank intervenes as pound romps ahead

By Anne Segall

THE POUND leapt on the exchanges yesterday as international money flooded back to London, drawn by high interest rates and evidence that the Government has been shocked into taking the problem of inflation seriously again.

The Bank of England stepped in to calm the market after the pound gained more than two pennings in as many hours and put on a dazzling display against the retreating dollar.

City dealers described conditions as frantic, blaming a huge overnight order from the Far East for sparking a frenzied rush of buy orders from around the world.

The Bank intervened heavily, concentrating mainly on European currencies in its efforts to keep down sterling. By the close, sterling had retreated from its 200+ levels but was still 1½ cents firmer at \$1.7255 and nearly one penny better at DM 3.1715. In

index terms it gained 0.3 to 76.2 after reaching 76.5 at lunchtime.

City firms believe sentiment has swung firmly behind sterling, with the Japanese in particular looking closely at longer-term investments like gilts. Gilt-edged prices edged ½ higher yesterday.

Interest rates in Britain have been pushed up by 3 p.c. to 10½ p.c. in a matter of weeks.

Britain's two biggest building societies, the Halifax and Abbey National, raising mortgage rates yesterday also helped sentiment. Investors believe this will take the heat out of the housing market and thus help cool the economy.

Interest rates are expected to be held high even if the pound reaches uncomfortable levels.

The determined efforts of central banks to halt the recent, spectacular run up in the dollar was also a factor in sterling's renewed popularity.

Girobank sale plea

BUILDING societies have been effectively ruled out of the bidding for Girobank, union leaders told MPs yesterday when they also pressed for the retention of the 5,500-worker Bootle, Merseyside central processing centre as a condition of the sale.

They said the Government wanted the business to go to a public limited company and had confirmed during discussions that the five clearing banks had been barred from the bidding along with building societies.

Sub-postmasters also told the Commons trade and industry

committee they had no plans to form a consortium which would make a bid while Kenneth Clarke, industry minister, has made it clear that employee bids are unlikely to be entertained.

More than 50 institutions have expressed interest in Girobank which is due to produce its results today and provide a further guide on whether it can justify valuation of up to £500m.

The Government wants to complete the sale by the autumn, once the successful applicant has been vetted by the Bank of England.

GUS properties valued at £1bn

By Jonathan Confino

GREAT Universal Stores, Britain's biggest mail order group, yesterday revealed a 56 p.c. leap in the value of its property portfolio to £1 billion, alongside another year of solid profits growth.

The company also announced that it is seriously considering buying up to 15 p.c. of its shares and is calling a meeting within the next few weeks to win shareholders' approval.

The property revaluation pushes assets per share up to £9.40, with this figure topping £10 once the £54m profit from the sale of its stake in troubled Harris Queensway is included. This compares with the current share price of £10.80, up 57p.

GUS announced that profits for the year to end-March, excluding property gains, rose by 11 p.c. to £375.4m. It said they

would have been higher but for the much reduced contribution from Harris Queensway and exchange rate fluctuations.

Mr Bowman said he was happy with the price received from the James Gulliver-led consortium for its Harris Queensway holding. He denied that there had ever been any intention of grooming Sir Philip Harris to take over from GUS chairman Sir Isaac Wolfson.

GUS said it was planning to get into the leisure sector if it could find the right acquisition. Only last month it took a 25 p.c. stake in Penguin Hotel Group, a new venture formed by Michael Golder, founder of the Kennedy Brookes restaurant and hotel chain.

Three years ago it withdrew from the leisure field when it sold Global Tours to Intasan.

Winebank's £100,000 judgment

AN INTERIM legal judgment for more than £100,000 was given yesterday against Ronald Clempson to Winebank, a company he launched through the business expansion scheme in 1985.

It invests in wine, but despite raising £625,000, it was refused BES approval, depriving investors of tax relief.

Mr Clempson was removed as chairman by shareholders at the start of this year.

Yesterday's judgment concerned Winebank money spent on services and a lease. The company still trades but may be recapitalised or liquidated.

Investors to meet MPs over Clowes

A GROUP of Barlow Clowes investors is to see Corporate Affairs minister Francis Maude on Tuesday, bringing to three the number of meetings with politicians it has scheduled for that day. Labour's City spokesman Tony Blair and Conservative Nicholas Winterton have agreed to meet the group, which is calling for compensation, stressing that the British and Gibraltar operations of Barlow Clowes were inextricably linked.

Meanwhile the joint receiver of Gibraltar-based Barlow Clowes International said yesterday that he would be writing shortly to the 11,000 investors asking them to confirm a statement of their investment up to June 7.

GUS is also looking in North America and Europe to expand its existing mail order, property rental, retailing, and consume and corporate finance empire. The group has a £300m plus cash pile.

Mr Bowman said that the mail order business, which accounts for more than half of profits, has maintained its market share of about 43 p.c. in the face of tough competition.

He admitted that Next has shaken up the industry with its recently-introduced catalogue and said GUS was meeting this challenge by ploughing £20m this year into improving service to customers.

A final 19.5p dividend makes total of 28.5p (24.5p) from earnings 11 p.c. ahead at 99p.

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COMMERCIAL IN CONFIDENCE

1. MRS LOMAX
2. ECONOMIC SECRETARY

From: P C Diggle
Date: 20 July 1988
cc: PS/Chancellor
Mr Scholar
Mrs Brown
Miss Noble o/r
Mr Dickson
Mr Bridgeman
Mr Watson
Mr Fleet

BUILDING SOCIETIES: GIROBANK

Mr Westhead recorded in his note of 18 July two questions you had raised about the possible acquisition of Girobank by a building society.

2. First, you asked whether it would be feasible for a society planning conversion to arrange for a third party to hold Girobank until conversion had been completed. The straight answer is that we do not know. This option has been put to the societies which have identified themselves as potential bidders. They received it as a constructive but fairly unattractive option. We know that this kind of arrangement can sometimes be organised for more minor deals. In this particular case, the most important hurdle is probably the attitude of the Bank of England. As Girobank's regulator, the Bank will want to ensure clear and efficient management throughout the sale process. This would clearly be harder to deliver if there were two successive transfers of control within a matter of months.

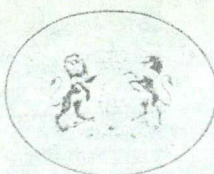
3. Second, you asked about Girobank's dependence on commercial business. The information we have falls well short of a prospectus. But we understand from Girobank in confidence that:

- (a) some 55% of gross revenue in 1987/88 came from commercial (ie non-personal) sources;
- (b) 45% of average balances in 1987/88 were from the commercial sector (using the same definition);
- (c) about 60% of average lending in 1987/88 was to non-personal entities;
- (d) more than half of profit in 1987/88 derived from commercial business;
- (e) (d) has also been true for several years, implying that (a), (b) and (c) reflect medium term trends rather than a sudden recent change in the business mix.

4. No doubt it would be possible to strip Girobank of all this commercial business, leaving a hard core of personal accounts. But this core seems unlikely to be profitable in its own right, and any purchaser which retained only this part of the business would need to make major changes such as diversification or increases in charges to regain viability. This analysis is qualitative but, I believe, sound.

5. I should perhaps emphasise that, given the decision to prevent a building society from holding Girobank, it is not really for the Commission to take a view on the commercial quality of any society's plans to purchase it. The main interest will rest with the Bank, which will have to decide whether any plan offered meets its regulatory requirements, both for Girobank itself and for the purchasing society after conversion.

C. Peter
for P C DIGGLE



FROM: G R WESTHEAD
DATE: 25 July 1988

MRS DIGGLE

cc PS/Chancellor
Mr Scholar
Mrs Brown
Miss Noble
Mr Dickson

Mr Bridgeman - BSC
Mr Watson - BSC
Mr Fleet - BSC

BUILDING SOCIETIES : GIROBANK

The Economic Secretary has seen and was grateful for your further minute of 20 July. He wonders whether a deferred sale would be a possibility - ie if a Building Society were the highest bidder Girobank could remain in the Post Office until the Building Society had converted. I would be grateful for your thoughts on this (you may care to speak to Mrs Brown in PE division first).

Guy Westhead.

GUY WESTHEAD
Assistant Private Secretary



FROM: MRS M E BROWN

DATE: 5 AUGUST 1988

MRS BROWN

cc: PS/Chancellor
PS/Financial Secretary
PS/Sir P Middleton
Mr Anson
Mr Scholar
Mr Monck
Mr Moore
Miss Noble
Mr Dickson
Mr Tarkowski
Mr Bridgeman - BSC
Mr Watson - BSC
Mrs Diggle - BSC
Mr Fleet - BSC

BUILDING SOCIETIES: GIROBANK

The Economic Secretary has seen and was most grateful for your minute of 4 August on the above. The Economic Secretary thinks that the points made in paragraph 4 of your note is a very good one. But nonetheless the Economic Secretary thinks it is useful to have the delayed sale option up our sleeves, if there are few bids and/or the criteria in paragraph 2(a) and 2(b) in your note.

Guy Westhead.

GUY WESTHEAD
Assistant Private Secretary

CONFIDENTIAL

...bk/meb/min 92

ECONOMIC SECRETARY

FROM: MRS M E BROWN
DATE: 4 AUGUST 1988

cc PS/Chancellor
PS/Financial Secretary
Sir P Middleton
Mr Anson
Mr Scholar
Mr Monck (or)
Mr Moore (or)
Miss Noble
Mr Dixon
Mr Tarkowski
Mr Bridgeman)
Mr Watson) BSC
Mrs Diggle)
Mr Fleet)

BUILDING SOCIETIES: GIROBANK

1. You asked (Mr Westhead's minute of 25 July) whether a deferred sale of Girobank would be a possibility if a building society were the highest bidder, but had to wait for conversion to PLC status.

2. The Government's public position is that Girobank will be sold by the end of 1988-89, and sooner if possible. The aim is to free it from public sector restrictions as quickly as possible. I do not think that would preclude negotiating a later completion date with a prospective purchaser, if that purchaser were:

(a) acceptable in prudential and commercial terms; and

(b) had put in a bid which exceeded the runner-up by a sufficient margin to justify the delay in receiving proceeds.

3. A preliminary information memorandum was recently sent to some 90 enquirers. These include several building societies, a number of overseas and UK banks, some insurance and investment companies, several merchant banks (which are presumably fronting

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for unnamed clients) and three retailers (GUS, Littlewoods and Woolworths). We have no feel yet for the likely quality and acceptability of bids: I am meeting DTI and the Post Office shortly and will be asking for a preliminary assessment.

4. FIM think it highly unlikely that any building society bid will be attractive. The Bank has indicated that it is likely to have substantial reservations about such a bid, since a building society which converts will have a substantial task coping with the transition to PLC status, without at the same time coping with the assimilation of a somewhat unusual banking business.

Mary Brown

MRS M E BROWN

COMMERCIAL IN CONFIDENCE

EST

O/M

Please also see Chancellor's
comment about Girobank (attached)

FROM: MRS R LOMAX
DATE: 26 OCTOBER 1988

4 ms 26/10

ECONOMIC SECRETARY

cc: PS/Chancellor
Mr Monck
Mr Moore
Miss Noble o/r
Mr Dickson
Mr Kroll
Mr Tarkowski
Ms Wheldon, T/Sol

[Handwritten signature]
26/10

GIROBANK AND BUILDING SOCIETIES

Mr Westhead's minute of 24 October recorded your request for past papers on building societies' interest in the Girobank sale to be reviewed.

2. We have already warned the Building Societies Commission that there could, just possibly, be late interest from a building society, either on its own account or, more likely, as part of a consortium. They are happy to review the issues once again, if a serious proposition is put to them.

3. The only half way serious building society runner seems to be the Birmingham Midshires, who are said to be still involved with the Charterhouse consortium. Charterhouse have spoken to Mr Tarkowski, and Schrodgers have given the same message, informally, to the Building Societies Commission. On my advice, both PE and the BSC have stressed that the Birmingham Midshires should approach the Commission at the earliest opportunity, if they do have a serious interest: nothing is being ruled out, but, as the society already knows, the Commission identified a number of problems when Midshires spoke to them before about Girobank. While these would need to be looked at again, we have tried to convey the message that the BSC would be prepared to do so in a constructive spirit.

COMMERCIAL IN CONFIDENCE

4. In the absence of a direct approach from Midshires, Mr Watson finally rang them this morning, and set up a meeting tomorrow afternoon which we (Mr Dickson) will also attend.

5. I gather that the advisers may also be thinking of trawling one or two of the larger societies. I should be most surprised if that leads anywhere, but once again the message is the same: any society with a serious interest needs to speak to the BSC as soon as possible.



RACHEL LOMAX

CONFIDENTIAL



FROM: G R WESTHEAD
DATE: 24 OCTOBER 1988

MR TARKOWSKI

cc: PS/Chancellor
Mr Monck
Mr Moore
Mrs Lomax
Mr Peretz o/r
Mr Gieve
Mrs Brown
Miss O'Mara o.r
Mr Kroll
Ms Wheldon, T/Sol

GIROBANK

The Economic Secretary has seen Mr Newton's letter of 20 October to the Chancellor. He has commented that there could well be problems in the light of this if a building society applies for the reasons we considered in the past. He would be grateful if the papers about building societies' interest in the sale of Girobank could be reviewed. You will notice nevertheless that I have not at this stage copied these papers to the Building Societies Commission. You may wish to do so.

2. The Economic Secretary has also commented that if Girobank withdraws, the option of merging the National Savings Ordinary Account re-emerges.

GUY WESTHEAD
ASSISTANT PRIVATE SECRETARY



Thank.
No good @ all
Dad was sh
Kane of the p

Ch/ GIROBANK

Mr John Barker, chairman of the Alliance of Leicester phoned to say that their proposal to acquire Girobank had received a very negative response from the Building Societies Commission.

~~Schroder~~
John M. A.L. what
John M. Bondy
Thank he is
Don't. A.L.
action to
I think
I think
take.

I understand that Schroders will now be pressing the BSC to take a more constructive approach, i.e. to tell A+L whether the acquisition would be acceptable if Girobank was divested of its corporate business.

Officials here agree that the BSC have responded too hastily and unhelpfully. Will keep you informed of developments.

DIS

24.1.89



FROM: G R WESTHEAD
DATE: 27 October 1988

MRS LOMAX

cc: Mr Dickson
Mr Tarkowski

GIROBANK AND BUILDING SOCIETIES

The Economic Secretary has seen and was grateful for your minute of 26 October.

Guy Westhead,

**GUY WESTHEAD
ASSISTANT PRIVATE SECRETARY**

CONFIDENTIAL: COMMERCIAL IN CONFIDENCE

Ch
Doesn't convince me.
Why shouldn't we make an
exception for Girobank?
Disarmed in draft
2-11

FROM: G F DICKSON

DATE: 25 JANUARY 1989

1. MR ODLING-SMEE

CC

PS/Chancellor
PS/Financial Secretary
Sir P Middleton
Mr Anson
Mr Scholar
Mr Monck
Mr Moore
Mr Bent
Mr Judge
Mr Kroll
Mr Tyrie
Mr Call
Ms Wheldon (T.Sol)

2. ECONOMIC SECRETARY

Ch/ This is tricky. A substantial proportion of
Giro's income comes from corporate business
(tho' v. little is lending) and, if divested, would
make it pretty unattractive acquisition. And yet
we have set our face against mutuals getting
involved in corporate business. Why didn't

BUILDING SOCIETIES: GIROBANK

A+L realise this?

Dis

You might like to be aware that the Alliance and Leicester Building Society have again shown serious interest in purchasing Girobank. They wrote to Mr Bridgeman at the Building Societies Commission (BSC) seeking a formal view on whether the Commission would make the necessary Designation Order to allow them to purchase Girobank. Our understanding last week was that the BSC intended to write seeking further details of the A&L's proposal. However, they have now replied that they had considered the matter last year (Mrs Diggle's submission to you of 12 July) and had decided against making an Order.

L at flag

2. The A&L appear to be upset by this reply. Their Chairman, Mr Baker, phoned the Chancellor's office yesterday morning and their Chief Executive, Mr Durward, spoke to Mr Monck. Mr Monck confirmed that you would be the appropriate Minister to contact. (I believe your office gave the same advice to Mr Baker).

3. Mr Newton (Girobank's sponsor Minister) ^{below} has also written today to the Financial Secretary. We will provide a draft reply in the light of your response to this submission.

Background

4. It would not be possible for a society to purchase or invest in a deposit-taker such as Girobank without a Designation Order

(negative procedure) under Section 18(3) of the Building Societies Act 1986. The BSC took the view last year that such an Order would not be consistent with the framework of the Act as redefined by the revised Schedule 8 Orders (although technically the Order could be made). When the review of Schedule 8 was taking place last Spring, you made clear your view that societies should provide services in the main to the personal sector rather than to companies. This was made clear in the press release and during the debate on the Orders. In relation to banking services, one of the Orders makes clear that the main banking services (such as deposit taking and lending) are restricted to individuals.

5. The BSC decided that because commercial business (lending and money transmission) accounts for more than half the profit, gross revenue and lending of Girobank and almost half its customers' balances, it would not be a suitable body for designation. They noted that there were two possible exemption which they might be prepared to consider further. Firstly, acquisition followed by immediate disposal of the corporate business components. (The A&L told the BSC they do not wish to do that). Secondly, acquisition in the final stages of conversion to a plc; but this is unlikely to be a practical proposition. The Bank of England will want to ensure clear and efficient management throughout. This would be harder to deliver during a re-arrangement of the purchasers.

6. Towards the end of last year the BSC also considered the possibility of a Designation Order for Girobank which would limit the investment by a society to a share of the equity commensurate with the amount of Girobank's personal sector business. This would allow a society to participate in a consortium with other banks or societies. The idea was discussed with a couple of societies but no decision, even in principle, was taken by the BSC.

Discussion

7. It is pretty clear that, under existing legislation, societies cannot carry out much corporate business. The A&L have total assets of around £10 billion compared to Girobank's £1.9

billion. On a crude measure, corporate business could account for around 8 per cent of the combined business. While, in the long term, it might make sense to allow societies to carry out more corporate business, it would be more in line with the easing of restrictions on other activities by societies if the change was phased in.

8. Even without the restrictions on corporate business in the legislation, the Commissioners might well have decided against the designation of Girobank. To do so would create a precedent and could lead a number of societies to request that similar companies be designated. Societies would be in the strange position of being limited mainly to mortgages and unsecured loans under £10,000 on their own balance sheet, but would be able to carry out corporate banking through a subsidiary.

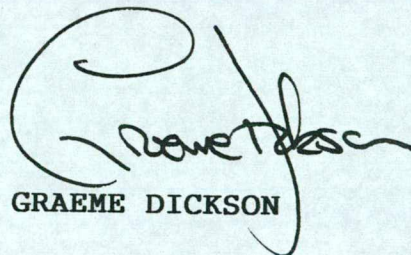
9. Both the Commission and the Bank would also need to be satisfied of the prudential aspects of such a purchase. The BSC did not get to the stage of examining the A&L's plans in any detail or considering the capital backing that would be required for such an undertaking. It may well be that a purchase could be turned down on prudential grounds, but, given the size of the A&L, this is less likely than with a small society.

X 10. PE suggest that the A&L should be encouraged to examine whether purchase of Girobank followed by a staged rundown of the corporate lending business would be feasible. Of a total gross contribution (ie excluding fixed costs) of £215m in 1988-89, corporate lending accounts for only £1m. Other corporate services - mainly money transmission and current accounts - accounted for £140m. The A&L will clearly want the latter source of income and to remove it would not make commercial sense. The BSC's reply left open the possibility of acquisition followed by disposal of the corporate business; we are uncertain how they would react to a slower rundown or to a rundown of only the corporate lending business. They have also offered to meet the A&L. However, A&L are unlikely to accept the invitation without an indication that progress can be made.

Recommendation

11. I recommend that you support the Building Societies Commission's line on this. They may have not handled the Alliance and Leicester's proposal very tactfully, but their decision was in line with the policy statements made last year. Signalling a change in policy on corporate business would not guarantee a change of mind by the Commissioners. They may still object on prudential grounds and you would not wish to challenge that.

12. If you are content, we can provide a draft reply to the Alliance and Leicester, if they write seeking a change in the restrictions on corporate business by societies. If you are also content to pursue the disposal option we can explore with BSC officials how much of Girobank would need to be cut to bring it, in time, within a building society's powers. We would also need to establish whether this route and the time table would be acceptable to the Bank (as Girobank's supervisor).


GRAEME DICKSON

ALLIANCE ■ ■ ■ LEICESTER

pwsp

EST
Re Mr. Mathews's submission, a subject of course to the view of Bank, I am attracted to PS's suggestion @ X - it's not a good idea to go to Girobank (we have to disprove it)

Private & Confidential

P Lilley Esq MP
Economic Secretary to the Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

25th January 1989
ASD/SL

see submission below

ECONOMIC SECRETARY	
REC'D	25 JAN 1989
ACTION:	Mr Dickson
COPIES TO	PS/CHX PS/CST
	PS/EST PS/PMG
	Sir P Middleton
	Mr Scholar

*with a view to...
Girobank...
do so...
Bridgeman (BSC)*

Dear Mr. Lilley,

The Alliance & Leicester Building Society has for some time been interested in the possibility of making a bid for Girobank.

In July last year building societies generally were invited to consider the proposal. A few weeks later the Building Societies Commission made it clear that, on reflection, their view was that such a purchase would be ultra vires.

Towards the end of 1988 rather to our surprise we received clear and active encouragement to reconsider the purchase (subject, of course, to discussions with the Building Societies Commission). This encouragement reached us from the Finance Director of the Post Office, from Schrodgers (acting for the Post Office) and from Hambros (acting for HMG). We were led to understand that an approach from this Society would be both legitimate and welcome.

In the light of these indications we began to re-examine our earlier thinking and I spoke to Gerald Watson at the Building Societies Commission by way of early warning in December.

On the 11th January 1989 I wrote to Michael Bridgeman and a copy of my letter is attached. Since then discussions have continued with Girobank and a major meeting at Board level was fixed for today.

It came therefore as a very unwelcome surprise to receive yesterday Terry Mathews letter dated 23rd January 1989 (also attached). Since we received this letter we have been strongly encouraged to allow the meeting to take place today and it will.

Girobank (shown of Corporate Law) et v. much a special case: I do not see any difficulty in reg. process.

*Corporate Law...
do not...
keep a...
rest of...
Corporate Law...
transmission...*

P Lilley Esq MP

25th January 1989

I am sure you can understand our astonishment when we receive incompatible views from separate official sources. I should be very grateful for a definitive answer to the question of whether we may, or may not, bid for Girobank should we decide to do so.

Yours sincerely,

Scott Arward.

Encs

ALLIANCE  LEICESTER

STRICTLY PRIVATE & CONFIDENTIAL

J M Bridgeman Esq
Chairman & First Commissioner
The Building Societies Commission
15 Great Marlborough Street
London
W1V 2AX

11th January 1989

Dear Michael

I am writing regarding the current efforts being made by the Government to take Girobank out of the public sector.

The Bank was originally put up for sale in June 1988 and invitations for its purchase were made. After some discussion the decision was taken that it would not be possible to allow a building society to buy it and although the Alliance & Leicester had expressed some tentative interest this was not, therefore, pursued any further.

As a result of the failure to find a suitable bidder, we now understand that a negotiated purchase is being sought and the Society has had an initial meeting both with Girobank and with Schroders.

The Society has developed a business strategy which indicates the need to widen its base of retail financial services. Many of the existing retail business areas of Girobank and many which it is developing are complementary to those of the Society. Consequently, the Alliance & Leicester is considering the purchase of Girobank.

Before we can reasonably proceed much further, we need to be aware of the current views of the Commission regarding both the constitutional and regulatory issues. It appears from our investigation of Girobank that it is viable only as a complete entity. While our main interest lies with the personal retail activities of Girobank we should not wish to separate out those components which closely relate to our business and somehow acquire them while disposing of those which are less related.

For a purchase to be successful we believe the Bank has to be taken as a whole. This therefore raises the question of the activities of Girobank which are outside those normally conducted by a building society.

While some form of joint ownership could make it possible to separate these areas, we do not feel this is a desirable route and our interest would be solely in 100% ownership of the Bank.

We recognise that there are aspects of banking undertaken by Girobank which the Society does not have the expertise to manage. We should therefore be looking to the existing management team to continue to run the business while we jointly develop the marketing opportunities. We should therefore expect a clearly defined entity of the Bank to continue to function as a subsidiary of the Alliance & Leicester.

It may be useful to outline the particular benefits which we could at this stage expect from the ownership of Girobank.

The Alliance & Leicester has recently launched a card-based transaction account ('CashPlus') which provides payment facilities through ATM's, branches and by telephone. It does not offer a cheque book. While this absence is seen as a disadvantage, we also recognise the very substantial costs in setting up chequing facilities from scratch. Girobank already has the infrastructure for a full cheque account and would thus complement the Society's progress in this respect. Its credit card operation is also well-developed, which is another intended development of CashPlus. Moreover, the Bank's client base would provide a virtual doubling of the customers with whom we are directly in contact.

Our own secured lending and savings products fit well with Girobank's existing strategy of product development.

So far as distribution systems are concerned, their development of direct-mail and telephone-marketing also fit well with the Society's distribution channels and the areas we wish to develop.

In conclusion, I hope that you will be able to confirm that it is acceptable for us to pursue the Girobank opportunity in the manner I have described. Since I gave an early warning to Gerald Watson in December a measure of urgency has developed and I look forward to hearing from you.

Yours sincerely



Building Societies Commission

15 Great Marlborough Street
London W1V 2AX

01-437 9992

T. F. Mathews
Commissioner

PERSONAL IN CONFIDENCE

A S Durward Esq
Chief General Manager
Alliance & Leicester Building Society
Glen Road
Oadby
Leicester
LE2 4PF

23 January 1989

Dear Scott,

Michael Bridgeman has asked me to reply to your letter of 11 January.

2. We have considered your proposal very carefully in the light of our consideration of proposals to designate Girobank last year, and the Commission's decision at that time.

3. The question of the extent to which it would be right to enable building societies to participate in the provision of non-personal financial services was, of course, considered in the Schedule 8 review. The Treasury then took the view, in relation to the Commercial Assets and Services Order, that it would be inconsistent with the nature and purpose of building societies to enable them to undertake significant corporate sector business. The Order was, therefore, relatively tightly drawn to specify services provided to individuals.

4. Our understanding of the structure of Girobank is that services to the corporate sector form a major part of the business. This is incompatible with the general stance taken so recently by Ministers and endorsed by Parliament. The Commission therefore decided that it could not contemplate the designation of Girobank.

5. There are two possible exceptions which the Commission might consider further:

- (a) Acquisition followed by disposal of the corporate business components - but you do not wish to do this and, in any case, it may not be a practical proposition.
- (b) Acquisition in the final stages of conversion, in the interregnum between confirmation and vesting day.

A S Durward Esq

-2-

23 January 1989

6. I am afraid I do not see any new arguments to deploy which might cause the Commission to reconsider its decision. Michael or I would be happy to discuss with you if you wish.

Yours sincerely
Tomy Mathews

T F MATHEWS

CONFIDENTIAL: COMMERCIAL IN CONFIDENCE



FROM: D I SPARKES
DATE: 26 January 1989

PS/ECONOMIC SECRETARY

cc PS/Financial Secretary
Sir P Middleton
Mr Anson
Mr Scholar
Mr Monck
Mr Odling-Smee
Mr Moore
Mr Bent
Mr Judge
Mr Kroll
Mr Dickson
Mr Tyrie
Mr Call
Ms Wheldon - T. Sol

BUILDING SOCIETIES: GIROBANK

The Chancellor has seen Mr Dickson's minute of 25 January to the Economic Secretary concerning the response the Alliance and Leicester Building Society have received from the Building Societies Commission, and Mr Newton's and the Alliance and Leicester's letters of the same date.

2. Subject of course to the views of the Bank, the Chancellor is attracted to the suggestion that the Alliance and Leicester should be permitted to acquire Girobank (which we badly need to dispose of) on the condition that they dispose of or run down Girobank's corporate lending business. They would be permitted to retain the rest of Girobank's corporate business, mainly money transmission services. The Chancellor has commented that, shorn of corporate lending, Girobank is very much a special case and he does not think that it would create a precedent.


DUNCAN SPARKES

C O N F I D E N T I A L
C O M M E R C I A L I N C O N F I D E N C E

FROM: S M A JAMES
DATE: 27 JANUARY 1989

MR DICKSON

cc: PS/Chancellor
PS/Financial Secretary
Sir P Middleton
Mr Anson
Mr Scholar
Mr Monck
Mr Odling-Smee
Mr D J L Moore
Mr Bent
Mr Judge
Mr Kroll
Mr Tyrie
Mr Call
Ms Wheldon (Tsy Sol)

pwp

BUILDING SOCIETIES : GIROBANK

The Economic Secretary was grateful for your minute of 25 January. He has also seen Mr Sparkes' note of 26 January, and Mr Newton's and the Alliance and Leicester's letters of 25 January.

2. The Economic Secretary has commented that corporate money transmission services (and the current accounts which he assumes came in its train) are sui generis. Neither the Act nor the Schedule 8 Review were designed to deal with them. The designation power was included for precisely this purpose - dealing with unforeseen complexities of the real world. In fact at the time of the review we decided to rule out societies being given freedom to undertake lending to corporate customers. To the extent that other services got caught up in the ban that was accidental. In fact the Economic Secretary was under the impression that societies remained free to service corporate customers at least through subsidiaries - eg stockbrokers, life assurance, other insurance. He would be grateful to know whether his understanding is correct.

C O N F I D E N T I A L
C O M M E R C I A L I N C O N F I D E N C E

3. There seems every reason to consider letting Alliance & Leicester acquire Giro if they agree to run down corporate lending or cap it unless specific prudential reasons are advanced against it. The Commission should look at this again.

SMA

S M A JAMES

Private Secretary

Susan 02.27.1.89

CONFIDENTIAL COMMERCIAL-IN-CONFIDENCE



pmf

FROM: MISS S J FEEST
DATE: 27 January 1989

PS/Economic Secretary

cc APS/Chancellor
(Mr D I Sparkes)
Sir P Middleton
Mr Anson
Mr Scholar
Mr Monck
Mr Odling-Smee
Mr Moore
Mr Bent
Mr Judge
Mr Kroll
Mr Dickson
Mr Tyrie
Mr Call
Ms Wheldon - T. Sol

BUILDING SOCIETIES: GIROBANK

The Financial Secretary has seen Mr Dickson's submission of 25 January 1989 and Mr Sparkes' of 26 January 1989.

He agrees with the Chancellor's view on this matter.

Susan

SUSAN FEEST

CONFIDENTIAL
COMMERCIAL IN CONFIDENCE

From: J ODLING-SMEE

27th January 1989

MR DICKSON

cc PS/Chancellor
PS/Financial Secretary
PS/Economic Secretary
Sir Peter Middleton
Mr Anson
Mr Scholar
Mr Monck
Mr Moore
Mr Bent
Mr Judge
Mr Kroll
Mr Tyrie
Mr Call
Ms Wheldon (T.Sol)

GWP -

BUILDING SOCIETIES: GIROBANK

I had a long conversation with Mr Bridgeman yesterday. I said that Ministers would like to find a way in which the Alliance and Leicester could acquire Girobank while satisfying the Building Societies Commission that the purchase was not ultra vires. While we were content to explore possible options ourselves, along with DTI and the financial advisers, we would naturally welcome any advice which the Commission could give us. If it seemed likely that there was no feasible option, given the Commercial Assets and Services Order, then we might have to advise Ministers on possible changes to that Order.

2. Following some initial reluctance to contemplate possible ways in which the Alliance and Leicester proposal could go ahead, he agreed to consider in broad terms whether there were alternative arrangements which might satisfy the Commission. He cannot, of course, commit the Commission at this stage, but his views will nevertheless be useful.

CONFIDENTIAL
COMMERCIAL IN CONFIDENCE

I do not think that we can advise the Economic and Financial Secretaries how to reply to the letters they have received from the Alliance and Leicester and Mr Newton respectively until we have a response from Mr Bridgeman and can consider its implications. I hope that this will not take too long.

ODS

J ODLING-SMEE

CONFIDENTIAL

Mr Odling-Smee

From: J M Bridgeman

Date: 31 January 1989

cc: **Principal Private Secretary**

PS/EST

Sir Peter Middleton

Mr Scholar

Mr Monck

Mr Moore

Mr Dickson

Mr Mathews

Mrs Diggle

GIROBANK PLC

ALLIANCE AND LEICESTER BUILDING SOCIETY

1. I attach a note dealing with the issues raised by Mr Durward's letter, including those which we identified on Thursday last. While I have consulted the other Commissioners individually, and I would expect the Commission to support what follows, it must be regarded as my personal view at this stage, ahead of a Commission meeting.

Purchase outright

2. The fundamental problem about a building society, such as the Alliance and Leicester, buying Girobank as a whole is that, in terms of balance sheet and turnover, half or more of the latter's business appears to arise from commercial business, much of which is outside the powers at present available to societies. Moreover, the excesses over existing powers are not minor. They are ones in which other societies are interested on competitive grounds - for example some are interested in developing their money transmission business in competition with Girobank, but require the ability to allow overdrafts to commercial customers; others are interested in loans to small

businesses analogous to the loans which you said Girobank made to sub postmasters. So, "level playing fields" would require major changes of powers for other societies also.

3. Two of the critical points are ones where Treasury Ministers took a more restrictive stance last year than that recommended by this Commission -

(a) the limit on unsecured advances (which was raised to £10,000 rather than abolished and replaced by a prudential control);

and (b) the limitation on services to individuals (which was kept to that and not extended to small companies, as a logical consequence of the decisions on (a)).

4. The scale of general policy changes which would be necessary, if permitting one society to acquire Girobank was not to put others at a disadvantage, would be substantial. It would require:-

(a) allowing overdrafts limited to money transmission without statutory limit to commercial customers;

(b) allowing other loans to companies or at least to small businesses;

(c) raising the £10,000 limit on advances to individuals at least to a level which avoided anomalies with (a) and (b) - £25,000, or possibly £50,000.

(d) raising the Class 3 Asset limits for 1989 and 1990.

Some of these changes would require affirmative resolution orders. It is difficult to see what, Girobank apart, could be used to justify changes on this scale so soon after the 1988 package, which was intended to cover the changes contemplated within the then planning horizons of societies. They would go far beyond the relatively minor fine tuning adjustments which societies had been led to expect would

be all that would happen in the next year or two. Moreover, although this is very much for the Treasury, credit conditions would not appear to have changed sufficiently yet to justify raising the £10,000 limit substantially.

Other options

5. If there is **not** to be a major policy change on this scale, then the Commission would be ready to facilitate a bid by Alliance and Leicester for just the retail part of the business, if

(a) the society thought it worthwhile - Mr Durward says his society is not interested in this option, but that view could change;

and (b) the society could satisfy the Commission on prudential grounds, (and also the Bank if the retail part of Girobank were to remain as a distinct authorised deposit taker).

Alternatively, we would be ready to consider further the merits of a proposal from the Alliance and Leicester, or another society, to take a stake in Girobank plc, provided that the stake was not more than commensurate with Girobank's personal sector business (paragraphs 12 and 26 of note).

6. The Commission would **not** be content with Alliance and Leicester acquiring Girobank as a whole, with some undertaking about future disposals. That would risk placing the BSC in a tactical position which we should avoid: the Alliance and Leicester might well tell us later that the society could only sell off the parts on time at a substantial loss. Moreover in this particular case, it would not make commercial sense, given the critical operational and financial importance of the contract with Post Office counters. That needs to be negotiated by the final purchaser, to suit the rest of his business, not handed on from the Alliance and Leicester.

7. Nor would it be right to agree to acquisition in anticipation of conversion. That would prejudice the views of members on conversion.

The fundamental question

8. The key question is whether Treasury Ministers want to commission now a further fundamental review of society powers on the scale outlined in paragraph 4. If Ministers do, the steps would be:-

- (a) a snap examination by BSC and Treasury officials to establish the scope of the exercise, and what might emerge from Pandora's box, before there was any public commitment to it;
- (b) if, in the light of (a), Ministers decided to go ahead, announcement of study, and proposed consultation;
- (c) tell Alliance and Leicester, and any other building society interested, that that examination might lead to sufficient widening of powers to permit bids for Girobank, but warn them they would need to make a prudential case;
- (d) carry out review, on a similar pattern to the 1987-88 schedule 8 review.

9. Such a review would not necessarily lead to a building society bid for Girobank since, even if the policy changes were agreed, the Alliance and Leicester, or other society, would still need to make its prudential case. I fear that Mr Durward has not yet faced up to that task or the issues involved.

10. I would advise against such a review. A change on this scale is not warranted by anything that has happened in the last nine months to societies generally. The resultant direction of change would not necessarily make strategic sense: the extension to allow small business loans (as opposed to overdrafts linked to money transmission) would probably not be a high priority, if Girobank were not at issue. The review would divert scarce resources which would be better devoted to supervision and other immediate tasks, such as the Abbey National

conversion. I would expect the Commission, if asked, to support that advice.

11. If Ministers agree that there should not be a general review of powers, and that any changes this year should be confined to fine tuning of the kind referred to in paragraphs 12 to 14 of the note, then the steps are:-

- (i) to establish what, if anything, the Economic Secretary should say in his reply about the Alliance and Leicester being misled by merchant banks;
- (ii) for the Economic Secretary to reply to Mr Durward, to say that Mr Mathews' letter fairly describes the Commission's position on a designation order for acquisition of Girobank as an entity: if Mr Durward wants to pursue the options of either acquiring the retail part of Girobank, or otherwise taking a part interest, he should take up the offer in the letter of a talk with the Commission, this time at a formative stage;
- (iii) for the position to be explained to the Post Office and various merchant banks to avoid further misunderstanding. The risks of points being lost in transmission might be best avoided if those who ~~appear~~ to have caused the confusion, namely the Finance Director of the Post Office, the merchant banks and DTI, came here for a briefing;
- (iv) after the dust has settled, for us to suggest to Mr Durward that everyone's time would have been saved if he had talked to us earlier and more frankly, and to draw the moral for future relations with the Commission.

J.M.B.

J M Bridgeman

CONFIDENTIAL

BUILDING SOCIETIES COMMISSION

Alliance and Leicester Building Society

Proposed bid for Girobank plc

An issues note

This note comments on the issues raised by the letter from the Chief Executive of the Alliance and Leicester Building Society to the Economic Secretary, dated 25 January 1989. It covers:-

- (i) the apparent misunderstanding;
- (ii) the 1988 decisions on the Schedule 8 review;
- (iii) the consequent guidance which the Building Societies Commission gave to societies about purchasing Girobank;
- (iv) subsequent developments on powers;
- (v) the policy changes necessary to allow the Alliance and Leicester to acquire Girobank as a whole;
- (vi) alternative options, including
 - (a) acquisition of the part of the business dealing with individuals;
 - (b) acquisition of the whole in anticipation either of disposing of the commercial element, or of the society converting;
 - (c) joint purchase.
- (vii) balance sheet limits;
- (viii) prudential issues.

The conclusions for the future handling of the case are set out in the covering minute.

The Apparent Misunderstandings

2. This correspondence has many of the signs of an attempted "bounce".

3. Before the Economic Secretary replies, it would be useful to know how, and on what authority, the Post Office and merchant banks gave the Alliance and Leicester the impression which Mr Durward says they

did - if they in fact did so. This is a point which might better be put by Treasury officials through DTI, rather than from here.

4. That said, Mr Durward in turn was somewhat naive in apparently taking the banks' word for it, and not putting the matter explicitly to the Commission much earlier. Indeed the society is under an obligation to discuss an initiative on this scale at an early stage, under Prudential Note 1988/4 which gave guidance on when the Commission expected to be informed on new initiatives. Moreover, it was disingenuous of him not to refer in any way to that understanding from the merchant banks (especially Hambros) in his letter to the Commission of 11 January. (We will take both points up with him, when the immediate dust has settled.)

5. Mr Durward says that he gave Mr Watson "early warning". There is no record of any meeting between Mr Durward and Mr Watson in December. There may have been a telephone conversation, but it is not known what passed: it would not be appropriate to enquire now of Mr Watson. But, even accepting that something did pass between them, it is very doubtful whether Mr Watson regarded it as "advance warning" of the intention of the Alliance and Leicester to revert to the idea of outright purchase since

- (i) Mr Watson did not put Mr Mathews on warning, when he handed over certain other matters about that society to him; and
- (ii) if Mr Watson had regarded it as such a warning, all his regulator's instincts would surely have caused him to warn Mr Durward that the Commission would need strong arguments to cause it to change its summer 1988 view (Mr Watson had chaired the Commission meeting which considered the matter), and reminded him of the need to consult us sooner rather than later on both legal and prudential aspects.

The 1988 decisions

(a) General powers

6. The question of how far societies might extend their activities to companies rather than individuals was one of the aspects of the extension of powers most discussed between the Economic Secretary, the Commission and officials on the Schedule 8 review.

7. The Building Societies Commission recommended that, on a range of activities, the powers of societies to act for individuals should be extended to acting for small companies (in the Companies Act sense) so that, say, a window cleaner who incorporated for tax purposes would not need to move his account from a society, if that account included an overdraft facility. This was linked to the Building Societies Commission's recommendation that the limit on unsecured lending, then of £5,000, be abolished, on the grounds that

- (i) exposure to an individual should be limited prudentially, rather than statutorily;
- (ii) while the limit of £5,000 might be reasonable in relation to one type of account - credit card, personal loans etc - it was a significant restraint because it applied to the aggregate indebtedness across all such accounts.

8. The Economic Secretary's decision, endorsed by the Chancellor, was that:-

- (i) on monetary and other grounds the limit on unsecured lending should remain, and be raised only to £10,000;
- (ii) largely in consequence of that, the various powers to provide services should be limited to individuals: he considered that an extension to small companies, while retaining the £10,000 limit on advances would merely allow societies the riskiest part of the business. (The BSC would entirely agree.)

[The relevant extracts from the EST's minute of 12 January 1988 are set out in Annex A for ease of reference.]

9. The EST accordingly said in the written reply announcing the decisions:

"Societies will, as at present, continue to provide services primarily to the personal sector, rather than to companies".

This was echoed in Ministerial statements in both Houses on the affirmative resolutions.

10. More specifically the decisions on the activities, which are relevant to the possible acquisition of Girobank, were:-

Activity	Extent of services permitted to individuals or to companies
Advances on Mortgage Arranging such loans on mortgage	Not limited by kind. But aggregate of such lending "on balance sheet" to companies falls within Class 2 limit (10%, rising to 17.5% next year and 25% in 1993).
Unsecured loans, including overdrafts and credit cards	Individuals only, within £10,000 limit for each individual
Arranging unsecured loans "off balance sheet"	Individuals only

Money transmission services	Not limited - except that an overdraft facility is not available - only occasional (ie accidental and irregular) overdrawn is permitted, so that a society has discretion not to bounce a cheque
Hire purchase, leasing etc	Individuals only, the capital value again counting against the £10,000 limit
Guarantees	Individuals only
Foreign exchange transactions	Individuals only, except as part of money transmission, or "de minimis".

The powers were **not** extended to cover activities, such as factoring, which of their nature would be specifically for commercial clients.

(b) **Girobank**

11. The BSC was originally moderately encouraging to societies about the possibility of designating Girobank as a permitted subsidiary so that they could bid for it, on the basis that it was mainly concerned with personal accounts and with money transmission. However the Commission then learnt that:

- (a) some 55% of Girobank's gross revenue in 1987-88 derived from commercial (non-personal) sources, including local authorities;
- (b) some 45% of average balances were **not** from the personal sector;
- (c) some 60% of average lending was to the commercial sector;
- (d) more than half of Girobank's profit was attributable to commercial business.

It concluded that to allow a society to acquire Girobank would be totally inconsistent with the decisions announced only two months earlier by the Economic Secretary. Mrs Diggle's minute of 12 July reporting that to the Economic Secretary is attached as Annex B: Mrs Lomax endorsed that conclusion on behalf of FIM. The four interested societies, including Alliance and Leicester, were informed of it.

12. There were subsequently some soundings of the BSC about the possibility of a society having a minority stake in a consortium which would acquire Girobank. The staff response was that the BSC might be ready to consider proposals to allow such an interest, where the scale of participation by the society was no more than commensurate with those activities of Girobank which were proper for a society. This proposal came to nothing: so the Commission itself was not asked to

take a view on it. Nor has it yet taken a view on how far it is desirable, and practicable, to have more generally a rule permitting societies to invest in associates which have wider powers, but subject to such a commensurate limit on the society's stake.

Subsequent developments generally

13. The 1988 decisions were not intended to last indefinitely: the announced intention of the decisions was to give societies a clear indication of the powers which would be available to them within their then planning horizons. It was envisaged that there would be thereafter:

- (a) a further major review, in, say, about 3 years, in the light of subsequent developments by societies and in financial markets, to once again provide societies with a framework for some years ahead for their planning;
- (b) in the meantime, some amending or designation orders needed to deal with developments not foreseen in 1988, or to cover particular proposals, which did not quite fit the detailed legal framework but which were nevertheless within the general spirit of the decision.

14. A number of societies have recently expressed disquiet about the restriction of certain services to individuals rather than to small companies. Other societies have been encountering problems in expanding money transmission services, because of the exclusion from their powers of power to allow incidental overdrafts to bodies corporate. One major building society is considering the acquisition of a half interest in a finance house at present owned by a clearer. The BSA are likely to be making representations for changes on some related points.

15. The Commission staff have accordingly been considering whether it would be desirable and practicable to make some shifts, without prejudicing the general stance agreed last year, and in particular presuming the continuance of the £10,000 limit, at or about that level. There may also be a need to stop up a possible route for evasion of that limit by the creation of multiple subsidiaries. The Commission itself has yet to consider these points. But it could well decide to put proposals for modest changes to the Treasury for discussion, with a view to securing consent to the necessary orders during the next few months.

Present Options

(a) Acquisition of Girobank as an entity

16. This is the option which Alliance and Leicester now wish to pursue. But nothing which has happened in the last eight months would appear to justify a change in the Commission's view.

17. It would certainly be inconceivable now to keep the present regime for the generality of societies, and to allow the Alliance and Leicester to gain Girobank as a whole. It would give that society a totally unjustifiable and unfair competitive advantage over other societies interested in developing their money transmission services, and in particular over the other societies which might have shown an interest in Girobank, were it not for the Commission's known views.

18. Accordingly, the acquisition of Girobank by a society, such as the Alliance and Leicester, could only be authorised in the context of policy changes for societies generally which

- (a) allowed overdrafts (without limit) to commercial customers (including the large companies, since much of the money transmission business of Girobank is for supermarket chains);
- (b) allowed other loans, at least to small companies and traders;
- (c) raised the £10,000 limit for individual customers, at least to a level which avoided anomalies with (a) and (b) - £25,000, if not £50,000;
- (d) possibly a more general extension of services to small companies.

The first runs directly counter to the general emphasis of the Act on societies being concerned with retail financial services, and to what the Economic Secretary said about his general approach last May. The Commission has presumed that there has not yet been sufficient change in credit conditions to make Treasury Ministers ready to contemplate the third change.

19. To reopen the policy to this extent now, and to raise the forward path for balance sheet limits (see paragraph 26 below), so soon after the 1988 review, would be very much allowing one case, in which everyone would see the Exchequer had an interest, to dominate the view on both the desired pace of change and the desired direction for the entire industry. (It is not clear that loans to small businesses, as opposed to overdraft facilities for them, would be a high priority for extension of powers, especially given the risks involved).

(b) Purchase of the retail part of Girobank

20. Subject to one proviso, it would be open to the Alliance and Leicester to acquire a substantial part of Girobank's business, merely by exercising the society's existing powers. That would include:-

- (i) its personal account business;

- (ii) its personal loan business - except that the Post Office would need to retain, or to transfer to another lender, loans of £10,000 or over;
- (iii) its personal credit card business, subject to that caveat, and the need to apply the individual limit across (ii) and (iii);
- (iv) its personal money transmission business, including both the ATM's in the Link network and the social security payments;
- (v) its commercial money transmission business, insofar as it does not require overdrafts facilities;
- (vi) its membership of the clearing system, provided that the volumes under (iii), (iv) and (v) were sufficient to meet the thresholds for membership;
- (vii) foreign exchange and travellers cheques for individuals.

21. It is not clear that such retail business is in fact severable from the rest. If a practicable dividing line could be found which was close to the present limit of powers, but included only minor excesses, the Commission would probably regard it as reasonable to make a designation order - that is "par excellence" what the discretionary power to make such orders is for.

22. The proviso referred to in paragraph 20 is that, if the retail part of Girobank were to be kept as a distinct subsidiary (rather than merged into the Alliance and Leicester) there would need to be a designation order, to overcome the general ban on deposit taking by subsidiaries, and the subsidiary would need authorisation under the Banking Act. This would require clear specification of the responsibilities of the two boards and the two supervisors!

23. But the figures we saw last year suggested that the personal business is not very profitable and may be making a loss. The Alliance and Leicester letter to the Commission made it clear that they have rejected this option.

(c) Acquisition of Girobank, and subsequent disposal of the commercial element.

24. This has been mentioned at various times in the past. It is essentially an alternative route to the same result as the preceding one. It would, arguably, be consistent with a general provision that a society has 3 months to bring the activities of an acquired subsidiary within the powers permitted for the subsidiary of a society.

25. However, it seems doubtful whether it would be an acceptable route in this case:

- (i) the scale would be significantly greater than envisaged for such a transition;
- (ii) there would consequently be real doubts about whether the Alliance and Leicester would in fact find a buyer;
- (iii) there would be a distinct risk that the Alliance and Leicester would then turn round, sooner or later, and say that the BSC would have to give them more time, or the Alliance and Leicester would make a loss on it: no sensible supervisor walks into that trap;
- (iii) both retail and commercial sectors of the business are critically dependent on relations with the Post Office Counters Limited and, in particular, on the contract under which the counters provide services for the buyers and the buyers give it certain assurances about future business. (The counters provide the bulk cash handling service for many of Girobank's commercial customers as well as acting as the sale points for retail customers). Any purchaser of the commercial business would want to negotiate his own contract with the counters subsidiary, not inherit one negotiated by Alliance and Leicester, especially given the constraint that the Counter would in part be negotiating for its agents, the sub-postmasters.

The last factor in particular means that if there is to be a split of the business, the Post Office should itself sell the two parts direct to the ultimate holders.

(d) A minority interest

26. As mentioned above, some societies showed an interest last autumn in joining consortia to purchase Girobank. The Commission staff indicated a readiness at least to consider whether such a minority interest would be acceptable, on the basis that the society's financial stake would not be more than commensurate with the activities of Girobank which were open to a society. (Such consortia have other difficulties, notably in clearly establishing responsibility, and both the Bank and we might have difficulty with one). It appears unlikely that the Alliance and Leicester would be interested in this.

(e) Purchase in anticipation of conversion

27. The question was raised last summer whether it would be possible for a society to purchase Girobank, in the expectation that it would subsequently convert. The Commission then decided that it would be wrong to allow this. It would effectively prejudice the decision of members - on which the Commission has the duty of holding the ring.

It would cause serious problems should the society fail to secure the necessary votes.

Balance Sheet Limits

28. The outright purchase of the whole of Girobank by the Alliance and Leicester would require not only the policy changes on powers outlined in paragraph 18 above, but a change in the path of graduated increases in the balance sheet limits, set in summer 1988. The path for the limit on Class 3 assets was then set as:-

From Jan 87 to Dec 89	5%
From Jan 90 to Dec 90	7.5%
From Jan 91 to Dec 92	10%
From Jan 93	15%

29. Under the normal principles, the "commercial assets" of a subsidiary, such as Girobank, would be aggregated with the assets of the Alliance and Leicester for this purpose: Girobank's mortgage book would go to Class 1 or Class 2, the rest of its loan book (including Visa and overdrafts) to Class 3. We do not have precise information about Girobank's loan book, but it would appear that such aggregation would take the Class 3 assets of the Alliance and Leicester group over the present 5% limit, and probably uncomfortably close to the 7.5% limit set for 1990.

30. It would appear that the Alliance and Leicester have not considered this point. But it would certainly require an increase in the 5% limit, if the purchase were made in 1989, and probably also an increase in the 7.5% limit for 1990. The Commission does not have discretion to raise the Class 3 limit for individual societies: the increase would have to be general and would require an affirmative resolution of both Houses.

Prudential Matters

31. The Commission is not yet able to form a view on this. The Alliance and Leicester has not given it the prudential assessment expected from a society considering such a development - all societies are on notice that they should provide something on the lines of Annex C for a development of this significance.

32. The critical factors would probably be:-

- (a) capital - the society has not said how both the purchase price and any subsequent capital are to be funded, and assessed the effects on both the capital requirement of the society (as a group) and on the capital available to meet it;
- (b) direction and management - the Alliance and Leicester letter to the Commission indicated that it would keep Girobank management, but gave no explanation of how the society would secure effective direction of

Girobank thereafter: what Mr Durward says suggests he has not faced upto the problem, and would not seem sufficient to meet the statutory obligations on the board of the society;

- (c) division of responsibility between boards, and the parallel division of responsibility for supervision if Girobank were to continue as a separately authorised institution under the Banking Act. This could pose awkward problems which it might be difficult to resolve in a way satisfactory to both supervisors!

32. The Alliance and Leicester may be able to satisfy the Commission on all 3. But it would be premature to conclude at this stage that they would. Mr Durward's handling of the current correspondence does not make the Commission confident that the society has in fact yet done its homework properly.

Building Societies Commission
15 Great Marlborough Street
LONDON W1V 2AX

January 1989

CONFIDENTIAL

Extracts from minute, dated 12 January 1988, from the Economic Secretary to the Chancellor, entitled "Revision of Schedule 8".

Services to Companies

18. Emphasis on services to individuals was a recurrent theme of Ministers during the Bill debates. The BSC proposal is that 'individuals' should be broadened to include small-ish companies.

19. The BSA argue that societies can already lend unsecured and offer other services to unincorporated businesses - these are, in practice, indistinguishable from individuals. But when such customers incorporate, the society must tell them to go to a bank. The BSA does not appear to realise that in practice societies can also already lend to plcs so long as they do so on the security of property.

20. The BSC's proposal would only make sense in the context of abolition of, or a substantial increase in, the unsecured loan limit - currently £5,000 per borrower. I recommend a modest increase below. At such a level only very small companies would be potential customers. They have the worst risk record and societies have no experience of unsecured lending in this field. It would be absurd to permit societies to lend only to large or established companies.

21. So I recommend no change in this restriction, although there is a danger that the DTI may object.

The £5,000 limit on Unsecured Loans

26. The BSC would like to abolish the limit altogether. The BSA have asked for £25,000. They argue that £5,000, particularly with potential credit card and EFT(POS) restraints, will leave little scope for meeting reasonable borrowing needs of customers. (Abbey mentioned that their average loan in the first year of unsecured lending has been £2,150, but have had to turn away people who wanted over £5,000. They still want to raise the limit.)

27. In my view any major increase in this limit would meet stiff Parliamentary opposition. It would provoke concern among those who saw building society funds being diverted from their traditional purpose of home loans to consumer debt. Moreover, it would aggravate fears of excessive lending both to the imprudent and in aggregate. Neither of these fears would be justified.

28. I would recommend that the limit be raised to £10,000 (or at most £15,000). This will be perfectly adequate for financing cars, furniture and most emergencies.

FROM: G F DICKSON

DATE: 1 FEBRUARY 1989

- 1. MR ODLING-SMEE DGS
1/2
- 2. ECONOMIC SECRETARY

cc PS/Chancellor ✓
 PS/Financial Secretary
 Mr Scholar
 Mr Judge
 Miss Wheldon - T.Sol

BUILDING SOCIETIES: GIROBANK

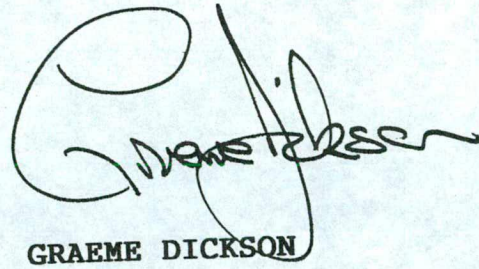
Ms James' minute of 27 January asked for confirmation of the services that building societies could provide to corporate customers.

2. The shortest explanation is to list the Schedule 8 services which are restricted to individuals only. In the field of Banking services, the following are restricted to individuals: arranging the taking of deposits, unsecured lending, leasing and hire purchase, guarantees (except in respect of money transmission services) foreign exchange and arranging these activities. The other aspects of banking services are not restricted. Trusteeship is restricted to express trusts where the majority of the beneficiaries are individuals. Executorship is by its nature confined to services to individuals.

3. The remaining Schedule 8 services (Investment services, Insurance services, and Land services) are not restricted by legislation to provision for individuals. Societies may provide them to corporate customers to the extent that they are applicable to companies. In particular; stockbroking services, tax and financial planning, portfolio management, insurance advice, investment advice, arranging insurance, safe deposit facilities and removals services can all be provided to companies.

4. I believe you also commented on the provision of corporate money transmission services. The original Schedule 8 contained a service described as "money transmission services". Provision of this service is now included within the general term "banking

services" and does not appear to be restricted. The limit on guarantees arising from money transmission was abolished in the review to facilitate societies' participation in the clearing systems.



GRAEME DICKSON



pmw

Chy

EST is generally content with Mr Dickson's advice. He is meeting officials on Monday to discuss, prior to a meeting with Bridgeman on Tuesday.

Are you content to narrow down the options 2(iv) & 2(v) in Mr Dickson's note? OK

You will want to read Bridgeman's minute (at flag). He seems to take a grisly relish in thwarting the A+L. He clearly believes A+L's bid is a "try on".

(Bridgeman to
Mills because
AsL didn't
come to
was just.) 215

FROM: G F DICKSON
DATE: 1 FEBRUARY 1989

- 1. MR ODLING-SMEE
- 2. ECONOMIC SECRETARY

- cc PS/Chancellor
PS/Financial Secretary
Sir P Middleton
Mr Anson
Mr Scholar
Mr Monck
Mr D J L Moore
Mr Bent
Mr Judge
Mr Kroll
Mr Tyrie
Mr Call
Ms Wheldon TSol

The A and L's wish to purchase Giro outright creates serious difficulties. We recommend that they should consider alternative arrangements (eg. splitting Giro, or buying it with partners).

*Do-8
2/2*

GIROBANK: ALLIANCE AND LEICESTER BUILDING SOCIETY

You will have seen Mr Bridgeman's minute of 31 January in which he sets out the issues raised by a building society wishing to purchase Girobank. This note discusses the options suggested by his minute, the attachment to which provides the background. It has been agreed with PE.

- 2. The main options seem to us to be:
 - (i) outright purchase of Girobank as a going concern, including corporate lending, using a Designation Order;
 - (ii) a major review of building societies' powers to allow any society to undertake this kind of business and hence to bid for Girobank;
 - (iii) acquisition of Girobank as a whole, with an undertaking to dispose of corporate lending and other activities within a given time;
 - (iv) a consortium including a building society could purchase Girobank;
 - (v) split retail banking and money transmission out of Girobank and allow a society to purchase that part.

3. Option (i) is not consistent with the decisions made last year not to allow unsecured lending to companies. It would be difficult to sustain the argument that Girobank did not create any precedents. Other societies, some of which would like to buy various types of financial institutions, would try to exploit this. Option (ii) would also represent a major shift of policy. It may also not be possible in a reasonable time. Such a review, even if desired by Ministers, could take up to 6 months.

4. Option (iii), which you mentioned (Ms James' minute of 27 January), would allow the Alliance & Leicester to acquire Girobank if they agreed to run down the corporate lending or cap it. Mr Bridgeman states that the Commission would not be content to allow this solution. He believes that they would be in a difficult position to act if the A&L could not make the disposal within the agreed time for genuine commercial reasons. This seems right to us: the Commission could be faced with a choice between forcing the A&L to incur losses by disposing of the corporate business, and allowing them to breach the undertaking.

5. Option (iv) appears to have been considered by a number of societies last year, but none was attracted to this solution. It is, however, possible that further searches could turn up suitable partners. (The BSC would probably prefer the majority of members of a consortium to be financial institutions.)

6. The remaining option (v) is to remove, by one method or another (eg selling off separately or running down), the unacceptable loans or other business from Girobank before it is sold. The portion of Girobank that Mr Bridgeman envisages that A&L could purchase (set out in para 20 of the "issues note" attached to his minute) is:

- (i) Girobank's personal account business;
- (ii) Girobank's personal loan business (of £10,000 or under per individual);
- (iii) personal credit card business (together with (ii) to be £10,000 or under per individual);

- (iv) personal money transmission including ATMs and Social Security payments;
- (v) commercial money transmission, if it does not require full overdraft facilities. (Societies can allow occasional overdrawing to prevent cheques being stopped);
- (vi) membership of the clearing system.; and
- (vii) foreign exchange and travellers cheques for individuals.

7. It is by no means certain whether this option would run. At present A&L have rejected it. In their letter to the Commission of 11 January they said:

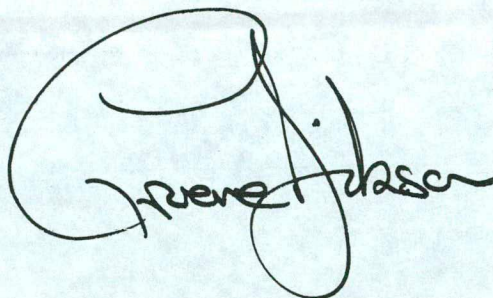
"While our main interest lies with the personal retail activities of Girobank we should not wish to separate out those components which closely relate to our business and somehow acquire them while disposing of those which are less related. For a purchase to be successful we believe the Bank has to be taken as a whole."...

8. It could be, however, that, faced with a firm policy decision on the lines we recommend, they would be willing to think again about either option (iv) or (v). Schrodgers have suggested informally to PE that (v) could be workable. We should now press A&L to clarify their position with the Commission and also to talk urgently with Girobank about the implications of splitting the business.

Conclusion

9. Assuming that you do not wish to pursue the policy changes implied by (i) and (ii), and that the Commission continues to oppose (iii), we are left with (iv) and (v). If you agree, we recommend that you (or the Financial Secretary) should reply to Mr Newton's letter of 25 January, explaining the policy constraints and our wish to run options (iv) and (v). This letter

should say that, subject to any urgent points which DTI have, you will reply to Mr Durward asking him to take up the offer of talks with the Commission and to pursue the viable options with them and with Girobank.

A handwritten signature in black ink, appearing to read 'Graeme Dickson'. The signature is stylized with large loops and a cursive style.

GRAEME DICKSON

CONFIDENTIAL
(Limited Circulation)

Economic Secretary

From: J M Bridgeman

Date: 24 April 1989

cc: Principal Private
Secretary

PS/Chief Secretary

Sir Peter Middleton

Mr Scholar

Mr Moore

Mr Odling-Smee

Mr Pirie

*Ch/ I am advised that this latest
broadside from Bridgeman should
be taken with a pinch of salt.
The threats he perceives to
the A+L purchase are already
known to us and - more importantly -
to A+L.*

Commissioners

*1 June Mr B
is approach
the construction
solutions
problems*

Alliance and Leicester Building Society

Proposed Purchase of Girobank

You should, I think, be aware that

- (a) the Alliance and Leicester plans for the acquisition of Girobank are still so inchoate that it will almost certainly need the full-time (or more) allowed as preferred bidder to make a prudential case to the Commission; and
- (b) there must be considerable doubt about whether the society will be able to satisfy the Commission that it is prudent for it to acquire Girobank.

(I am accordingly disclosing what follows under the "public interest" gateway in the confidentiality section (section 53 of the 1986 Act).

2. You will recall that I warned in January that the Commission had reservations, particularly on the score of direction and management, and we were careful to warn the Alliance and Leicester that our clearance of any bid on prudential grounds must not be taken for granted.

3. Three developements since then have , if anything, strengthened those reservations:-

(i) it became apparent when we discussed this with the Chairman and Chief Executive last week that there is a fundamental choice about the future integration of the two - in particular will Alliance and Leicester members be able to operate cheque accounts managed by Girobank from Alliance and Leicester offices? The strategic case for the acquisition is that it will lead to that facility for Alliance and Leicester members. The costings etc are now on the basis that the two incompatible systems will not be integrated. The Alliance and Leicester has not yet resolved this issue;

(ii) the Alliance and Leicester has not yet done anything further about strengthening their board and senior management. The Commission had been prompting them on the need for this if it was to remain a society. The Bank had indicated the need for strengthening if it wished to convert. The society is now proposing to take on a formidable management task in developing Girobank as part of the Alliance and Leicester group - a difficult one, given Girobank's relationship with, and present dependency on, Post Office Counters.

(iii) the Alliance and Leicester and its auditors have just reported what appear to be significant defects in the system of control and inspection: for

example £275 million of mortgage were being carried in suspense accounts, not proper borrowers accounts. We are examining this as a matter of urgency. But it would appear possible that the society has not yet integrated properly the administrative systems of the two constituent societies, legally merged over three years ago. That would not be a good basis for launching a takeover for Girobank.

4. It does not appear likely that the Alliance and Leicester will be in a position to complete its submission to us until near the end of the time now allowed to negotiate the contract. The fundamental risk against which the Commission (and Bank) need reassurance is that bringing together two institutions with problems, each of which are probably surmountable if the institutions remain separate, will not lead to a major problem institution (whether a building society or a bank if it converts.)

J.M.B.

J M Bridgeman

CONFIDENTIAL



FROM: S M A JAMES
DATE: 26 April 1989

MR BRIDGEMAN - BSC

cc: PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
Sir P Middleton
Mr Scholar
Mr D J L Moore
Mr Odling-Smee
Mr Pirie
Mr Dickson
Mr Judge

mp

ALLIANCE & LEICESTER BUILDING SOCIETY: PROPOSED PURCHASE OF GIROBANK

The Economic Secretary was grateful for your minute of 24 April.

2. He has commented that he trusts Alliance & Leicester have been made fully aware of these hurdles which they must surmount.

SMAJ

S M A JAMES
Private Secretary

CONFIDENTIAL

CONFIDENTIAL

(NB: Restricted Disclosure under section 53 of the Building Societies Act 1986)

1. MR. BRIDGEMAN
2. ECONOMIC SECRETARY

From: J.M. Palmer
Date: 18 August 1989

cc. PS/Chancellor
PS/Financial Secretary
Sir Peter Middleton HMT
Mr Scholar O.R HMT
Mr Walsh HMT
Mr Moore HMT
~~Mr Pirie~~ *Miss Noble* HMT
Mr Dickson HMT
Mr Bridgeman BSC
Mrs Gilmore O.R BSC
Mr Procter BSC
Mr Mathews BSC

Ch. To be aware
The same these windows
18/8

ALLIANCE & LEICESTER BUILDING SOCIETY
POSSIBLE ACQUISITION OF GIROBANK

Summary

This minute is for background only. It is possible, but far from certain, that this proposal will come to Treasury Ministers during September before you return from CFM.

2. Negotiations are still in progress, with a couple of critical points outstanding between the Alliance & Leicester and the Post Office, and with the society's management not yet having either put a recommendation to its board or put sufficient to the Building Societies Commission for it to take an overall prudential view.

3. It is therefore conceivable that this may come to Ministers in one of several ways. In descending order of probability, they are:

- (i) with a request from the Commission for Treasury consent to a Designation Order under section 18 of the Building Societies Act 1986;
- (ii) with a request from some combination of the society, the Post Office and DTI to reopen the earlier decision of your predecessor and the Commission that any building society bidding for Girobank should not be able to exercise powers which were not available to societies generally, and consequently that Girobank's corporate lending would have to be put "off balance sheet";
- (iii) an "appeal" by the society against refusal of the Commission to make the Order on prudential grounds.

4. If the Order is made, it is quite possible that the Opposition will pray against it when Parliament reassembles as a way of securing a debate on the privatisation of Girobank.

Background

(a) Alliance & Leicester

5. The **Alliance & Leicester** was formed by a merger four years ago of two societies, the Alliance (based in Hove) and the Leicester. It is now the fifth largest society, and has total assets of around £12 billion and reserves of around £500 million. It operates through over 400 branches employing nearly 4,000 staff. Its main administration is divided between centres at Hove and Oadby (outside Leicester) with a small London office.

(b) Girobank

6. **Girobank**, wholly owned by the Post Office, has total assets of £2½ billion and capital and reserves of £100 million. It has no branches, operating through Post Offices under a contract with Post Office Counters, and by post. Its central administration is at Bootle, and it also has a small London office. Staff number over 6,000. The main attraction of Girobank to Alliance & Leicester is that it would enable it to offer

society members a cheque account without the society having to set up all the infrastructure from scratch and join the relevant clearing systems itself.

(c) The 1986 Act

7. (i) The 1986 Building Societies Act was designed to provide a framework for evolution of building societies either by continuing as mutual savings and mortgage institutions or by converting to become commercial banks.
- (ii) Powers available to societies were widened, but remain consistent with the public perception of what a building society is and with what can prudently be allowed.
- (iii) The powers available can be extended by secondary legislation in the fields of financial services and services related to land.
- (iv) There was a major review of powers in 1988 leading to considerable extensions. This recognised that:
- (a) financial markets had developed much more rapidly than expected in 1985 when the decisions were taken on the 1986 Act; and
 - (b) societies needed to have certainty about the powers which would be available to them during their planning periods.
8. Societies were given powers to provide money transmission services to companies and retail customers in the 1986 Act. However, it was decided that their lending powers should still be restricted to:
- (a) if secured on land - lending to any borrower;
 - (b) if unsecured - lending to individuals only.

The decision not to allow unsecured lending to companies was based on a combination of the fact that it would take societies further from the retail banking field, that it would require new management skills and that it would involve new types of risk.

9. The Act allows societies to have subsidiaries and to take equity shares in other companies. In general these have to be limited to companies which only do things within the powers available to societies. Societies can carry on some activities, e.g. estate agency or stock broking, only through subsidiaries. On the other hand they are required to carry out their mainstream activities - deposit taking and mortgage lending - through the society itself. There is power, however, for the Commission to make "designation orders" with the consent of the Treasury which enable societies to invest in named subsidiaries, or a class of subsidiaries, which are exempted in whole or part from these limitations. Such a designation order would be required for a society to acquire Girobank and keep it as a separate subsidiary, in order to take it outside the general prohibitions on deposit taking and mortgage lending through subsidiaries.

Sale of Girobank to a building society

10. When Girobank was originally offered for sale in the summer of 1988, societies were advised that they could not bid because the substantial amount of corporate lending that Girobank carried out would be ultra vires. At the request of the Alliance & Leicester, this was reconsidered by the Commission and the then Economic Secretary in January 1989. The key decisions then taken were:-

- (i) if a society were to be allowed to acquire Girobank, it would have to be on such a basis that it did not gain a competitive advantage over other societies by exercising through Girobank powers not generally available to the others. It would not therefore be allowed to continue Girobank's corporate lending activities as principal;
- (ii) the powers available to the generality of societies would be extended in two respects: societies would be allowed to offer temporary overdrafts to companies incidental to the provision of money transmission services, and to arrange, as agent, loans and leases to corporate borrowers on behalf of third party principals.

11. The Orders effecting the two agreed changes in powers have been made and came into effect on 1 July. These two changes make it feasible for a society to acquire Girobank by reducing the amount of restructuring of Girobank's business that would be needed to bring it within the powers available to societies (though corporate lending as principal is still off-limits). At the same time other societies were helped to develop money transmission services in competition with Girobank and other banks.

12. The Commission issued in February a guidance note setting out the basis on which a society might bid for Girobank, and the prudential points on which the Commission would need to be satisfied. It was sent to those societies large enough to be serious potential bidders. (A copy is attached as Annex A: you may like to refer to it briefly). Meanwhile, only Alliance & Leicester chose to bid and was selected as preferred bidder: its main rival was Co-operative Bank.

Recent Developments

13. As preferred bidder, Alliance & Leicester has had greater access to Girobank and has spent the last few months evaluating Girobank's business and negotiating with the Post Office on purchase terms, in particular the terms of the continuing contract between Girobank and Post Office Counters. The Commission explained to the society in April and in May those aspects of the purchase considered critical for the future health of the enlarged Alliance & Leicester group, which it expected the society to assess and on which it would need to be satisfied. The Commission staff have also discussed with the society what transitional or de minimis provisions are required in the Designation Order, consistent with the policy decision at the beginning of the year (paragraph 10 above).

14. The following critical steps remain:-

- (i) the society needs to complete its negotiations with the Post Office, resolving the problem, (which has recently resurfaced) of how to dispose of Girobank's existing corporate lending;
- (ii) the society's executive then needs to complete its assessment of the proposed acquisition, on the terms and at the price negotiated, and put a recommendation to its Board for a decision;

- (iii) when it is ready the society will put its final proposals to the Commission;
- (iv) the Commission staff will assess the prudential aspects of the proposals and make a recommendation to the Commission;
- (v) given the complexity and importance of the proposals, the Commission may well need further discussions with the society after it has seen the final proposals as a whole;
- (vi) if the Commission then reaches a favourable decision on prudential grounds, it can, with the Treasury's consent, make the Order.

Issues for the Commission and HMT

(a) Powers

15. This is a matter for both the Commission and HMT. The present draft of the Order designates Girobank on a basis consistent with the Commission's February guidance note, and should therefore raise no new policy issues.

16. However, the society and the Post Office have not yet agreed an "off-balance sheet" arrangement for Girobank's existing corporate loans as unforeseen difficulties have arisen late in the day. One earlier attempt to solve the problem using a public sector guarantee has already been rejected on public expenditure grounds, but a request for special treatment may resurface.

17. It is difficult to see scope for a major change on this which:

- (i) would not require a reopening of the 1988 decision on corporate lending by societies generally;
- (ii) might not, both on equitable and public expenditure grounds, require a reopening of the second tender for Girobank. The other large societies took their decision not to bid on the basis, inter alia, that the February decision on powers would be adhered to. We do not know how they would have decided if they had known that there would be a change in relation to corporate lending.

(b) Prudential

18. Under the Act this is essentially a matter for the Commission, although we presume that Treasury Ministers may want reassurance that the Commission is content on this aspect, before giving Treasury consent to the Order. The Bank of England also have to be content with the arrangements for managing Girobank, and the capacity of the Alliance & Leicester to stand behind it, given that Girobank will remain an authorised institution under the Banking Act.

19. For your information, the position is essentially this. The Commission was concerned that the Alliance & Leicester appeared to have put in their bid in March without a full evaluation of the potential consequences. There appeared to be a risk that the acquisition would overstretch either the Alliance & Leicester's management or its financial resources, leading it to becoming a "lame duck". This underlay the First Commissioner's warning to your predecessor that the bid might founder on prudential grounds.

20. Since then, the Commission staff have made plain to the Alliance & Leicester the points on which the Commission will need to be satisfied, and also sought, by raising questions in discussions, to ensure that the Alliance & Leicester were aware of the potential risks as we saw them. The Alliance & Leicester appear to have been going about their task thoroughly - indeed the present outstanding issues on the Department of Social Security contract and, as a result, the Counters contract stem from the recognition of the potential consequences of future changes in respect of each.

21. However, we have yet to have the Alliance & Leicester's final assessment, its full proposals for board and management and its board's decision on the acquisition: we may get them fairly shortly. The Commission will then have to consider:

- (i) is there in fact such an additional risk to investors that the deal should not proceed?
- (ii) are there further steps or assurances which we should request from Alliance & Leicester directed to reducing that risk?

Designation Order

22. The Order would basically designate Girobank as suitable for investment by a building society: it would set out restrictions (mainly to ensure Girobank is confined within existing powers) and apply transitional exemptions. A summary of the key provisions proposed for the Order is attached as Annex B: this is the package that will be recommended to the Commission, and if it agrees then to Treasury Ministers, as being consistent with the policy set out in the Guidance Note. I am sending separately to your PS the full text of the latest draft of the Order.

Powers of societies generally

23. There are two other minor extensions of the powers of societies generally which have been requested by various societies and which Commission staff will shortly be recommending to the Commission: they are basically "in-filling" of areas already open to societies and do not constitute a major departure.

24. The first is the designation, as suitable for investment or support by a society, of additional joint operators in money transmission and credit cards. Some, such as VISA, Access and BACS, are already designated. The additions would be:

SWIFT
Mastercard
Eurocard
Switch

The second is to allow societies to hold foreign currency liquid assets to match foreign currency liabilities (which they may already incur). If a designation order is made for Girobank by, say, mid October, the first extension could conveniently be covered in the same Order. Otherwise it will need to be achieved by a separate Order. The second extension relates to a different power under the Act, and would need a separate Order anyway: if implemented in this way no special provision for Girobank's foreign currency accounts is required.

Timetable

25. The Commission will make the Order only after it has reached a favourable prudential decision, for two reasons:-

- (i) the Order must technically fit the final agreed transaction;
- (ii) for the Order to be made first would give the wrong signals to all parties as it would be misinterpreted as a prudential decision. Were the Commission then to rule against on prudential grounds, the society would be placed in a difficult position with possible damage to investor confidence.

26. The Post Office is pressing for a decision from both the society and the Commission. At this moment, however, the society has not yet completed its negotiations or put forward a recommendation to its Board. When it is ready to put a final proposal to the Commission, it accepts the need for dialogue with the Commission on matters arising out of that proposal before the Commission makes its decision.

27. If both the society's Board and the Commission decide that the acquisition may go ahead, there is an operational desire for the sale to be settled quickly. Girobank and its staff have endured uncertainty for a long time, with repeated press speculation. This will be eased if the Order is made and laid before Parliament, so allowing the society to enter into a conditional contract of sale - such limited anticipation of powers is permitted - before the Order comes into effect.

28. If the Order were made in the Recess, it would seem impolitic to have an effective date before there had been time for a debate after the Recess, given the likelihood of an Opposition prayer against it. This means that the effective date of the Order would have to be the later of:

- (i) a date in early November; and
- (ii) 21 days after laying.

Conclusion

- * It is possible, on one scenario for the outcome of negotiations in the next few weeks, that this Designation Order may be put forward for the Treasury's consent in mid-September.
- * It would be in a form which raises no new policy issue, but merely gave effect to policy agreed by your predecessor.
- * If agreed by Treasury Ministers, it would be laid in the Recess, but given an effective date in early November, allowing time for a debate when Parliament reassembles.
- * But, as I have explained, it may well come forward later than that and possibly the issue may arise in a different form.

J M PALMER

ANNEX A

BUILDING SOCIETIES ACT 1986

Guidance Note

Possible purchase of Girobank plc



This note sets out the basis on which the Building Societies Commission would be prepared to consider making a designation order, under section 18 of the Building Societies Act 1986, for Girobank plc, to enable a building society to acquire that company as an entity and to operate it thereafter as a distinct subsidiary, if the society so wished.

This note is based on the assumption that two draft orders sent to the Building Societies Association for consultation on 17 February 1989 will be made in substantially their present form, to take effect on 1 July 1989. They are:

- the Building Societies (Money Transmission Services) Order 1989; and
- the Building Societies (Provision of Services) Order 1989.

That is dependent on the present consultation on drafts, and on the passage of the necessary affirmative resolution by each House of Parliament. Throughout "Girobank" is used to refer to "Girobank plc".

General

2. The Commission would be ready to use its powers to make a designation order under section 18 for Girobank, so overcoming the general prohibition on a building society having a deposit taking or mortgage lending subsidiary, provided that any society tendering for Girobank had satisfied the Commission that:-

- (a) it had been agreed that the activities to be pursued by, and assets held by, Girobank after acquisition, would be restructured so that they would be within the powers available to societies generally from the time of acquisition;
- (b) the balance sheet limits in section 20 would be met, with Girobank aggregated with the society for this purpose;
- (c) arrangements had been made for the effective direction and management of Girobank as part of the group run by the society, which both satisfied this Commission that the criteria of prudent management would be met for the group, and satisfied the Bank of England that continued authorisation of Girobank under the Banking Act was merited;
- (d) more generally, the society had satisfied the Commission that the criteria of prudent management would be met for the group as a whole.

Powers

3. The Commission considers that competitive equality for building societies requires that any building society acquiring Girobank should keep its activities, from the time of acquisition, within the powers available to building societies generally. This would mean that a building society acquiring Girobank would have to agree with the Post Office that the latter should retain, or sell direct to a third party, those remaining assets on Girobank's balance sheet which would be outside a society's powers.

4. The extent of the adjustment necessary will be reduced by the two extensions of powers, announced by the Economic Secretary in a written reply to a question by Mr Kenneth Hind MP on 17 February. Subject to the outcome of the current consultations, and the passing in one case of the requisite affirmative resolution by each House of Parliament, the powers of societies generally will be extended in two respects:

- (a) a society will have power to offer an overdraft facility to a commercial customer, provided it is for temporary or occasional use and is incidental to the provision of a money transmission facility; and
- (b) the power of a society to arrange, unsecured loans off its balance sheet, or to lease "chattels" off balance-sheet, will no longer be restricted to individuals. (Its power to manage such loans as an agent is not at present restricted).

It is intended that these powers will be available to societies, subject in the case of (a) to adoption by the society, from 1 July 1989.

5. The Commission is aware of three classes of asset which would still need to be taken off Girobank's balance sheet before acquisition, but there may be others:

- (i) commercial loans (excluding temporary or occasional overdrafts incidental to money transmission facilities);
- (ii) loans to individuals over £10,000, and those which bring the total indebtedness of the individual to Girobank over £10,000; and
- (iii) leased assets for companies, or to individuals over the £10,000 limit.

6. The society or Girobank would have power after transfer to manage such a loan and/or lease book as an agent for the Post Office or third party. But the arrangements for the transfer of the book from Girobank and, if applicable, subsequent management of it, would have to meet the Bank of England's criteria for the loans and/or leases not to require capital backing by Girobank: if that were the case the Commission would accept that the group similarly did not need further capital backing on account of that book. (NB: Girobank, if it were a building society subsidiary, would not be able to provide initial finance for a vehicle securitising such loans.)

7. The Building Societies Commission would not be prepared to agree to any material business outside the powers available to societies generally being transferred with Girobank, in the expectation of subsequent sale or rundown, essentially because there could be no certainty about either the practicability or timing of such a sale. All such business would have to be taken off Girobank's balance sheet before the latter's purchase by the society, and in a way which did not leave a material contingent liability on Girobank.

8. The Commission would however be prepared to consider a request from a society that the designation order would allow one or other of two de minimis exceptions. The first would be that the conditions in the designation order might allow the society acquiring Girobank 3 months to bring the memorandum of Girobank within the powers available to the society, in a way analagous to that provided in section 18(8)(c). This would allow a limited further period for rundown of minor and incidental business. But all such business outside the society's powers would have to have stopped before the change of memorandum. Also this procedure could only be used for the transition in respect of minor items: it could not prudently cover any transfer as part of Girobank of material business outside a society's powers, because of the potential consequences if a further transfer to a third party could not be completed successfully in the limited time available.

9. Alternatively, the Commission would be prepared to consider a request to retain permanently some element of the business of Girobank outside the powers available to societies generally on the grounds that it was de minimis. The Commission would not expect to allow on such a de minimis basis any financial activities, such as commercial lending, which have been deliberately excluded from the powers available to societies generally.

10. The Commission envisage that Girobank should in general be a single tier subsidiary. But it would clearly be necessary to cover, in some way, Girobank's interest in, for example, various parts of the clearing system and Visa International. But this would need to be discussed further between the legal staff of the Commission, the society and Girobank, before the designation order was made.

Balance Sheet Limits

11. The balance sheet limits in section 20 will apply to the aggregated assets of Girobank and the society at the end of each financial year following acquisition. The Commission envisages that the criteria set out in the October 1988 consultation paper on acquisition by subsidiaries of mortgage books would be applied to determine what part of the existing mortgage book of Girobank could be aggregated with the Class 1 or Class 2 assets of the society for this purpose. If Girobank initiated further mortgages after its acquisition by the society, the Class 1 and 2 criteria would be those applicable to new loans by a society.

12. If the society found it necessary, in order to keep within the Class 3 limit, to transfer off balance sheet some of Girobank's lending, even though it would be a permitted Class 3 asset if acquired, the Commission would again expect to apply the criterion that the arrangements must be such as for the Bank of England not to require Girobank to have capital backing against any residual liability.

Prudential Aspects

13. The Commission would expect any society tendering for Girobank to satisfy it, before the society became committed, that the proposed acquisition would be consistent with the society maintaining the criteria of prudent management. For this purpose, the Commission would expect information covering the relevant points set out in Annex B to the Prudential Note 1988/4. Just three aspects which would be of particular relevance in this case are mentioned here.

14. If the society wished to maintain Girobank as a distinct legal entity - a wholly owned subsidiary - rather than bringing all its business onto the society's own books:-

- (i) the society would have to satisfy section 45 of the 1986 Act in respect of the society and Girobank; and
- (ii) the subsidiary would have to meet the requirements of the Bank of England for continued authorisation under the Banking Act 1987.

15. Section 45 makes it clear that the board of the society are responsible for the observance of the criteria of prudent management by a subsidiary: they must therefore have arrangements for effective direction by the parent board and control of the subsidiary sufficient to secure that. This would probably require both representation on the board of Girobank plc and provision in the memorandum and articles that the society might remove the board. The Commission would need to be satisfied both that the proposed arrangements were sufficient for this purpose, and that the board and senior management of the society had the appropriate skills for the wider range of activities.

16. In accordance with the treatment of subsidiaries set out in Prudential Note 1987/1:

- (i) the Girobank subsidiary would have to be capitalised to meet the capital requirements of the Bank for authorisation;
- (ii) both the society and its group, including the Girobank subsidiary on an aggregated basis, would need to meet the capital adequacy criteria in that note.

In particular, the Commission would need to be satisfied, inter alia, about:

- (a) the effect on the society's capital position of the purchase;
- (b) the arrangements for financing future capital expenditure of Girobank;
- (c) the effect on the expected financial position of the society for the next few years, with appropriate sensitivity analysis of the effects of varying the assumptions used for the "main case".

17. Sections 71 and 82 and the reports under them would apply to the subsidiary, as to the society. (Section 71(10)). Girobank has been subject to similar requirements under the Banking Act 1987, but the society's board and auditors would nevertheless need to secure confirmation of the position before it assumed responsibility. In addition, it would need to ensure that Girobank had the systems in place to monitor the observance of the limitations on its powers consequent on its ownership by the society - eg the section 16 limit on indebtedness by an individual in respect of unsecured lending. That aspect of Girobank's systems would similarly need to be the subject of particular attention in the preparation of the section 82 report from the society's auditors, since it would not be covered by the equivalent report of Girobank's auditors under the Banking Act.

Timetable

18. Any society wishing to acquire Girobank on the basis outlined above would need to adopt the power to hold as Class 3 assets balances due on money transmission service accounts, and to amend its memorandum to add "Girobank plc" to the list of designated bodies, before it could enter into an unconditional contract to acquire it.

19. A society would be able to use the power under section 105 for limited anticipation to enter into a conditional contract once

- (i) the draft Treasury order on money transmission service debt had been approved by both Houses;
- (ii) the Commission order removing the restrictions on arranging loans and leases had been laid; and
- (iii) the order designating Girobank had been laid.

It is anticipated that the first two may not be for a month or two, to enable time for the consultation, and then for Parliamentary time to be found for the necessary affirmative resolutions. The timing of the designation order depends on when one or more societies proposing to tender have satisfied the Commission, and where appropriate the Bank of England, on the points in this note. It will probably also be necessary to delay that order until the successful bidder and Girobank's legal advisers have been able to satisfy themselves that the draft contract for purchase and the conditions in the draft order fit.

20. Any contract to purchase could only become unconditional after the effective date for the changes to the society's memorandum. Societies are reminded that:-

- (i) the Act requires a minimum period of 3 weeks between the Central Office receiving an amendment of a memorandum for registration and that registration;
- (ii) the Central Office takes the view that while it cannot properly receive such an amendment of rules until the designation order has been laid, a society can, with care to ensure that effective notice is

given to members of the substance of the resolution, pass a valid special resolution approving the amendment before that. The effective date for the change must be on or after the date on which the order comes into effect - which is expected to be 1 July 1989 for the two general orders.

So it would be possible for a society to give effective notice within the next few weeks to its members of proposed memorandum changes in respect of "Girobank plc" and "money transmission service debts", provided that on the latter they followed the procedure to give effective notice set out in paragraph 5 of the letter from the Commission to the BSA of 17 February 1989: that letter was circulated to societies under cover of DCE 1989/3.

Queries

21. Any question which a building society may have on this note should be directed, in the first instance, to its supervisor in the Commission.

Building Societies Commission
15 Great Marlborough Street
LONDON
W1V 2AX

February 1989

ANNEX B

Principal provisions of the draft Girobank Designation Order

(referred to briefly in the main submission)

Corporate Lending

The draft Order will not permit Girobank to carry on unsecured corporate lending as principal. It is still expected that Girobank, upon acquisition by Alliance & Leicester, would transfer its existing corporate loan and leasing portfolio to the Post Office, continuing to manage it as agent. Difficulties have arisen at a late stage on this route, but the parties are working to resolve the problem. The society intends to reach agreement with a commercial bank to introduce to it new corporate business which Girobank would manage on its behalf.

2. The Designation Order will provide transitional exemption, for a period of twelve months, to cover the running down of certain existing corporate lending business:-

- (i) short term money market loans already outstanding, which will be repaid over the next few months and which, therefore, would not be transferred to the Post Office; and
- (ii) existing acceptance credit facilities expiring within a year, which could not be transferred to the Post Office as it is not an eligible bank; the very few longer term facilities of the same kind are to be transferred to the commercial bank referred to above.

The maximum amounts for which Girobank will take advantage of the exemptions will be specified in private guidance to Alliance & Leicester.

Other Transitional Provisions for Girobank

3. Transitional or de minimis exemption is also to be given in respect of:-

- (i) a small amount of outstanding short-term interest-rate futures contracts, which do not comply with the regulations applicable to societies' use of hedging instruments. These will all mature within a few months;
- (ii) a very small amount, around £2.5 million, of outstanding long-term loans to local authorities, which do not quite qualify as permitted liquid assets that societies are allowed to hold; and
- (iii) a small number of unsecured overdrafts and loans to individuals where the facility limit exceeds £10,000 (the current limit for societies' unsecured lending to individuals). The proposed exemption relates to existing commitments only and does not permit the limit of any such facility to be further increased.

In none of these cases will Girobank be permitted to undertake further ultra vires business after acquisition.

Subordinate Bodies

4. Girobank will be permitted to invest in, or support, other bodies already designated by name as suitable for societies' investment and support. This mainly applies to the consortium bodies which operate common payment and clearing systems, and the credit card companies operating VISA and Access. Girobank will also be permitted to invest in bodies already designated generically, but not to have two or more tiers of subordinate companies. All this falls within the general powers of societies. An exception is the power to invest in the vehicle through which the Banking Ombudsman scheme operates, which has no relevance to other societies but is desirable for Girobank.

Overseas Giro business

5. Girobank is also to be specifically empowered to fulfil obligations as the UK participant in the international postal giro network established by the Universal Postal Union.

Other Money Transmission Companies

6. A wide range of companies operating shared payments and clearing networks, ATM networks, and credit cards are already designated by name. This range includes APACS, LINK and the VISA and Access groups. The Commission staff will be recommending that the Commission designate four more such companies, as a number of societies are keen to join the relevant networks. The four are:

- (i) **Swift**, the international money transmission network;
- (ii) **Mastercard**, the international parent of Access, through which some banks now operate direct;
- (iii) **Eurocard**, the counterpart of Mastercard for cross border money transmission;
- (iv) **Switch**, the UK network for electronic funds transfer.

Designation of these organisations does not break new ground but is a natural extension of the existing list. Girobank is, as it happens, already a member of Swift. Designation of all four, for all societies, may conveniently be achieved in the same order as Girobank as they all relate to the same power under the Act.

Foreign currency liquid assets

7. At present societies may borrow in foreign currencies but normally swap the proceeds into sterling immediately since they can only hold foreign currency assets as banknotes or customer advances. The Commission staff will be recommending that a separate order, applicable to all societies, be made to extend powers to hold liquid assets in foreign currencies as well. This change would be desirable for societies generally as they begin to take advantage of the EC single market, as it

will assist effective management of foreign currency liabilities and assets. It will also help societies borrow in the US commercial paper market which typically involves temporary holdings of US dollar proceeds for which a safe home is needed before the swap into sterling takes place. If this general approach is followed, no specific provision for Girobank's own foreign currency money transmission services is needed in this Order.

J M PALMER

[ANNEX]



FROM: J M G TAYLOR

DATE: 25 August 1989

PS/ECONOMIC SECRETARY

cc PS/Financial Secretary
Sir P Middleton
Mr Scholar o/r
Mr Walsh
Mr Moore
Miss Noble
Mr Dickson

mp

Mr Bridgeman - BSC
Mr Palmer - BSC
Mrs Gilmore o/r - BSC
Mr Procter - BSC
Mr Mathews - BSC

ALLIANCE & LEICESTER BUILDING SOCIETY POSSIBLE ACQUISITION OF GIROBANK

The Chancellor has seen Mr Palmer's (BSC) minute of 18 August. He has commented that the sooner this is resolved, the better.

JMG

J M G TAYLOR

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CONFIDENTIAL

Economic Secretary

From: Mrs Gilmore

Date: 16 October 1989

cc: PS/Chancellor

PS/Economic Secretary

PS/Sir Peter Middleton

Mr Scholar

Mr Walsh

Miss Noble

Mr Quinn

Mr Barnes

Mr Bridgeman

Mr Mathews

Handwritten notes in red ink:
- A large scribble at the top left.
- "Mr Gilmore" written vertically.
- "Mr Quinn" written vertically.
- "Mr Barnes" written vertically.
- "Mr Mathews" written vertically.
- "Mr Scholar" written vertically.
- "Mr Walsh" written vertically.
- "Miss Noble" written vertically.
- "PS/Chancellor" written vertically.
- "PS/Economic Secretary" written vertically.
- "PS/Sir Peter Middleton" written vertically.
- "Mr Bridgeman" written vertically.
- "Mr Mathews" written vertically.

I have raised the question of
risk with Bridgeman & Johnston.
They doubt there is much danger
at present but agree on the need
to watch vigilantly. Bridgeman
my word a note.

JL

"TAKE-OVERS" OF BUILDING SOCIETIES

Handwritten note:
Thank you

Introduction

1. This paper raises some issues which Ministers may wish to consider in the context of possible take-overs of building societies and offers advice on the line which might be taken publicly and on certain steps proposed by the Building Societies Commission.

Background

2. Under the Building Societies Act 1986, a building society can transfer its business to another society; to a public limited company set up for the purpose, or to an existing company. For ease of reference these possibilities are described here as "merger", "conversion" and "take-over" respectively.

3. Some background to the building society movements is given in Annex A. As well as the wider powers given in the Building Societies Act 1986, and the schedule 8 review (see Annex A) the Act also provided that societies which wished to expand their activities out of the range allowed to building societies could convert to corporate status and contemplated the possibility of transfer to an existing company. However, it is clear from the overall structure and philosophy of the Act, and from the specific conversion provisions that mass self-conversion or take-over leading, in effect, to the demise of the movement was never even contemplated. Ministerial statements at the time (Annex B) envisage a continued building society sector in the foreseeable future.

4. Perhaps most importantly in current circumstances, major predatory interest in building societies was not considered; and consequently there is no clear policy on the matter and no rules of conduct to govern such activities.

The Current Situation

5. At the present time, there is a good deal of talk in the media, among the main city advisory professions, and in the building society industry itself about take-overs, both friendly and predatory. But it is worth noting that there are only two or three publicly identified potential buyers, although advisors purport to have long lists of potential acquirers. All those we know of appear to rule out hostile action. Equally, we know of no current situation where the parties are actually engaged and intend to proceed to a wedding. None the less, we have to plan for the fact that one may arise fairly soon and it is on the cards that a significant number more could arise in a fairly short amount of time. Alternatively, there could be a prolonged process of attrition, including some forced marriages, after which the building society movement would cease to exist in the form recognisable today.

6. Such a development may, indeed, be a necessary piece of evolution, but it is worth noting here that it was not a part of the explicit intention of the 1986 Act that take-over should be a significant evolutionary route for societies and the public might be surprised if that were to happen more or less accidentally. It is perhaps a general policy issue to which we will need to return as the situation becomes more clear. Related more specific questions are whether the current uncertainty about take-overs may block conversions or desirable intra-building society mergers; whether larger building societies have a 'level playing field' with companies for taking over smaller societies and whether inadequately regulated predatory activity may break out among societies. The rest of this note considers how the current situation might be handled by the Building Societies Commission, other supervisors - notably the Bank of England - and by Ministers.

The Mechanics of Take-over

7. Discussion with advisors who have been to see us suggests that almost all potential buyers and many advisors have had, until now, a very naive view of the necessary steps for a take-over. To oversimplify, we believe that a "hostile" take-over of a building society would be so destructive as to be self defeating, but that some boards could be threatened, persuaded, or bribed into a take-over which they really considered against their members' interests. Finally, some societies will genuinely want to be taken over, but the processes are long and complex and no more than two conversions or take-overs could be underway at any one time unless very significant changes were made. Merger procedures are of course much more well established but could now run into an external offer. This point is further discussed in paragraph 11.

8. The conversion provisions in the Act protect the interests of the shareholding (ie depositor) and borrowing members of a society in that they require comprehensive, clear and accurate information to be given about the issues on which members are to vote; they require proper conduct of that vote, and they require confirmation by the Commission that the provisions have been complied with and the vote has been properly conducted. There are also limitations on the inducements

which can be offered. In preparing the information, society, advisors and Commission staff have to check that the material is comprehensible complete and consistent with audited accounts, stated future plans and the relevant aspects of the law. Since, in most cases, there will be millions of voters, these requirements are no more than common justice, but they take time, thought and attention to apply - both by the board and management of the society and by the Commission. Finally, the Bank of England must be fully satisfied that the new organisation can appropriately operate as an authorised bank. This situation is way away from the share buying operations to which predators are accustomed and we consider that, as a minimum, we should take steps to make more widely known the basic mechanics of the transfer procedures by publishing the factual paper at Annex D.

BSC Attitude to Take-Over

9. The Commission has said that it is neutral on the issue, in principle, whether a society should or should not, convert. That stance was taken up principally in relation to self conversion where questions of predatory or hostile behaviour do not arise. It is possible that the market place might read across too readily into questions of take-over and assume indifference rather than impartiality. In fact, we would not be indifferent if the circumstances of take-overs were destabilising, disorderly or otherwise involved undue pressure from outside on the board of a building society. We do therefore have views about the behaviour of predators, in keeping with our prime duties under section 1 of the Act and, moreover, the interests of other regulatory authorities may be involved. As to the building society itself we will wish to be satisfied that the board of a society in recommending a transfer have a proper forward plan which they can explain, and that the schemes of incentives to members to vote do not simply seek to circumvent the provisions of the Act in some way. We are still working on the matter, but a number of the wilder incentives and devices that have been suggested to us by various advisors in the City (perhaps those whereby those third parties could bring pressure to bear) are, fairly much, a put-up job; and we need to say so. These are ones which we would ourselves turn down, leaving others to litigate if they felt

they could - not ones we would even agree to test in court in a friendly action.

Role of Advisors

10. Since mergers and acquisitions have become the flavour of the year (perhaps because there are too many advisors with too much time on their hands), it is certainly true that there is a good deal of competitive bidding for the custom of potential "acquirers", "aquired" and those who might want to be defended. This has produced a somewhat super-heated atmosphere which is causing ripples even among some very small societies who are not likely potential targets in reality, and whose boards may be taking undue time out from managing their businesses to worry about take-over. It may also destabilise some who genuinely are targets to the detriment of their investors. We therefore think it would be appropriate to put out some guidance on the facts, probably through the British Merchant Bankers Association, to help take the steam out of the situation - on the lines of Annex D. We believe the Bank of England would be happy to help with such an approach. It would, inevitably, become public, and we think that this is right.

A Code

11. Even if some of the heat drains away from the situation, there remains the question of the public behaviour of acquiring companies and of advisors in take-over and merger situations. Building society take-overs are of course are not governed by the take-over code and there is, at present, nothing to stop purely frivolous and wrecking publicity being put out by a competitor simply to disturb the sequence of a deal. This also applies to wrecking directed at a true merger of two societies. Equally there is nothing to stop an acquirer and his advisors approaching a dozen building societies at once with more or less frivolous intent in most cases. There is also no regulation of advertising or other public statements by predators or wreckers. We think, therefore, that we should work on a code which would cover certain basic "rules of the game" for these situations, in consultation with the Bank of England and the Take-Over Panel, submit it to

Ministers and publish it. The areas to be covered in such a code, and some bare bones for it, are attached in Annex C. We would expect to develop a code for societies also, reading across the relevant provisions of the code for companies, which the Building Societies Commission would enforce.

Tasks of the Building Societies Commission

12. The Commission itself has to look to the situation where, after taking the above steps to channel disorderly situations, there might still be more genuine take-over, conversion and/or merger cases than it is possible to handle at any one time. In that situation, we would expect our first response to be to establish a queue - as in the case of the capital markets - or some other basis of selectivity (perhaps giving priority to society initiated conversions). But, if that proved unacceptable to the societies, the public and the Government, there would be two choices:

- (i) primary legislation to alter the conversion processes so that members' rights were protected in some very rough and ready way (eg a per capita distribution of total net assets - however defined); or
- (ii) an increase in the number of Commissioners and Commission staff specifically for the purpose of processing conversion cases.

Neither of these is attractive. A rapid increase in Commission staff would mainly be by professional secondments and those are expensive: we might need to increase the fees to societies then and there. Even with secondments, we could not process conversions en masse, as the prudential supervision of societies is and must remain the first claim on time. Primary legislation to change the rules would be complicated, need a good deal of thought and legal preparation, and would lead to further debate about many provisions of current building society law. Finally we could raise the voting thresholds so high as to choke off transfers, especially take-overs, but this would be indefensible unless the code had been flouted or chaotic conditions had developed.

13. At present we propose to wait on these issues to see how the situation develops, since no sensible recommendations can be made without knowing how many takeover cases may develop and how fast. In practice, now that a number of the major societies have declared their intention to stay independant for the time being, the situation may not precipitate so fast, but, if it does, we will come back to Ministers with advice.

Summary and Conclusions

14. This note sets out a complex picture, with many uncertainties, very briefly. As the situation unfolds, we will be happy to respond to requests for further information so far as we can. If it is wished we could also develop some broad policy advice on 'should there be building societies at all?'.
.

15. Leaving the global issue on one side, we propose:

- (i) to explain publicly the Commission's stance as described in paragraph 9 above;
- (ii) to make plain the conduct which we expect of advisers and principals (in consultation with the Bank of England who regulate most of them) and to publish guidance on the law to be complied with in a take-over (paragraph 10 above and Annex D);
- (iii) with the help of the Bank of England and their Take-Over Panel to develop a "Take-Over" code around the skeleton in Annex C (paragraph 11 above) - one key element will be to make sure that offers which get published must be bona fide ones;
- (iv) to develop some contingency plans to deal with an uprush in take-over activity, but at this stage on the basis that our first response would be to establish a queue, or some system of selectivity

however arbitrary and unpopular that might be
(paragraph 12 above).

16. If Ministers would like to discuss these conclusions with us, we will be happy to do so. We would wish to proceed on (i) - (iii) above quickly and to take forward planning on (iv) and (v). Letters to Ministers, Parliamentary Questions and other statements or speeches Ministers might wish to make could draw on the above material taking account of our advice on the state of play on take-overs at the given time. We are assuming that, at present, Ministers will not wish to volunteer any general statement, at a time when it is still unclear whether a major issue exists or not.

R E J Gilmore

ff R E J Gilmore

Building Societies Commission

17 October 1989

BUILDING SOCIETIES: HISTORY AND OPERATIONS

The 1986 legislation made it possible for a building society to be taken over by an existing company. This paper sets out briefly the background to the building societies movement, and describes the changes that have taken place, especially over the last 10 years.

Background

2. From humble beginnings some 200 years ago, societies have developed into highly visible and important financial institutions. Societies today bear a strong resemblance to banks in their operations with retail customers - and by many people are regarded as a direct alternative, but rather more approachable and 'customer friendly'.

3. In early days, so-called 'terminating societies' were formed by groups of people who agreed to pool their savings to enable each of them to own their own home. Houses were built as sufficient funds had been accumulated and allocated to members in turn. All members continued making payments to the society until all had bought houses, at which stage the society had achieved its purpose, and it would be terminated.

4. It soon became obvious that there was a ready flow of new members and that there was no need for the society to terminate. New 'permanent' societies were formed.

5. The crucial feature of the societies from the early days was the mutuality of interest - every member understood his responsibility to and rights in the society and could identify his interest in the enterprise. Each participant had a 'share' in the society and an equal say in its affairs - the amount of his investment or borrowing was immaterial.

6. As the societies grew in both numbers and size, they were seen as safe havens for savings and a fair and sympathetic source of mortgage loans. The movement had its problems in the nineteenth century such as insolvency or bad management, but this did not affect public confidence in them. Even today they are seen in the same light with over 7 million families currently buying their homes through society borrowing and many millions depositing funds with building societies. The respectability of the societies, their sympathetic understanding in hard times and the approachability of management and staff has earned societies an unusual affection in the minds of the British public.

Growth of societies up to 1980

7. Table 1 shows the growth of funds placed with the movement, now better described as an industry, and the decline in the number of societies since the turn of the century - partly through the winding up of terminating societies, and partly through the transfer of engagements of small societies to larger ones.

8. Between 1950 and 1980, the movement changed markedly in the scale of the typical society, but hardly at all in the character of its business. In 1950 total assets, in 1983 prices, was £13 billion. There were 819 societies, and only 650 branch offices, less than one for the "average society". By 1980 total assets had risen five fold in real terms to £67 billion at 1983 prices. The number of societies had fallen to 273, so assets per society had risen fifteen fold. The number of branches had increased more than correspondingly to nearly 5,700 in total - an average of nearly 22 per society.

9. These three decades were characterised by:

lack of effective competition from the clearing banks,
constrained by monetary controls;

societies' share of the mortgage market increasing as local
authorities and insurance companies pulled out of the market -
it was over 80% by the late 1970's;

lack of price competition between societies, who operated a
recommended rate system: partly because of ministerial
pressure from time to time to keep down the mortgage rate;
rates tended to be set "below the market" with a consequent
need to ration mortgages;

non-price competition between societies, notably through the
proliferation of branch offices; but very little in terms of
the range of services offered, or in terms of differentiation
of types of mortgages and savings products;

societies being remarkably self-contained and separate from
the rest of the financial system, despite their size - in
total they held broadly the same amount of private sector
sterling deposits as the banks.

All these characteristics were to change in the following decade.

The early 1980s

10. The most immediate cause of the change was the ending of monetary
controls on the banks in 1980, and their subsequent aggressive
competition in the retail market - initially in 1982 in the mortgage
market, but subsequently from 1985 onwards in the retail savings

market. Improving technology, and increasing rates of change and competition in the retail financial services market both also played their part.

11. The recommended rate system operated by the Building Societies Association was progressively eroded under that competitive pressure, and came to an end after the Chancellor announced in 1984 that its exemption from the Restrictive Trade Protection Act would end with the new building societies legislation.

12. The large incursion of the clearing banks into the mortgage market in 1982, when societies share of the market fell to 57%, brought home to societies their need to widen the range of savings and investment products, and other services, if they were to compete. They found that the powers open to them under what was, in this respect, still 1874 legislation, were insufficient. That legislation had defined the purpose of a society as being to raise funds from its members for the purpose of lending to members secured on first mortgage: they could only do what was necessary for that purpose. Societies accordingly began to press for new legislation to widen their powers.

13. In the meantime, the major societies developed such services as were available within their powers - ATM networks, cheque books, although without guarantee cards or overdrafts unless it was done as an agent for another, introducing members to finance houses for personal loans to top up mortgages. Societies recovered some of their mortgage market share, although this was probably as much due to the banks pulling back for reasons unrelated to that market as to societies. They also took limited steps into direct participation in the housing market by establishing parallel housing associations.

14. Societies did not, in fact, fare badly over this period. Total assets doubled in real terms between 1980 and 1987. The number of societies halved - table 2 shows the effect on concentration. Capital

ratios improved by a quarter. While their market share in the mortgage market declined, their share of the "personal sector liquid assets" grew further from 46% in 1980 to 53% in 1987.

The 1986 Act

15. The form of the 1986 Act, which mainly took effect on 1 January 1987, is basically that foreshadowed in the June 1974 Green Paper "Building Societies: A New Framework". Its essential premises were:

- (i) building societies were to be able to evolve, while retaining their essential character of mutual, member based organisations, raising funds primarily from the retail market, to lend to finance owner occupation of homes;
- (ii) for this purpose they were to have a wider range of powers, but related either to financial services or to the property market; these included powers to engage in housing development as well as to provide overdrafts, personal loans etc;
- (iii) societies were to be allowed to operate elsewhere in the EC through subsidiaries - or directly if orders were made;
- (iv) the retention of the essential nature of a society, and also the prudential need for it to evolve progressively, would be assured by a series of limits on key balance sheet ratios - the "nature limits"; the Act enabled those limits to be raised by order within a specified range;
- (v) a society which wished to diversify beyond that could convert into a company, regulated under the Banking Act, or transfer to an existing company;

- (vi) the prudential powers were to be strengthened, broadly into line with those of the Bank of England: the decision to vest them in a Building Societies Commission was announced when the Bill was published;
- (vii) the Investor Protection Scheme was made statutory: it protected 90% of the first £10,000 (since raised to £20,000)

1987

16. 1987 did not turn out as societies had hoped. They were subject to a strong competitive attack in both the savings and mortgage markets. Competition with the clearers ^{had} forced ^{retail} interest rates for a period above wholesale rates. This created an opening for the new mortgage lenders, funding themselves on the wholesale markets. Under competition from the new lenders and the banks, societies share of the mortgage market fell below 50%.

17. Societies ability to compete was also inhibited by their relatively small use of the wholesale market. Their ability to make greater use of it was limited by their inexperience in it, and consequent prudential need to limit the speed of entry of each society to its management capabilities. They also pressed for an increase in the nature limit of 20% on the proportion of funding from wholesale markets. The Commission raised it to 40% (the top of the range permitted by the Act) before it was having an effect on more than one or two societies.

18. Societies started to make use of their new powers - notably by the acquisition of estate agent chains, but also through development of interest bearing cheque accounts, by offering consumer credit, etc.

19. However, unexpected teething troubles started to appear with the way in which the service powers had been expressed in statute -largely due to services taking forms which had not been precisely foreseen when the Act was being drafted two to three years earlier. Moreover societies complained that setting the powers and nature limits in the Act in relation to what it was reasonable to expect societies to do in 1987-88, say, gave them no basis for planning forward: they did not know whether or not the powers would be extended or limits raised by the end of their planning periods.

20. These problems led to a joint Treasury and Commission review of the powers available to societies and of the nature limits - called the "Schedule 8 Review", since that schedule defines the service powers.

The Schedule 8 Review

21. The Schedule 8 Review led to four orders made in June 1988 - two affirmative resolutions, two negative. Its main effects were:

- (i) to accept the principle that societies should have a framework for planning ahead;
- (ii) to set a timetable for raising the nature limits to the top of the permitted range by 1993;
- (iii) to extend the powers of a society to own financial services subsidiaries - life insurance companies, fund managers, stockbrokers (but not market makers);
- (iv) to define the powers to give services in a way less likely to run into difficulty with market and technical innovations - they are now defined so far as possible by very broad areas, less specific exclusion.

22. The "nature limit" requirements now are that:

- (i) mortgages on owner occupied residential property (Class 1) must amount to at least 90% of commercial assets - this falls to 75% by 1993;
- (ii) total mortgages, including commercial mortgages, must amount to 95% of commercial assets, falling to 85% by 1993;
- (iii) this leaves only 5% now, 15% by 1993, for riskier assets - e.g. unsecured consumer lending, ownership of estate agents, direct participation in property development.

The main continuing limitation on powers is that many of them are limited to services to the individual, rather than services to companies.

1988 and 1989

23. Societies have now recovered, in substance and morale, from 1987. In particular:

- (i) the Schedule 8 Review has had the intended effect of giving them confidence that the regulatory framework would evolve. The majority of major societies are now content and have said that they see no need to convert, at least on that account;
- (ii) societies have had no difficulty in securing retail funds since the 1987 stock market crash;

(iii) the reversal of the relativity between retail and wholesale rates has enabled them to put a squeeze on the new mortgage lenders. The clearing banks are also much less aggressive in the mortgage market, and societies have recouped their market share - it is probably now over 70% again;

(iv) despite competition, profitability has remained good, and societies have been strengthening their capital position.

24. However, the latest rise in ^{market, and so} mortgage rates faces them with the immediate prospect of further reduced activity in the mortgage market (with effects on receipts of insurance commissions and profits of estate agent subsidiaries), an increasing number of borrowers in difficulty with repayments, and in due course higher repossessions at a time when the housing market is likely to be stagnant or falling, depending on the region.

Table 1: Building societies-Service activity 1900-88

Number (except where indicated)

Year	Societies	Branches	Shareholders	Borrowers	Total assets	Share of new mortgage lending
			Millions	Millions	£ billion	%
1900	2286	..	0.6	..	0.06	..
1910	1723	..	0.6	..	0.08	..
1920	1271	..	0.7	..	0.09	..
1930	1026	..	1.5	0.7	0.37	..
1940	952	..	2.1	1.5	0.76	..
1950	819	..	2.3	1.5	1.26	..
1955	783	..	3.0	2.0	2.07	..
1960	726	..	3.9	2.3	3.17	..
1965	605	..	5.9	2.8	5.53	..
1970	481	2016	10.3	3.7	10.82	..
1975	382	3375	17.9	4.4	24.20	..
1980	273	5684	30.6	5.4	53.80	..
1981	253	6163	33.4	5.5	61.81	..
1982	227	6480	36.6	5.6	73.03	..
1983	206	6643	37.7	5.9	85.87	..
1984	190	6816	39.4	6.3	102.69	85.4
1985	167	6926	40.0	6.7	120.77	77.0
1986(a)	152	6954	40.6	7.0	140.60	73.4
1987(a)	138	6962	42.0	7.2	160.10	51.5
1988(a)	130	6912	43.8	7.4	188.84	60.0

(a) Including Northern Ireland societies

Table 2: Building societies - Degree of concentration 1930-88

Per cent

Year	Share of total assets of the largest 20 societies				
	Largest 5	Next 5	Largest 10	Next 10	Largest 20
1930	39.1	14.3	53.4	11.3	65.0
1940	38.0	12.3	50.3	10.4	60.7
1950	37.3	11.5	48.9	13.6	62.5
1955	40.5	11.4	51.9	12.5	64.4
1960	45.3	11.6	56.9	11.7	68.6
1965	47.1	14.2	61.3	12.4	73.7
1970	50.1	14.2	64.3	13.1	77.4
1975	52.9	15.3	68.2	14.2	82.3
1980	55.4	15.7	71.1	13.3	84.4
1981	55.1	15.6	70.7	14.2	84.9
1982	55.7	17.4	73.1	13.3	86.4
1983	55.7	17.6	73.3	13.8	87.1
1984	56.3	17.2	73.6	14.1	87.7
1985	56.6	19.9	76.4	12.2	88.6
1986(a)	56.8	19.8	76.6	12.6	89.2
1987(a)	60.8	18.5	79.3	10.6	89.9
1988(a)	62.5	18.2	80.7	10.1	90.8

(a) including Northern Ireland societies

STATEMENTS BY THE ECONOMIC SECRETARY TO THE TREASURY (MR IAN STEWART)
ON THE FUTURE OF BUILDING SOCIETIES AND THE 1986 ACT:

1, BUILDING SOCIETIES BILL : COMMONS 2nd READING

a) General;

" The main purpose of the legislation before the House today is to enable them to continue to develop and prosper in a world which has changed a great deal since the societies came into being at the end of the 18th century."

" In today's fast-changing markets, societies need to be able to offer a wide range of facilities to an increasingly sophisticated public if they are to continue to compete effectively. New technology and greater customer awareness are posing a new challenge for all financial institutions, but I believe that, by allowing the societies more scope, we will not only enable them to develop their business but will bring extra healthy competition into housing and finance."

b) On mutuality and constitutional provisions;

" Throughout their existence, the constitution of building societies has been based on mutual ownership. This Bill is based on the principle that as long as the members of a society so wish, its mutual status should continue."

2, BUILDING SOCIETIES BILL : COMMITTEE STAGE

a) On merger provisions;

" The reason for having a provision of this kind in the Bill is that we believe in mutuality. We believe that the members of building societies have rights and that they should not be frustrated or obstructed by a board that is not prepared to consider their interests. Those are the underlying reasons why we felt that these provisions should be included in the Bill."

The hon. Gentleman said that this would lead to mergers for the wrong reasons. It is designed specifically to encourage mergers for the right reasons and to make mergers for the wrong reasons more difficult.

The reason why I say that is that this is to enable the members of smaller building societies to know of alternatives to their being gobbled up by the majors. In some cases a takeover by a large society of a small one may be in everyone's best interests—it may not be necessarily or intrinsically bad—but I am concerned that we should be able to preserve the local and regional aspects of the building society movement and should encourage the smaller societies, if they want or need to, to link with each other and not be forced into the hands of the larger societies."

(CONTD.)

b) On Conversion ;

I do not want to spend too long on the history of this matter. However, I have been told that it was dreamt up by the Treasury. I have pointed out that it has a longer history and that originally this idea was initiated by the Building Societies Association. I accept the hon. Lady's point that in its latest form the association is not quite so enthusiastic about the idea as it was originally, but that does not mean that the BSA believes that this route should not be open at all. I find myself very much in agreement with the Building Societies Association about this.

I do not think that our proposals are likely to lead to any great rush to conversion. Indeed, I should not have wanted them to be formulated in the way in which they are formulated if that had been the likely consequence. However, I agree with the right hon. Member for Halton and with the Building Societies Association in its note to hon. Members that this is not an option that many societies will want to consider.

In some quarters I have been strongly criticised for making the requirements far too difficult. In other quarters I have been criticised for apparently making it possible for a mad rush to take place by the whole of the building society movement towards conversion. My view is that the truth, as is so often the case, lies in between the two, and that the proposals that we have put forward are realistic. They are not permissive, in the sense that they make it easy for members of building societies to take the decision to convert. At the same time, they are not unattainable.

The hon. Member for Thurrock (Dr. McDonald) suggested that I might have some prejudice against mutual status. That is certainly not the case. And the hon. Member for Maryhill asked how these proposals would strengthen the building society movement. I have the same respect for the building society movement as he has. I appreciate the qualities of loyalty and the traditions that have given the building society movement its strength. I do not wish to dismantle all that. Certainly I do not want an Act that I have taken through this House to be on the statute book which would lead to such a consequence. There are many provisions in the Bill which strengthen the concept of mutuality. I do not intend to rehearse them now, but they give members a greater opportunity to take part in the affairs of building societies. They also give members better opportunities to vote on issues than they have ever had under the existing legislation. Therefore I do not think that I can fairly be accused of doing anything to dismantle the mutual principle. Indeed, I hope that we have given it a new strength and a new lease of life."

A "TAKE-OVER" CODE**Background**

1. The merchant banks, and some management consultants, are actively seeking to stimulate take-over business. This has already caused some concern among building societies and interest among potential bidders. Much of this concern and interest appears to be ill-informed. The risk is that all this activity could have a destabilising effect, either in relation to a particular society or the industry generally.

2. The City take-over code is a voluntary arrangement observed by companies having a common interest in orderly bidding arrangements; any company may at one time or another be either a bidder or a target. The City Code is concerned essentially with ensuring that full information is provided to all interested parties.

3. For building societies there is not the same common interest between bidders and targets to sustain a voluntary code. On the other hand, there would be some backing from the regulators' statutory powers: approval of the transfer statement; and, authorisation under the Banking Act 1987. Moreover, the statutory transfer statement must provide disclosure of all material information to all interested parties (society members entitled to vote) as in the City take-over code.

Features of a Code of Conduct

4. The following main headings are for consideration:

(a) to apply to (be observed by):

(i) merchant banks, stockbrokers,
financial and other professional
advisers;

- (ii) bidders, and their associates;
 - (iii) building societies, and their directors and officers;
- (b) the interests of society shareholders and depositors and borrowing members to be protected;
 - (c) the financial stability of building societies generally to be preserved;
 - (d) the Commission and Bank of England to be informed and consulted at an early stage, and in any event well before any public statement is issued;
 - (e) proposals for distributions of cash, shares or other rights to members to be confirmed as lawful before any public statement is made;
 - (f) confirmation to be obtained from the Bank of England that it is minded to authorise, or continue to authorise, the successor company before any public statement is made;
 - (g) any public statements, to members or otherwise, to avoid partial or potentially misleading "information", and to identify who is responsible for making them;

and some questions to consider in developing the Code

- (h) how can we prevent spoiling tactics - eg counter-bids from people who do not intend to buy? Are there any sanctions which the Commission or Bank could apply?
- (i) should we take a view on multiple approaches by potential acquirers to many societies with the purpose of targetting only one?

Note: the Commission will apply a parallel code to building society bids for other societies.

**PROCEDURES AND RESTRICTIONS CONCERNING
THE TRANSFER OF THE BUSINESS OF A BUILDING SOCIETY
TO AN EXISTING COMPANY**

In using the conventional terms 'takeover' and 'bid', it needs to be emphasised that in applying them to a building society a radically different process is involved from a takeover of a company. In that case it leads to a change of ownership of the company's share capital while the company continues in existence with the same business and assets as before. A 'takeover' of a building society by an independantly owned company can only be achieved in accordance with the provisions and procedures laid down in the Building Societies Act and the regulations made under it and it involves the transfer of the assets and liabilities of the society to the successor company by operation of law under the statutory provisions and the society itself ceasing to exist. Investing and borrowing members of a society are not 'bought out' for cash or investments in the successor company: they combine as debtors and creditors of the successor company's banking business. The Commission is involved in two stages of the statutory procedure: approval of the Transfer Statement sent to members prior to voting on the relevant resolution, and subsequently approving the formal transfer.

The provisions in the Building Societies Act 1986 which govern the transfer of the business of a building society to a specially set up company or to an existing company require comprehensive, clear and accurate information to be given to members of a society about the issues on which they are to vote; they require proper conduct of that vote, and they require confirmation by the Commission that the provisions have been complied with and the vote has been properly conducted. In preparing the information, society, advisers and Commission staff have to check that the material is complete and comprehensible and consistent with audited accounts, stated future plans and relevant aspects of the law. This note considers the provisions of the Act which prescribe the procedures and restrictions to be considered by the parties to a bid. It is of relevance both to an agreed takeover and to a hostile bid.

1. The successor company

1.1 Section 97(3) provides that "The successor may be [a specially formed company] or an existing company which is to assume and conduct the society's business in its place". Section 97(12) defines a company as "a company within the meaning of the Companies Act 1985 or the Companies (Northern Ireland) Order 1986 which is a public company limited by shares", and an existing company is "a company carrying on business as a going concern on the date of the transfer agreement". Section 98(3) provides that the Commission shall not confirm the transfer if "there is a substantial risk that the successor will not become or, as the case may be, remain an authorised institution for the purposes of the Banking Act 1987". In short, the business of a building society may only be transferred to a UK registered public company which is a going concern and which is acceptable to the Bank of England. To be a going concern, it would seem that the company must be actively carrying on a business in its own right before it can acquire the business of a building society. Conversely, it would not seem possible to establish a company which would carry on no substantive business, other than employing its capital, simply as a vehicle for taking over a building society.

1.2 The successor company does not need to be an authorised bank at the time of the offer or the transfer agreement; but, it must be carrying on business (of any kind) as a going concern. Authorisation is a key criterion. A bid will not be credible unless the company has first obtained an indication from the Bank of England that it is prepared to authorise, or to continue the authorisation of, the successor company, upon transfer. As a practical matter, the Bank of England would find it difficult to authorise an institution whose business from the time of authorisation was not predominantly banking, and would require to be satisfied that the parent company (if any) as controller was fit and proper within the terms of paragraph 1 of Schedule 3 to the Banking Act 1987.

2. Cash distributions

2.1 Section 100(1) provides that (subject to the restrictions in later sub-sections) "the terms of a transfer may include provision for part of the funds of the society or its successor to be distributed among members of the society". Section 100(9)

provides that "Any distribution of funds to members of the society, except for the [mandatory bonus to investing members not entitled to vote on the transfer resolution] shall only be made to those members who held shares in the society throughout the period of two years which expired with the qualifying day; and it is unlawful for any distribution to be made in contravention of the provisions of this sub-section". "The qualifying day" is fixed by the transfer agreement and is relevant for other purposes. In his judgment in the Abbey National case (see paragraph 3.2 below) the Vice Chancellor thought that the restriction to two year members was perfectly clear in sub-section (9). No distribution of funds can, therefore, be made to borrowing members.

2.2 The funds to be distributed must be the funds of the society or of the successor company in order to fall within the scope of section 100(1): they cannot, for instance, be the funds of some third party (e.g. the successor's parent company). In any event funds made available for the purposes of the transfer by a parent company would be reflected as a liability in the successor company's balance sheet and become part of its funds for the purposes of section 100.

2.3 The term "distribution of funds" is not defined in the relevant sections of the Act. On the other hand, the term is defined in section 96(8), concerning mergers between building societies, "with reference to bonuses paid to members, includes distribution by means of a special rate of interest available to members for a limited period". It is, therefore, arguable that, since section 96 goes out of its way to extend the definition, the lack of definition in section 100 implies a narrower meaning - i.e. cash payments only. In any event anything which might be classified as a "distribution of funds" must under section 100(9) only be made to two year shareholding members. Other "distributions" by way of, for example, debt instruments, special interest to savers or borrowers, discounts on goods and services, or benefits in kind are not expressly covered by section 100(1) and it is arguable that since a society's power to transfer its business to a successor is wholly dependent on the terms of sections 97 to 101, any feature of an agreement not authorised thereby would make the transaction **ultra vires and oblige the Commission to refuse confirmation under section 98.**

2.4 Any other distribution proposals (i.e. other than cash distributions to shareholding members of two years standing) included in a transfer agreement would, therefore, probably only be allowable after a successful application for approval by the Court.

3. Share distributions

3.1 Section 100(1) only covers rights to shares in the successor company. Rights to shares in a third party (e.g. the parent company of the successor) would, for the reasons given above, seem to be excluded.

3.2 Section 100(8) provides that "Where rights are to be conferred on members of the society to acquire shares in priority to other subscribers, the right shall be restricted to those of its members who held shares in the society throughout the period of two years which expired with the qualifying day; and it is unlawful for any right in relation to shares to be conferred in contravention of this sub-section". This provision was held not to prohibit the Abbey National scheme which the High Court judged to be lawful. In his judgment in *Abbey National Building Society v. The Building Societies Commission* on 9 January 1989, the Vice Chancellor, discussing sub-section (8) remarked "It is clear that Parliament was not meaning to provide that the only members who could be given rights to shares on a transfer were two year members; sub-section (9) shows clearly that the draftsman could easily so provide if that is what he wished to achieve". Any share scheme which falls outside section 100(8) must fall within the principles of that judgment if a further reference to the Courts is to be avoided.

3.3 Any proposal to distribute shares in the successor company, would be subject to the provisions of Part IV of the Companies Act 1985 and any applicable Stock Exchange Rules.

4. Meetings and resolutions

4.1 A transfer proposal must be approved by two resolutions passed by the members of the society:

- (a) a special resolution passed by a 75% majority of the investing members voting, on which at least 50% had voted (or by the holders of not less than 90% of the total value of shares held on the voting date). See Schedule 2, paragraph 30; and
- (b) a borrowing member's resolution passed by a simple majority of those voting.

In addition, if compensation is to be paid to the directors for loss of office, that must be approved by a separate special resolution passed by a 75% majority of the investing members voting, but there is no special quorum.

4.2 Only the board of the society is capable of putting these resolutions to the members. Schedule 2, paragraph (4) specifies that the rules of a society must provide for the right of members to requisition meetings and to move resolutions at meetings, but paragraph 31 of the schedule provides only for members to move resolutions, "other than a borrowing member's resolution" at Annual General Meetings. The Act permits, and societies' rules generally provide, that members' resolutions must be proposed by at least 50 members (10 members if the society is below the qualifying asset holding of £100 million) of two years standing with a minimum shareholding of £100. [It seems evident, therefore, that only the board can move a borrowing member's resolution].

4.3 Moreover, section 97(4) provides that the transfer resolutions are for the purpose of approving the terms of the transfer as set out in a transfer agreement conditionally agreed between the society and the successor company. Only the board, representing the society as a whole, is capable of contracting such an agreement and issuing the transfer statement required by section 98(1) and Schedule 17.

4.4 It is possible, as noted in paragraph 4.2 above, for a group of members to requisition a meeting and to propose resolutions. However, since the management of the society is vested in the board of directors, (see, for example, rule 18 of the BSA model rules) and members cannot move transfer resolutions as such, it appears that such resolutions in connection with a proposed transfer would have to be of a general nature.

4.5 A group of members may nominate directors to fill any vacancy which arises under sections 60 and 61 (50 members of two years standing with shares of at least £100 each) and each nominee is entitled to circulate a 200 word election address.

4.6 Also paragraph 15 of Schedule 2 provides that the Commission may direct that a member be given access to the register of members if the Commission is satisfied that it would be in the interests of the members as a whole for him to communicate with them on a subject relating to the society's affairs.

4.7 The Board of a society has at every stage the responsibility of deciding and advising its members on the future of the society. It has to consider all the circumstances including the terms of the resolution and the amount of support it received in the context of all other relevant factors.

5. Counter bids

5.1 The Act does not prevent a company from making a bid for a society, whether or not the society has announced its intention to convert either by the specially formed or the existing company routes. Any such offer received before the issue of the transfer statement must be reported in that statement - see regulation 3(3) and (4) of the Transfer of Business Regulations (SI 1988/1153).

6. Section 22

6.1 This section of the Building Societies Act imposes direct responsibility on societies for the liabilities of their subsidiaries and of certain associated bodies. A society receiving a takeover approach has to consider the effect a takeover may have on the standing and business interests of such companies.
