P.O - CH /NL/0252

PART A

Chex
Lawson

PART A

SECRET

(Circulate under cover and
notify REGISTRY of movement)

PO -CH /NL/0252

PART A

CHANCELLOR'S PAPERS ON
THE BUILDING SOCIETIES

DD: 25 years

27/9/95

Begins: 8/5/87

Ends: 29/1/88 (CONTINUED)

PO -CH /NL/0252 PART A

Inland Revenue

Policy Division
Somerset House

BY FAX

FROM : B O'CONNOR
8 May 1987

cc. Mr Haigh

Mr Kuczys

MORTGAGE INTEREST TAX RELIEF

You asked for comments on the brief attached to your note of 8 May to Miss Sinclair.

Suggested Answer

It might be preferable to quote the most recent statement of the Prime Minister viz:

> "Conservative party and Government are now the only people who do not want to limit in any way the present system of mortgage interest tax relief for home buyers" (Hansard 5 February 1987 col 1139).

Background

The first two paragraphs are not entirely accurate. I suggest the following with alternatives in square brackets:

> Tax relief is helping 8.4 million [nearly 8.5 million] people to buy their homes. 40 per cent of the beneficiaries have gross incomes of less than £12,000 a year. [More than half the beneficiaries have gross incomes of less than £15,000 a year]. The proportion of homes in Britain that are owner occupied has risen from 55 per cent in 1979 to 63 per cent now. It is Conservative policy to see that figure higher still.

Both the Opposition parties have said they will cut back on mortgage interest tax relief by confining it to the basic rate of income tax. The revenue saving would be about £340 million, making only a small contribution towards Labour's £34 billion spending plans. The revenue cost of mortgage interest relief as a whole is about £4.75 billion.

Mr Haigh has nothing to add.

B O'CONNOR

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

FROM D Y PITTS
DATE 25 JUNE 1987

FINANCIAL SECRETARY

MORTGAGE INTEREST RELIEF: HOME IMPROVEMENT LOAN ABUSE

1. We are now putting in hand, as has been reported to the PAC, the administrative action you approved to discourage abuse of interest relief for home improvement loans (paragraphs 3 to 6 of Mr O'Connor's minute below). Although there is inevitably an element of bluff in what we can do within present staffing constraints, that action should have some effect in deterring invalid claims.

2. Mr O'Connor's minute discusses the way forward in considering the further options Ministers selected for examination to tackle the problem - an estimate of tax loss for 1986/87 of £m100 has been published. A major consideration with you in selecting options was the Revenue staff cost.

---

cc Chancellor of the Exchequer
Chief Secretary
Economic Secretary
Sir P Middleton
Mr Cassell
Mr Peretz
Mr Scholar
Miss Sinclair
Mr Haigh
Mr Murphy
Mr Cropper
Mr Bridgeman - BSC

Chairman
Mr Isaac
Mr Painter
Mr Pollard
Mr Beighton
Mr Crawley
Mr Lawrance
Mr Pitts
Mr Lewis
Mr Davenport
Mr Whitear
Mr Marshall
Mr Bryce
Mr Yard
Mr I Stewart
Mr A C Gray
Mr O'Connor
PS/IR

3. The more radical of the options you chose - and the most effective way of curbing abuse by the minority - is to withdraw home improvement relief from everyone, or to retain it only for certain limited circumstances (paragraphs 8-13 of Mr O'Connor's minute). You will want to consider whether this would be consistent with the manifesto commitment "to retain the present mortgage tax system", and with 'jobs' and 'inner city' policies.

4. The alternative option you asked us to consider would for the first time require the lenders to play a major part in checking entitlement to tax relief in MIRAS cases and seek to shift more of the non-MIRAS cases, where relief is given by the tax office, into MIRAS. That would of course put significant administrative costs onto the lenders and complicate their lending process.

5. Either way, we assume you would act only against new loans, allowing the tax loss on existing loans to dry up as the loans are repaid. The prevention of tax loss, in 1988/89 some £m10, would build up over the next four years.

6. There is an immediate question for consideration. The abolition option is one Ministers would ordinarily want to consider much later in the year when the Budget proposals on personal tax (including anything on the MIR tax penalty on marriage) were firmer. But consultation, which you have agreed would be necessary, on the alternative option seems bound to evoke hostile reactions from the lenders. Do you want, before arousing that, to decide firmly whether or not to go for the abolition option? Unless you think having tried and - should that prove the case - failed to find a sustainable administrative option via the lenders would strengthen the case for ending relief altogether, it seems very desirable to do so (paragraph 21 of Mr O'Connor's minute). But - to allow time for consultation - that means reaching a decision in the next four or five weeks.

7. On that basis, the question to be decided now is do you want

a. (if so, presumably only after discussion with DTI and Environment Ministers) either to end the relief altogether or to go for one of the sub-options discussed by Mr O'Connor in paragraphs 9-13,

OR

b. to keep the present relief and go firmly for the 'lender' option?

8. What alternative is there to the choice in 6 above?

a. You could defer the decision in 7 until later this year. The abolition option would then still be on the cards for the 1988 Finance Bill, but the lenders option not until 1989.

b. You could wait until we can judge the effects of the administrative action we are now taking. If further action is then still needed, the abolition option could be legislated in 1989, but the lenders option not until 1990.

9. We seek your decision

a. whether to go forward as in 6 above, 8a or 8b:

b. if as in 6, on the questions in 7.

D Y PITTS

Inland Revenue

Policy Division
Somerset House

CONFIDENTIAL

FROM : B O'CONNOR
25 June 1987

1. Mr Pitts dr 25/6.

2. Financial Secretary

MORTGAGE INTEREST RELIEF : HOME IMPROVEMENT LOAN ABUSE

1. The purpose of this note is to seek early guidance on the pursuit of options for further action against abuse of improvement loan relief which might be included in the 1988 Budget.

2. Mr Kuczys' note of 27 February recorded the Chancellor's agreement to your recommendations in Mr Heywood's note of 26 February. The Chancellor suggested that the PAC option might also be kept in play.

---

cc. Chancellor
Chief Secretary
Economic Secretary
Sir P Middleton
Mr Cassell
Mr Peretz
Mr Scholar
Miss Sinclair
Mr Haigh
Mr Murphy
Mr Cropper
Mr Bridgeman BSC

Chairman
Mr Isaac
Mr Painter
Mr Pollard
Mr Beighton
Mr Crawley
Mr Lawrance
Mr Pitts
Mr Lewis
Mr Davenport
Mr Whitear
Mr Marshall
Mr Boyce
Mr Yard
Mr I Stewart
Mr Gray
Mr O'Connor
PS/IR

ACTION ALREADY TAKEN

3. The relief application forms for MIRAS and non-MIRAS loans have been redesigned on the lines agreed. Both forms will include a prominent warning about false declarations, and an instruction that receipts must be obtained for improvement work and made available to the Revenue on demand. Borrowers will also be given a copy of the completed and certified forms together with the guidance notes. At the PAC hearing on 6 May the Chairman explained these changes in detail. A copy of the relevant Minutes of Evidence is attached (Annex A).

4. Production of the forms is currently in the hands of the printers. Because of the large numbers involved HMSO have contracted the work to five separate firms. Delivery is scheduled to begin at the end of July in four weekly tranches so that all the forms will be in our hands before the end of August. Onward transmission to the lenders and distribution to their local branch offices means that it will probably be October before the new forms are in general use.

5. We are proposing to meet the representative bodies of the major lenders shortly to discuss the new forms. We shall use the opportunity to persuade lenders that they have a general responsibility (it is not spelled out in law) to ensure that borrowers are fully aware of the rules before they sign MIRAS claims. We shall also issue a guidance letter to all lenders. Some publicity is likely to be provoked and it might also be for consideration whether we should issue a Press Release.

6. Within our limited compliance resources we shall be monitoring closely the use of the new forms but it will be at least twelve months, towards the end of 1988, before we shall be able to make any valid assessment of their effectiveness.

THE OPTIONS FOR FURTHER ACTION

7. These are:-

i. Abolition of relief for improvement loans.

ii. Confining relief to loans wholly used for home improvements combined with full receipt requirement and checking of all claims.

iii. The PAC option requiring receipts with no additional checking.

ABOLITION OF RELIEF FOR IMPROVEMENT LOANS

8. This has been looked at and rejected in the past. Clearly it would effectively cure the abuse. There would also be staff savings in this Department but these would not be significant for several years if abolition were confined to new improvement loans. Abolition of relief for existing improvement loans would be difficult operationally because many such loans have been consolidated with purchase loans in the form of top-up mortgages and might no longer be identifiable. But, if identified, such consolidated loans would become "mixed" ie. only partly qualifying and, under present rules, would have to come out of MIRAS.

9. There are obvious objections to the exclusion of improvements if relief for purchase loans is to continue. At its simplest it is difficult to justify giving less relief to the borrower who purchases a dilapidated house for say £20,000 and spends £10,000 to bring it up to standard compared with the borrower who pays £30,000 for a house in good order. More generally it would remove an incentive to improve the existing housing stock particularly, for example, in the inner cities. Pressure from the environmental lobby has been to extend the relief to repairs as well as improvements. The main advantages and disadvantages were summarised by Mr Pitts in his note of 15 January to PS/Chancellor. A copy is attached (Annex B).

10. We have also considered whether something short of total abolition would be an acceptable approach in helping to reduce abuse. One possibility would be to restrict the categories of qualifying improvements to those which add to the living space. This would cover the building of extensions for grannies or extra bedrooms for growing families. It would retain equality of treatment for those who extend an existing house with those who move simply to acquire a larger home. A definition of additional habitable floor space could be devised with a minimum area equivalent to a small room but this would produce new anomalies and could not be confined to deserving cases. An extension used to house plants would qualify just as a room for granny. At the same time there would be no relief for making habitable an existing dilapidated room.

11. An alternative approach would be to limit relief to improvement loans taken out at the time of purchase or shortly after, say within one year. This would cope with the circumstances mentioned in paragraph 9. But it would discriminate against those who could not afford to undertake improvements until a later date.

12. Operationally we think the time limit approach in paragraph 11 is fairly straightforward but the extension option which discriminates between different types of work would cause problems. An arbitrary additional floor space requirement is likely to be controversial but the dimensions could be kept relatively modest. One obvious difficulty would be determining whether any associated work was really proper to the extension. But even with a flexible approach the number of qualifying loans would be reduced very substantially. A recent sample survey suggests that only about 13 per cent of relief claims for improvements relate to extensions. The types involved include loft conversions, rooms over garages, conservatories and porches as well as actual extensions. Lenders can be expected to refuse to undertake any verification beyond the borrower's word that the required additional floor space has been created. There would therefore still be scope for abuse but claims would be

substantially reduced so that we could check a much larger proportion than at present. We do not have figures available to show the proportion of improvement loans taken out at the time of purchase or shortly after but they are likely also to be a relatively small proportion of the total.

13. Distinguishing between improvement loans deserving relief and others is fraught with difficulty. Excluding obvious luxuries such as swimming pools which can qualify at present would make little difference because the numbers involved are tiny. Moreover those who do instal such features will generally already have an outstanding mortgage exceeding the £30,000 ceiling so will not get any relief. The average purchase loan in South East England now exceeds £30,000 so that if the ceiling is maintained the scope for relief on improvement loans will continue to decline. Outside the luxury categories the commonest improvement loans are for central heating and energy saving installations such as double glazing. Here it very much depends on individual circumstances whether or not relief could be regarded as deserved. Replacement of windows from motives of taste or fancy might not merit relief but the position is very different where frames have rotted and parted from the structure allowing damp to penetrate and perhaps made the particular room uninhabitable or at least expensive to keep warm.

Please see my note at the end. PW?

CONFINING RELIEF TO LOANS WHOLLY USED FOR IMPROVEMENTS AND FOR WHICH RECEIPTS PRODUCED

14. This option (numbered 3.6) was described in paragraphs 20-22, 33, 43 lines 1-7, and 49, of my note of 19 February. Paragraphs 37 and 39 are also relevant. It consists of two requirements. Firstly borrowers would be required to produce receipts either before any relief was allowed or, after a provisional allowance, within say nine months of obtaining an improvement loan. MIRAS lenders (and tax districts in the case of non-MIRAS qualifying loans) would be required to chase receipts and check that they were in order. Secondly the law would be changed so that interest on new loans would qualify for relief only if the loan was wholly applied to financing improvement work.

15. So-called mixed loans, that is loans partly for a qualifying purpose (improvements) and partly for other purposes are common. Present indications are that they will increase in numbers. Building societies and other lenders are actively promoting loans for all purposes, car buying, holidays, school fees etc as well as home improvements. Interest on the part applied to home improvements qualifies for tax relief within the £30,000 ceiling. These loans are dealt with outside MIRAS. They account for about 60 per cent of the non-MIRAS qualifying loans handled in tax districts. Over 200,000 new such loans are expected in the current year and the figure could be much higher following the promotion efforts of lenders. MIRAS lenders are not prepared to deal with the relief on these loans and we do not think it would be practicable to seek to force them to do so. There would be formidable problems in calculating gross interest on the non-qualifying part and net interest on the balance particularly if the loan added to existing loans went through the £30,000 ceiling and second lenders were involved.

16. The main attraction of this option is that it would lead eventually to a significant staff saving in this Department and enable redeployment to more stringent checking. If relief were allowable only for wholly improvement loans and receipts were required in all cases we think most borrowers would ensure that the receipts matched the loan (although the receipts might be fraudulent and lenders would be unlikely to detect these). This should restrict the number of doubtful cases referred by lenders. In estimating that this option might require additional staff of 50-70 in the first full year but with a net staff saving of 130 to 150 after five years we have made certain assumptions about the numbers of cases which might be referred by lenders. But it is difficult to forecast how many contentious cases will emerge. If our assumptions prove wrong or if other behavioural changes occur the staff figures will have to be revised.

17. Implementation of this option would require legislation. More controversially it would require lenders to change their commercial practices and increase administration costs which no doubt would be passed on to the borrowers. An outline of the necessary changes is included at paragraph 49. of my note of 19 February. Lenders would also face substantial extra costs in obtaining and checking receipts. If this Department were to undertake this work we estimated we should need over 1,000 extra staff after five years. Even if lenders could be persuaded to make separate loans for improvements there is still the difficulty that a borrower might, for genuine reasons, take out a larger loan than proves necessary. It would therefore be identified eventually as a mixed loan and no relief would be allowable. Any allowed prior to identification would have to be clawed back. We could perhaps operate a tolerance limit but, wherever the line was drawn, there would be those who fell just the wrong side. Moreover any tolerance limit would quickly become known and would be an open invitation to excessive borrowing up to the limit.

18. As you recognized (paragraph 11 of Mr Heywood's note of 26 February) the lenders should be given ample opportunity to air their views in advance of any implementation of this option. If, therefore, legislation is envisaged for 1988 we need to set up the consultation process fairly quickly. There are nearly 1800 prescribed MIRAS lenders and a few outside the scheme. Many are quite small but with these sort of numbers we think the consultation period should run for at least three months. We therefore need to get a consultation document to them by the end of July with a view to discussions in say September to November so that results could be evaluated and decisions taken in December. This should enable the legislation to be produced in time for the 1988 Budget.

19. I think it can be confidently predicted that lenders will react strongly and consultations are likely to be acrimonious. Morever, even if the consultations are restricted to lenders, it will be impossible to keep them confidential with so many involved. We can therefore expect representations from other quarters.

PAC OPTION

20. This option did not envisage any increase in the sample checking presently undertaken. The idea was that borrowers should be required to send receipts to the lenders in support of MIRAS improvement loans. The lenders would hold the receipts. In cases selected for sample checking our compliance unit would then obtain the receipts from the lenders. As explained in paragraph 42. of my note of 19 February we think this option would require significant extra staff who would be engaged in a largely unproductive paperchase. In any event we hope that the new forms with their requirement to obtain and keep receipts largely subsumes this option. The only difference is that the receipts will be held by the borrower rather than the lender until such time as we might call for them if the particular claim is selected for checking. We recommend no further pursuit of this option.

POINTS FOR DECISION

21. If it is intended to abolish relief for improvement loans or to restrict it severely to say extensions it would be inappropriate to open consultations about mixed loans with lenders with a view to persuading them to make expensive alterations to their commercial practices. There would clearly be no point in seeking to outlaw mixed loans if relief for all improvement loans was then to be withdrawn. Lenders who are, at best, likely to be ill disposed would be outraged if this happened. But if the mixed loan option is to run for 1988 we need early authority to open consultations.

22. An alternative approach would be to defer further consideration until the effect of the new forms can be evaluated.

23. As mentioned in paragraph 13, it is also important to have regard to the impact of the ceiling on improvement loans. If it is maintained at £30,000 and there are no behavioural changes the scope for obtaining relievable improvement loans will decline.

It is not clear to what extent this factor - which reduces the scope for invalid claims also - will offset what may otherwise be an increasing trend in abuse. RB

During the current year the number of mortgages over the limit is expected to increase from about 850,000 to 1.3 million. On the other hand any increase in the ceiling would create the opportunity for a significant rise in relievable improvement loans taken out by the large number of borrowers with £30,000 mortgages.

B O'CONNOR

Ending home improvement relief (for new loans) altogether may, on reflection, seem too drastic. So we looked to see if there was a way of sugaring the pill. Simply to exclude some "less deserving" cases, such as swimming pools, would not make a significant contribution to the problem of abuse. The other two options considered - extending living space (to preserve some parity with buying a bigger house) and improvements soon, say within one year, after purchase (as being roughly on a par with a purchase) rank against the relevant criteria -

a. a defensible dividing line? Both would leave arguably equally deserving cases without tax relief, but on the basis that a line has to be drawn somewhere, there is a case for either, but more especially for 'extensions':

b. workable? Yes, but 'extensions' less so - it would throw up some messy cases:

c. curb the abuse? So long as 'improvement' relief still exists, people will be able to sign claims which are invalid in whole or in part. But severely limiting the scope of the relief can in practice be expected to reduce significantly the number who do so. Hard to say which option would have the larger effect, but possibly the 'one-year' rule.

D Y PITTS

ANNEX A

[Chairman *Contd.*]

little time in a situation in which the recruits exceed the wastage; not by very many but by a few. Even a loss of 70 inspectors is a very serious problem because these are experienced people who have been through a long period of training and to replace them in terms of headcounts by new recruits still leaves us deficient in terms of experience. Nevertheless the recruitment figures are encouraging. We have also looked at two other particular areas, first of all some reorganisation of work within tax offices between the fully trained inspector, the man who takes five years to become fully effective after training, and the non-fully trained inspector, whose training period is much less than that. By some marginal adjustments between the two we hope to be able to move work from the fully trained inspector to the non-fully trained and therefore make better use of our fully trained inspector. We have also given considerable thought to the London problem which I mentioned just now. The fact is that we do find that the threat of a move to London on the part of a provincial inspector can very oftem precipitate the loss of that man. It is to do with factors that we are all familiar with: the very high cost of housing in London and the South East compared with some parts of the provinces. We think that part of the answer there lies in a thorough review of the rules for removal expenses. We have spoken to the Treasury about this; I know they have it under active consideration and I believe they are at the present time discussing proposals with the trade unions. Finally, on some more minor things but nevertheless they have a part to play, we are at the moment introducing a domestic re-instatement scheme in the Revenue which will apply right across the grades but will be particularly important for inspectors. If you have spent a long time and a lot of money training someone—I am talking particularly now about some of our lady inspectors—and they need a break for domestic reasons, to have a family, it is important for us to try to keep in touch with them and ease their path back into the department subsequently if they choose to return to their career. This domestic re-instatement will help a little. Those are the main things that we have done.

2218. Of course there has been a fall in the number of investigations. What effect do you see upon your recruitment policies and your recruitment actions on this fall in investigations?

(Mr Battishill) It is part of the general problem. Yes, there has been a small fallback in our investigation coverage, particularly of the self-employed population though I have to say that the percentage figures do conceal movements in the underlying base which are very significant indeed. It is true that our coverage of the self-employed has been dropping towards 2 per cent fairly consistently but that is against the background of a very very large rise indeed in the size of the Schedule D population. Over the last five years or so I believe that there has been something like a 30 per cent increase in the number of self-employed taxpayers. To keep pace with that and train inspectors of sufficient number is an increasingly difficult problem. What it really does is to reinforce the points I was making a moment or two ago that we need to recruit fully trained inspectors who deal with the investigation of companies and we also need to keep up our recruitment and promotion of non-fully trained inspectors who are largely the cadre of staff who deal with the self-employed population.

2219. Can I now turn to the Treasury Minute on LAPRAS/MIRAS. Paragraph 32 of this says that your estimate of tax loss on the whole field of home improvement loans is estimated at £100 million for 1986–87. Have you examined the reasons in detail for this loss?

(Mr Battishill) Yes, we have, because the figure is very much higher by a factor of 20 times than the figure of £4–£5 million which was included in the report from this Committee the last time the subject was looked at, but those two figures are not directly comparable. There are several reasons for this. The figure of £4–£5 million was made in 1984 and was specifically limited to only one category of home improvement loans within the MIRAS system, these were loans from second lenders, usually not a building society. The reason we looked at those loans in the first instance was because we thought that second loans would be the area most likely to be at risk of abuse. The latest figure of £100 million covers the whole field of home improvement loans: those within MIRAS and those outside MIRAS, those with second lenders and those with first lenders as well. If we had extended the £4–£5 million figure to cover all categories of home improvement loan, we think that the figure of £4–£5 million which was quoted in the earlier report from this Committee would probably have been in the region of about £17 million. How does one therefore build up from £17 million to £100 million? Again there are several factors. Since the original exercise we have discovered that there has been an increase in the average size of home improvement loan, the more recent exercise has also shown that building society loans for home improvements tend to have a longer life and so a larger size of loan plus a longer life plus, I have to say, in the latest exercise, a higher incidence of abuse. Those three factors cumulate on the wider base to give us a total figure which would be closer to £90 million. Over and above that, to get to the last £10 million, that is simply a feature of growth. Since the earlier exercise our best estimates are that the total number of home improvement loans has probably gone up by something like 15 per cent. I am afraid that is a rather complicated explanation but I felt that it was only right to take the Committee through the various steps which have got us from a figure of £5 million for a very limited sample, which relates only to that sample, to £100 million, which is our best estimate, though admittedly subject to margins of error for the whole home improvement population.

2220. This Committee took evidence last year and total tax relieve on home improvement loans was then estimated at between £250 and £500 million. The level of tax losses indicates then a level

[Chairman *Contd.*]

of abuse of between 20 and 40 per cent. What are you doing to reduce this level of tax loss?

(Mr Battishill) We would put the estimate of the total now at £500 million, the higher of those two figures. Yes, as a matter of arithmetic, the £100 million potential loss is about 20 per cent abuse rate. We have been looking at this very very carefully, particularly in the light of this Committee's report. We have done several things over the last year or two and we have some more in mind. First of all, we have centralised all our compliance checking of MIRAS loans in a single office in Bootle where we have specialist staff who are concentrating on this kind of work. We think that is a better approach than spreading this kind of compliance activity right across our whole district network. We have got 21 staff there who are specially trained to examine a structured sample of what we now designate high risk home improvement loans. Those staff are focusing entirely on that kind of work. We have got an improved coverage of the structured sample that we take each year. We now look not only at high risk high value improvement loans but we have also now taken a sample of high risk lower value improvement loans because we feel it is necessary to spread our coverage. Finally, we have decided to re-design the form which taxpayers use to claim tax relief on a home improvement loan. This is rather important because the re-design of the form and the procedures that go with it will enable us to do several things. Firstly, we shall be able to include a clear warning about the penalties of making a false declaration. Tax payers must be in no doubt about the seriousness of making a false claim of this kind. Secondly, and this picks up a theme which the Committee themselves looked at, we shall make it clear on the face of the form that receipts for home improvement loans must be obtained by borrowers and they must be kept and made available on demand to the Revenue. Thirdly, and this is the first time this will have happened, we shall arrange for the lenders to provide the borrowers with a copy of the forms that they have signed to keep with those receipts because it seems to us that with the level of abuse that has been revealed it is important that borrowers, having signed an important document, should then get a copy of it to remind them of the seriousness of the document they have signed. At the same time as we issue the new forms, which we hope will be in the summer, we shall have discussions with the lenders and remind them both of the importance of the documentation and therefore the importance of ensuring that their own staff bring to the notice of the borrowers the importance of their act of signing. We feel that with this combination of changes we shall be able to bring home to those who are borrowing for home improvement what their obligations are in a way that perhaps the existing documentation has not quite achieved.

2221. Thank you for that. I have a couple more questions I should like to ask: first about the Keith Committee's recommendations mentioned in paragraphs 21 and 24. Do you have any comments on the length of time it is taking to get these into effect?

(Mr Battishill) It is no more than a reflection of the sheer size of the task that Lord Keith's Committee identified. In the income tax, capital gains tax and corporation tax field alone he produced a list of 99 recommendations. Ministers have felt that with a task of that size it is only right that there should be a very full period of consultation and that implementation of those recommendations after consultation should be phased over a period. The first and important stage of that process is taking place at the moment in the Finance Bill with those priority items which the Government recognised in the consultative document last year. We still have until December for people to let us have their views on the remainder of those recommendations. It is just simply the size of the task.

2222. Paragraph 33 of the C&AG's report on the Appropriation Accounts deals with the composite rate arrangements which I gather is not going to be properly done until 1989–90. Have you made any calculation of how much it is costing us or the level of risk of incorrect calculation?

(Mr Battishill) It is true that the composite rate will not reflect until that year a survey of investors in all the institutions to which the composite rate now applies. It will not, until that date, reflect the circumstances of investors in bank deposits or local authority accounts; it will in fact be based on an existing survey of building society depositors, that is certainly true. Because we do not yet have a survey of those other two groups, it is in fact impossible for me to answer your question. Until we have the next survey we simply do not have the factual information on which to judge whether arithmetically the composite rate is exactly right, a fraction high or a fraction low, reflecting the whole population of investors. I have to say we have no reason to think that basing the rate on the existing sample of building society investors will cause the composite rate to be significantly higher or lower. I say that because of two facts. First of all, 85 per cent of all the interest that we are talking about, subject to the composite rate, is paid by the building societies in the first place, so it is only the last 15 per cent which is not reflected in the current survey. Secondly, something approaching 50 per cent of building society account holders in a recent survey were shown also to hold money on deposit with the banks. So 50 per cent of this survey were common to both classes anyway. When one takes those two factors together it is probably unlikely that the composite rate would vary very much one way or the other if we had the full survey.

Sir Michael Shaw

2223. Earlier on the staff question you referred to the fact that a threat of a move to London could sometimes cause wastage in itself. Is there the opposite, namely is it helpful to retain staff if you offer them the chance to move out of London?

(Mr Battishill) Sometimes it is and sometimes it is not. If we move large blocks of work and the staff that go with them out of London then the prospects

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

ANNEX B

FROM D Y PITTS
DATE 15 JANUARY 1987

1. MR PAINTER 15/1 Comment at end.

2. PS/CHANCELLOR

IMPROVEMENT LOAN: MIR

1. You asked for quick views on the possibility of ending tax relief for home improvement loans.

2. Context To curb abuse by calling for evidence in every case is costly. The cost may be justified by its reducing a tax loss, but it will be difficult to make the lenders' bear their cost; and the Revenue cost has to be authorised and provided. Against that background, I had suggested the PAC suggestion be seen against a range of options, at one end of which was ending relief altogether. (This was looked at in 1983/4. VAT was then being introducted for alterations.)

---

cc ~~Chancellor of the Exchequer~~
Financial Secretary → Chief Secretary
Economic Secretary
Sir P Middleton
Mr Cassell
Mr Bridgeman
Mr Peretz
Mr Hall
Mr Scholar
Mr Cropper
Mr Battishill
Mr Painter
Mr Pollard
Mr Beighton
Mr Lawrance
Mr Pitts
Mr Davenport
Mr O'Connor
Mr Whitear
Mr Gray
PS/IR

3. Advantages would include:-

a. it would remove scandal of the overt abuse (though some would be able to borrow more for house purchase in lieu):

b. a step towards reducing subsidies for owner-occupation:

c. help moderate increase in consumer credit:

d. yield revenue/reduce the cost of MIR:

e. modest contribution to simplifying the tax system.

4. Disadvantages:-

a. overkill as a reaction to abuse by a minority:

b. harmful to the building industry:

c. contrary to policy of keeping housing stock in good shape:

d. against grain of Ministerial commitments to keeping MIR:

e. little practical difference between buying a house in good condition and buying one in bad and doing it up (though Mr Ross Goobey suggests dealing with the latter through a housing grants system).

If, as seems inevitable given the procedural difficulties of drawing a line, the withdrawal of relief applied to extensions as well as "improvement", the change would arguably introduce a new distortion between extending and moving to a bigger house. It would establish substantial costs eg for the growing family, forced

D Y PITTS

ps3/1K

SECRET AND PERSONAL

NOTE OF A MEETING HELD IN HM TREASURY ON TUESDAY, 30 JUNE

Those present:

Chancellor
Financial Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mr Cropper

Mr Battishill - IR
Mr Isaac - IR

1988 BUDGET: TAX REFORMS

Paper: Mr Isaac of 22 June

The Chancellor said he was most grateful for Mr Isaac's paper, which was very helpful. Following this discussion, he would be grateful for a further paper. He stressed the importance of maintaining the security of these proposals.

2. Introducing his paper, Mr Isaac said he thought there were three areas to be looked at. First, the special reliefs that went hand in hand with high marginal rates (eg farmers' averaging). Second, the whole range of tax shelters, including those which he would not expect the Chancellor to want to curtail (BES, PEPs) and ones that certainly ought to be looked at (treatment of forestry, maintenance payments, Schedule E receipts basis, treatment of non-residents). Third, the differences in tax treatment of different forms of income and capital. It would not be practicable to take action on all of these in 1988. But it might be worth floating some ideas in the 1988 Budget. Officials would welcome guidance from the Chancellor on how far to pursue all this.

3. The Chancellor said that he would want to legislate for as much as possible of any reform in the 1988 Finance Bill. It was far preferable to introduce an overall reform package then, than to have a number of possibly controversial items hanging on until future years. In choosing from the menu which Mr Isaac had presented, we had to decide priorities - the constraints included resources in the Inland Revenue, and how much political capital would be used up on particular proposals. The meeting then considered a number of particular items in turn.

Mortgage interest relief

4. The Chancellor recorded the position agreed with the Prime Minister. Mortgage interest relief would continue at full marginal rates against the first tranche of interest - for the time being the interest on the first £30,000, although this could be reviewed. Some changes, such as putting the relief on a residence basis, or denying relief for home improvements, were still available as options.

Benefits in kind

5. The Chancellor said that this was an obvious area in which to take action. One option was to increase the charge on car benefits by more than 10 per cent. He wondered whether there was scope for attacking other perks, such as cheap loans. Mr Isaac argued that there was no tax advantage in the case of subsidised loans, and Mr Battishill said that what was needed there was improved compliance, not a change in the legislation.

6. The Financial Secretary noted that the fall in the real value of the £8,500 threshold had led to some rather trivial benefits being pursued by the Revenue. Mr Isaac said that trivial cases usually only arose as part of a larger investigation. The Chancellor, however, said that this was an area which was creating increasing friction with taxpayers. He asked the Revenue to look again at cost-effectiveness in this field. (One option might be a de minimis rule).

7. Nonetheless, the Chancellor did want to take the opportunity to improve the effectiveness of the tax system in relation to high value perks of top earners. Mr Battishill agreed that this was a problem which would need to be addressed in any case, as a result of the proposed UEL change, which would tend to reinforce the trend towards payment in kind at the top end. The Chancellor noted one conflict of objectives: the Government wanted to encourage employee share schemes. Any action taken should not discourage genuine use of employee trusts.

Taxation of savings

8. Mr Battishill pointed out that the reduction of top marginal rates would reduce the attractiveness of, for example, the BES. The Chancellor accepted that if, as a result, use of the scheme tailed off, there might be a case for bringing it to an end. But that was not a matter for the 1988 Budget.

9. The Financial Secretary wondered if there was a case for looking again at the taxation of different forms of savings, to achieve a more level playing field. It was noted, however, that the Green Paper undertaking meant that we were effectively confined to "levelling up". Sir P Middleton said we were already looking at financial services, and were about to announce a review of the tax treatment of life assurance.

10. The Chancellor had hoped that the review of the tax treatment of life assurance would be completed in time for the 1988 Budget. Mr Battishill, however, explained that this would not be possible. Although the 30 per cent rate of tax on policyholders' gains would be a clear anomaly, the position could be justified as a holding action until the tax regime for life assurance more generally was changed. Moreover, there were precedents in this area - the so-called "pegged rate". The Chancellor reluctantly accepted that further change would not be possible in 1988. And given the need to get the present Finance Bill through very quickly, it was not

feasible to enact the 35 per cent rate, as proposed in the Budget, in the present Finance Bill.

Corporation tax

11. The Chancellor said that we would come under increasing pressure from the CBI and others to reduce the main rate of Corporation tax, as the yield continued to increase. He asked for a note from the Revenue showing how the corporate sector would benefit from the Corporation tax reforms, as the cash flow effects worked through fully.

Conclusions

12. There was already a very heavy Finance Bill in prospect for 1988. For that reason, it might turn out that we only tackled a small number of items from the programme Mr Isaac had put forward. In particular, the general review of the tax treatment of savings was on a slower time track. Nonetheless, the Chancellor looked forward to receiving Mr Isaac's further paper.

A W KUCZYS

Circulation

Those present
Chief Secretary
Paymaster General
Economic Secretary
Mr Tyrie

745/102

SECRET

FROM: ROBERT CULPIN
DATE: 17 JULY 1987

CHANCELLOR

PRAYERS - BUILDING SOCIETY CREDIT CARDS

I happened, this morning, to discover that we are about to allow Building Societies to issue credit cards. I see the logic, but am concerned about the timing.

2. On Monday we have high bank lending and buoyant consumption (retail sales); on Wednesday high imports. It could be candy floss week. (And that is without counting selling more silver - BP on Tuesday - or releasing some brakes on the public sector - Thursday.)

3. Plastic money for Building Societies won't help.

4. I am persuaded that deferring the announcement would probably cause as much trouble as making it. But we must bury it, and imply that it follows obviously from the Building Societies Act. Do you think you could ask the Economic Secretary to put some effort into making it as boring, technical and inconspicuous as possible?

ROBERT CULPIN

SECRET

3361/48

CONFIDENTIAL

FROM: J J HEYWOOD
DATE: 3 August 1987

MR JOHNS IR

cc PS/Chancellor
Mr Scholar
Mr Murphy
Mr Cropper
Mr O'Connor IR
PS/IR

MORTGAGE INTEREST RELIEF: HOME IMPROVEMENT LOAN ABUSE

You asked me whether the Financial Secretary had decided yet how to proceed on this front, following Mr Pitts' minute of 25 June.

2. The Financial Secretary has decided that there should be no legislation in 1988, since he feels that we should wait until we can judge the effects of the administrative action currently in hand before deciding whether legislation is necessary. Nevertheless, he would like to have a further meeting in September to discuss the "lenders option" in more detail. His initial reaction was that this must be the front-runner for future action.

J.H.

JEREMY HEYWOOD
Private Secretary

Look urgently @ ~~[illegible]~~ confining MIR on home improvements to those improvements wh. receive mandatory HI grant.

N.

TCM
FST's office

Ch.

Home Improvement Loan Abuse

Sorry to bother you with these pps. again. The FST debriefed to his office, but their records seem garbled, and the FST's recollection is now unclear.

Do you want:

(i) officials to work up a scheme for 1988 which withdraws MIR for home improvements to home improvement grant recipients;

(ii) to leave matters as they are (i.e. no legislation in 1988;

(iii) to do something else?

JK 15/9

pup

Ch

One of the post-holiday tasks you asked me to pursue was where we were on withdrawal of MIR on home improvements

Attached papers (sorry you weren't shown them before) seem to show FST ruling this out in 1988, but Michael Schluter says FST is not as committed as that

I have spoken to him re.

AA

Inland Revenue

Policy Division
Somerset House

CONFIDENTIAL

FROM B O'CONNOR
17 August 1987

This is a welcome move by the B.S.A. MAY 17/8

1. Mr Johns

2. Financial Secretary

MORTGAGE INTEREST RELIEF : HOME IMPROVEMENT LOAN ABUSE

1. We note from Mr Heywood's minute of 3 August that there should be no legislation in 1988 but you wish to have a further meeting in September. We shall, of course, be ready to attend.

2. Meanwhile you might wish to be aware of the progress we are making with the introduction of the new MIRAS forms as mentioned in paragraphs 3 to 6 of my note of 25 June. We are now receiving these forms in batches from the printers and arranging onward delivery to the various lending organisations. We have also held meetings with the representative bodies of several of these organisations.

3. In the case of the Building Societies Association, whose members have by far the largest share of the home mortgage market, we are pleased to say they have taken a responsible and cooperative attitude. They have just issued a circular (copy attached) to their members in tough, uncompromising terms. The general tone is set in paragraph 2 and emphasised in the concluding paragraph 19. We must hope that it has the desired impact on the individual building societies and their borrowers.

B O'CONNOR

cc. PS/Chancellor
Mr Scholar
Mr Murphy
Mr Cropper
Mr Painter
Mr Pollard
Mr Johns
Mr Davenport
Mr Whitear
Mr A C Gray
Mr O'Connor
PS/IR

THE BUILDING SOCIETIES ASSOCIATION
3 Savile Row London W1X 1AF
Telephone: 01-437 0655 Fax: 01-734 6416 Telex: 24538 BSA G.

Restricted

Circular No 3621 13 August 1987

MORTGAGE INTEREST RELIEF AT SOURCE - MEASURES TO CURB ABUSE OF TAX RELIEF

Introduction

1. Parliament, the Government and the Inland Revenue have all been increasingly concerned at the extent to which tax relief under the mortgage interest relief at source (MIRAS) arrangements is being claimed for interest on loans not applied for a qualifying purpose (ie for the purchase or improvement of an only or main residence). Of particular concern are further advances and other loans ostensibly for home improvements, and re-mortgages.

2. The Association emphasises that this matter is being taken extremely seriously. In view of information provided by the Inland Revenue, and referred to in this Circular, it is clear that urgent and serious action is required by many societies (and other lenders) to make their administration procedures adequate to ensure that the law is complied with at all times. In particular, societies should ensure that all relevant staff are fully aware of the obligation on their society to inform the Inland Revenue if there is any reason to believe that a false claim for relief has been made, and of the consequences for the society of not so doing.

3. This Circular sets out the background to the present position and gives details of -

(a) action taken by the Inland Revenue - the introduction of a new version of the MIRAS declaration form (Miras 70), and

(b) action which the Inland Revenue expects all lenders to take - a tightening up of internal instructions and procedures,

in order that the level of false claims be substantially reduced.

House of Commons Committee of Public Accounts

4. In a report (389) issued in December 1986 the House of Commons Committee of Public Accounts took evidence from the Inland Revenue on the basis of an earlier report (HC358) by the National Audit Office (NAO) which had examined the Inland Revenue's implementation of the MIRAS arrangements. The NAO report had explained the ways in which the Inland Revenue verified MIRAS reimbursement claims by lenders. It revealed that although all borrowers' declarations (forms Miras 70) were checked for clerical errors or omissions, only a very small sample was selected for detailed investigation of eligibility. In 1984-85 the sample was 32,000 certificates out of 2.3 million (1.4%).

Proportionately larger samples were taken from what were termed "high risk loans", ie home improvement loans. In a special exercise carried out in 1984, 11.6% of the home improvement loans (ie separate loans ostensibly for home improvements, not including further advances on existing mortgages) were identified as prima facie ineligible for MIRAS. Some of these loans would have been eligible for tax relief but not through MIRAS. The Inland Revenue was extending the screening arrangements for "high risk loans" and expected this to result in a higher detection rate of ineligible loans.

5. The Public Accounts Committee recommended that the Inland Revenue should reconsider its reluctance to require mortgage borrowers for home improvements to confirm their eligibility for mortgage interest relief by supplying receipts for the work carried out. The Inland Revenue has taken note of the Association's view that a requirement for receipts to be supplied by borrowers, and retained by lenders for possible inspection, would result in too many practical administrative difficulties.

6. In June 1987 the House of Commons Committee of Public Accounts issued a further report (357 - i) of evidence taken from the Chairman of the Board of Inland Revenue on, inter alia, MIRAS. In his evidence the Chairman explained that the tax loss on wrongful claims to relief for interest on the whole field of home improvement loans (both within and outside MIRAS) was estimated at £100 million for 1986-87. This estimate was based on a more thorough sample and was many times higher than earlier estimates made by the Inland Revenue. Since the total amount of tax relief on home improvement loans was estimated at £500 million, this put the level of abuse at about 20%. Not surprisingly, the Committee demanded to know what the Inland Revenue were doing to reduce this level of tax abuse.

7. The Chairman explained that the Inland Revenue had taken the following action -

(a) Compliance checking of MIRAS loans had been centralised in a single office in Bootle where 21 specialist staff are concentrating on examining an improved structured sample of what are now designated "high risk home improvement loans".

(b) The declaration form for completion by the borrower (Miras 70) has been redesigned to incorporate the following major changes -

(i) a clearer warning about the penalties for making a false declaration,

(ii) a requirement for receipts to be obtained and kept by the borrower to be made available to the Inland Revenue on demand, and

(iii) a third copy of the form to be retained by the borrower as a reminder of the seriousness of the document.

(c) In conjunction with the issue of the revised declaration forms the Inland Revenue will arrange for lenders to be reminded of the importance of the documentation and therefore of ensuring that their own staff bring to the notice of borrowers the importance of what they are signing (hence this Circular).

The Chairman went on to indicate that the Inland Revenue will monitor the result of the above measures carefully because of the significant scale of the tax loss involved. He said that if these measures do not prove entirely satisfactory "we shall have to think again". The Inland Revenue has not to date instigated any proceedings for MIRAS offences. On this subject the Chairman said that the Inland Revenue would always be ready to take criminal proceedings in a suitable case of flagrant abuse. He explained - "each case has to be considered on its merits and for its particular circumstances but that we would take criminal proceedings in appropriate cases for false claims must remain our policy".

Revised Declaration Form Miras 70

9. On 24 July 1987 The Central Unit wrote to all lenders explaining the introduction of the revised version of form Miras 70. A copy of that letter forms Appendix 1 to this Circular. A copy of the revised form Miras 70 is reproduced as Appendix 2 to this Circular (this may be compared with the existing form which is reproduced on pages 122 and 123 of "Taxation Aspects of MIRAS - A Technical Guide for Building Societies"). Words on the form in manuscript square brackets are printed in red. The following new points should be noted -

(a) There are three copies of the form headed respectively "Lender's copy", "Revenue's copy" and "Borrower's copy".

(b) The full address of the lender's branch is required.

(c) The borrower's tax reference includes the National Insurance number.

(d) For loans for home improvements, the borrower is required to give the date the work was/will be started/finished and the name and address of the contractor concerned. There is a prominent statement of the requirement to obtain receipts for the work done and for them to be kept for production to the Inland Revenue on demand.

(e) The warning against a false declaration is more emphatic and is made more prominent.

(f) The borrower is required to certify that the notes on the back of the form have been read and understood.

(g) Reference on the back of the form to the period within which the residence purchased must be occupied (12 months) or the improvements undertaken (6 months before or after the loan) is made more prominent.

The new version of form Miras 70 should be brought into use as soon as possible; stocks of the existing version should be destroyed.

10. The Inland Revenue has advised the Association, and representatives of other MIRAS lenders, that it is very concerned that the MIRAS administration procedures of a number of lenders have become extremely lax. The following further points concerning MIRAS procedure, and form Miras 70 in particular, are drawn to societies' attention -

(a) The form Miras 70 should be completed by the borrower as near as possible to the date the loan is made (see paragraph 11 below).

(b) Forms Miras 70 must be complete in every detail - if some information is missing from a form it is not valid and should not be accepted. The Inland Revenue will return any incomplete form to the lender. As the borrower will have a copy of the form it will now be more inconvenient to rectify any omission discovered by the Inland Revenue, since either all copies of the form will have to be amended or a new form completed. Societies should therefore ensure that all forms Miras 70 are scrutinised for completeness, and any omissions rectified, at the earliest opportunity.

(c) Once signed by the borrower, the section of form Miras 70 to be completed by the borrower must not be altered or added to by lenders without the further initialled approval of the borrower to the change.

(d) The Inland Revenue has come across cases of the Miras 70 stating an allowable purpose for the loan, only to find a different, non-allowable, purpose stated on the mortgage application form. Societies should therefore ensure that all forms Miras 70 are compared with information given on other documentation in their possession.

(e) Where the borrower is using his own labour to carry out qualifying improvements and the loan is used for the purchase of materials etc, the Association suggests that the requirement to state the "name and address of the contractor(s)" should be read as requiring the "name and address of the supplier(s)".

(f) Where there is any doubt as to the eligibility of a particular item of expenditure for relief, this must be taken up between the borrower and his tax office.

11. Paragraph 3 of The Central Unit's letter dated 24 July 1987 (see Appendix 1) states that the correct time for completion of the form Miras 70 is the time the money is actually advanced and not the time the loan application is made. The Association has asked the Inland Revenue to reconsider the wording of this paragraph since such a requirement could cause considerable administrative difficulties. For the present, the Inland Revenue has agreed that this paragraph may be treated as suggesting that the form Miras 70 should be completed by the borrower as near as possible to the time the money is actually advanced. In the case of most loans for house purchase, and many further advances for improvements, the borrower's plans will usually be clear at an early stage, and it would seem not unreasonable for the Miras 70 to be completed at or about the time the offer of advance is made, provided the borrower is reminded of the requirement to advise the society and complete a new form if plans change. On the other hand, in respect of some further advances and other loans for improvements, it may well not be possible for the borrower to fully and accurately complete the form until much nearer the time of the advance.

12. The Association has also asked the Inland Revenue to reconsider the wording of the second sentence of the unnumbered paragraph at the bottom of the first page of The Central Unit's letter dated 24 July 1987, since this might be taken to imply that the borrower is necessarily seen personally by a representative of the society at a time suitable for the completion of the form Miras 70. Especially in the case of further advances on existing loans, this may well not be the case. A society might draw borrowers' attention to the need to read and complete the form Miras 70 conscientiously, and to study the notes on the back, by way of a suitably prominent notice in its standard loan documentation.

Revised Form Miras 3

13. Where the form Miras 70 is inappropriate, for example where a loan is used only partly for a qualifying purpose or for the purchase of a property to be used as the only or main residence of a dependent relative, but a borrower may nevertheless be entitled to tax relief for all or part of the interest on the loan, the borrower may complete and submit to the Inland Revenue a form Miras 3. That form has also been revised and a copy is reproduced as Appendix 3 to this Circular.

Abuse of Tax Relief

14. In probably the great majority of cases of false claims for relief under MIRAS, the lender has no reason to suspect that such a claim is being made. However, the Inland Revenue has made it clear that the number of cases of which it is aware where the lender ought to have known that a claim was false (for example, because the stated purpose of a loan is different on the Miras 70 to the mortgage application form), or where the lender (in the form of a member of its staff) openly suggested to borrowers that false claims be made, require a thorough review of, and, in many cases, revision to, lenders' procedures and instructions to staff.

15. The Inland Revenue has quoted to the Association, and to representatives of other MIRAS lenders, examples (on an anonymous basis) of some of the cases of serious MIRAS abuse which have led it to request lenders to thoroughly review their procedures. In some of these cases the Inland Revenue probably has enough evidence to mount criminal prosecutions for fraud if it chose to do so. The effect on public confidence in a society, a member of whose staff was found guilty of assisting in defrauding the Inland Revenue, could be significant. If, as might conceivably be the case, a society itself were to be found guilty of so acting, the consequences could be severe.

Action To Be Taken by Societies

16. Societies are reminded of the statutory provisions under which they are required to take action if they have any reason to believe that a wrongful claim for MIRAS relief is being made. Extracts from paragraphs 7, 8 and 9 of Schedule 7 to the Finance Act 1982, and relevant extracts from the Inland Revenue's MIRAS Lenders booklet, are reproduced in Appendix 4 to this Circular. If a society does not hold a fully and (to the best of its knowledge and belief) correctly completed form Miras 70, then a loan cannot be within MIRAS (unless and until a society receives a form Miras 4 from the Inland Revenue). Where from a scrutiny of form Miras 70 it is apparent that an incorrect claim is being made by the borrower, the society is obliged to advise the Inland Revenue. It is not sufficient merely for the society to check that the form is fully completed.

17. Furthermore, each society should ensure that its internal administration procedures are such that all members of staff likely to come into contact with borrowers and potential borrowers are aware of the vital need to record and pass on any indication that a loan might not qualify for MIRAS, and of the potentially serious consequences for the society of not so doing. It will be appreciated that a common reaction by borrowers discovered by the Inland Revenue to be making false claims for

relief is to say that they were told by the lender's staff that, irrespective of the actual purpose of the loan, if the form Miras 70 indicated that some qualifying improvement work had been carried out, the loan would be eligible for MIRAS. A society whose internal instructions on these matters are clear, forthright and unambiguous, will be in a better position to defend itself, if necessary, against any accusations of assisting to defraud the Inland Revenue, than will a society whose procedures appear, at best, to condone the "turning of a blind eye".

Mortgage Fraud

18. The Inland Revenue has also asked the Association to remind societies that where there is reason to believe that a mortgage has been obtained fraudulently from a society, especially where it is suspected to be one of a number of linked cases, it will very often be the case that fraudulent claims to relief have been made under MIRAS. It would be very helpful to the Inland Revenue if, at an early stage in an investigation, societies could contact The Central Unit with regard to any case where a mortgage fraud involving MIRAS is suspected, in particular, where there is an intended police prosecution. It may well be the case that the Inland Revenue's own investigation section could join with the police force concerned in mounting a dual prosecution of both mortgage and MIRAS offences.

Concluding Note

19. The Inland Revenue has made it plain that it has evidence of a significant level of abuse concerning claims to relief for interest on loans ostensibly for home improvements; some of this abuse may well arise with the knowledge of building society staff. If the level of abuse is not dramatically reduced it is quite likely that criminal prosecutions will be instigated in a few well-chosen cases. Ultimately, it is possible that a continuing high level of abuse could play a major part in ensuring that the political and administrative climate moves towards changes in mortgage interest tax relief itself. The Inland Revenue will accordingly be keeping the level of abuse under constant review.

C D French

C D French
Head of Financial Policy

NOTE Member-societies are reminded that the term "Restricted" when used on a Circular means that access to it should be restricted to member-societies, and their employees and advisers, for use in the furtherance of their business. Documents so classified should not be made available to the public or to the Press.

RJ8.46

COMMERCIAL-IN-CONFIDENCE

17 SEP 1987

FROM: J M G TAYLOR
DATE: 15 September 1987

APS/ECONOMIC SECRETARY

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Sir P Middleton
Sir G Littler
Mr Cassell
Mrs Lomax
Mr Ilett
Miss Noble
Mr Murphy o.r.
Mr Watson - BSC

BUILDING SOCIETY'S CONVERSION

The Chancellor has seen your note of the Economic Secretary's lunch with Kleinwort Benson on 15 September.

2. He has commented that the boost to wider share ownership which conversion à la Kleinwort Benson would give is a very important point indeed. He would be grateful for a note, routed via the Economic Secretary, on prospects for building society conversion over the next three years.

J M G TAYLOR

3764/036/

COMMERCIAL-IN-CONFIDENCE

FROM: G R WESTHEAD
DATE: 17 September 1987

MISS NOBLE

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Sir P Middleton
Sir G Littler
Mr Cassell
Mrs Lomax
Mr Ilett
Mr Murphy - o/r
Mr Watson - BSC

LUNCH AT KLEINWORT BENSON: TUESDAY 15 SEPTEMBER

The Economic Secretary lunched on Tuesday with Lord Rockley, (Deputy Chairman), David Clementi, Mrs Lesley Watts and John Williams of Kleinwort Benson. The lunch was an informal occasion which the Economic Secretary found very useful. As expected discussion focussed mainly on the possibility of building societies converting into banks.

2. Conversion

Kleinwort Benson said that they had held discussions with both the Building Societies Commission (BSC) and Treasury officials about conversion in general and in particular the work they were doing as advisors to the Abbey National. They had found the talks very useful and were pleased to have been given the opportunity of commenting on the Commission's consultative paper.

3. Kleinworts said they were hoping for maximum flexibility in the conversion regulations and that the regulations would serve as a framework for conversion rather than a rigid blueprint. However, they did have their own thoughts on conversion schemes and they had just sent in their own response to the Commission's paper. Under their proposed scheme a society's reserves would be capitalised and shares issued at the time of conversion to be held initially by a trustee, and then given to the qualifying

membership. This would mean that all of a society's account holders (above a certain de minimis cut-off of say £100) would become shareholders, in the new company after a qualifying period (Kleinworts suggest 2 years). Under this scheme the transfer of the society to its members (the new shareholders) would be the first stage of conversion and the raising of new capital for the business would be left until later. Kleinworts saw several advantages in their scheme. First, the long qualifying period would minimise the danger of short-term speculators becoming aware of an impending building society conversion and quickly opening an account so as to be able to participate in a free share offer. Second, the worth of the existing business would be realised by its existing members - ie long-standing account holders rather than non-members. In the Abbey National case there were approximately 8 million members. This could produce some 6-7 million potential shareholders of which 5 million or so might not have owned shares before.

4. The Economic Secretary said he found Kleinwort Benson's ideas very interesting and certainly worth exploring. He observed that conversion a la Kleinwort Benson would give a very helpful boost to the Government's policy of wider share ownership. He asked Kleinworts for their views on whether the different capital adequacy regimes for building societies and banks would cause problems.

5. Mr Clementi agreed this was a potential problem. The capital adequacy regime was far stiffer for banks than for building societies, largely because banks had a wider spread of assets on their books and were less mortgage-based. The Bank of England, who had to approve the capital adequacy ratios, would need to be convinced that a building society considering converting was capable of evolving and coming to terms with the stiffer requirements. Mr Clementi envisaged some form of transitional arrangements for capital adequacy ratios to permit effective regulation of a society as it passed from being regulated under the Building Societies Act to the Banking Act.

6. **Ownership of societies**

Kleinwort Benson said that it was not yet totally clear in the case of the Abbey National where ownership of the Society lay. They agreed with the society that the issue should be addressed in the society's rules and voted on by the membership. But they were not totally convinced that a TSB-type litigation situation could not arise.

7. The Economic Secretary mentioned in confidence, that there was another aspect of which Kleinwort Benson should be aware. This concerned whether or not the conversion of a society could be said to deprive members of their property rights in the society. There was a risk that this could be against the European Convention on Human Rights and that a conversion might therefore be challenged under the Convention by members who felt they had lost something without receiving due compensation for that loss. The Building Societies Commission were seeking legal advice.

8. **Timing of Conversion Regulations**

Kleinwort Benson asked the Economic Secretary about this. The Economic Secretary said that following closure of the consultation period on the Commission's paper, the Commission would consider the representations and then consider draft regulations. These draft regulations would then be issued and a further consultation period would commence before secondary legislation was considered. The Economic Secretary said he was aware that the 1986 Building Societies Act provided for Building Societies to be able to convert by 1 January 1988, subject to the Regulations being in place. This was rather unrealistic, but he hoped there would not be a long delay in the New Year. It was important to get the Regulations right first time and there was nothing to be gained by a hastily-produced set of regulations which then subsequently needed amendment. Kleinwort Benson agreed. The first conversion was still quite some way off and it was only important that the Regulations were ready by then.

Other Issues

9. **Financial Services Act**

Mr Clementi said that Kleinworts were concerned not only about the compliance costs of the Act but more importantly what they saw as the devastating effect it would have on practitioners, who were now beginning to realise how it would change their day-to-day activities. The Economic Secretary said that there were bound to be disadvantages with any self-regulatory regime, but he thought that the fact that the SIB had delegated much regulation to individual SROs would mean that practitioners would have enough input in the rules. But there were bound to be teething problems. He asked for Kleinworts' view on whether the Act was likely to drive business away from London. Lord Rockley doubted whether London's new-found position post-Big Bang as the leading capital market centre would be affected dramatically. But he thought it might have an impact in the medium term on institutions who had not yet made the move to London.

10. **Settlement problems**

Kleinwort Benson reported that there had been a marked improvement in recent weeks in the settlement problems of its stockbroking arm Kleinwort Grieveson. They had invested heavily in both soft and hardware and additional back-office staff. This was beginning to pay off. In the short-term their capital investment had led to an increase in commissions for small deals, but it was hoped this would be reversed later.

11. The Economic Secretary thanked Lord Rockley and his colleagues for a very interesting and useful discussion and welcomed a continuation of the dialogue between Kleinworts, the Treasury and the Commission about building society conversion.

Guy Westhead.

GUY WESTHEAD
Assistant Private Secretary

1/170987

FROM: G W WATSON
DATE: 18 SEPTEMBER 1907

1. MRS LOMAX
2. ECONOMIC SECRETARY

cc Chancellor
Sir P Middleton
Mr Cassell
Mrs Lomax
Miss Noble
Mr Murphy

Mr Bridgeman (or)
Mr Devlin
Mr Davis
Mr Hotson
Mr Starkey
Mr Mathews (or)
Mr Perkins
Mr Wood

BUILDING SOCIETIES: SCHEDULE 8 POWERS

I have minuted you separately about the urgent need to make two amendments to Schedule 8 to deal with problems related to the purchase of units in unit trusts, and the provision of investment advice.

2. This minute explains wider concerns about the structure and content of Schedule 8. It proposes an urgent review of the Schedule, jointly by Commission, Treasury and BSA, with a view to recommending changes. It seeks your agreement to such a review which is likely to lead to a further affirmative order.

3. Schedule 8 prescribes the services which societies may provide. The services can only be

27/42/18

"financial services", ie banking, insurance, investment, trusteeship and executorship; and

"services relating to land", ie relating to acquisition, management, development or disposal of land.

4. The Commission has become increasingly aware over the last few months of a fast growing discontent among societies, especially the larger ones, with the constraints on their activities represented by Schedule 8. The discontent has a number of causes:

(a) The approach taken in drafting the Schedule - specifying with some (intended) precision what building societies can do - means that there is a presumption that they cannot do things not specified. This constrasts with the position of banks under the Banking Act and has led to a number of limitations - for example:

(i) not able to issue credit cards or join EFTPOS;

(ii) probably unable to distribute privatisation prospectuses;

(iii) unable to sell "Britannias" over the counter;

(iv) unable to refer customers for mortgages to other building societies or another financial institution (except a bank) - or to write mortgages on behalf of another financial institution;

(v) unable to manage mortgages for a financial institution (other than another building society or a bank);

(vi) cannot deal direct with unit trust managers.

Similar problems continue to be identified as societies begin to contemplate new activities.

(b) The last minute changes while the Building Societies Bill was before the House, for example the provision for PEPs and unit trust pensions, has produced a situation in which identical activities can legitimately be carried out for one purpose, but are ultra vires for another.

(c) The financial services scene has developed much faster than was envisaged and the building societies, facing increasing competition in their traditional business, are looking to compete in new areas. They are therefore challenging the justification for some of the restrictions, such as on agency broking or giving guarantees which are built into Schedule 8.

5. The combination of these factors are undermining the credibility of the Act, and to some extent the Commission which is characterised, particularly when its lawyers find proposed activities are ultra vires, as negative and uncooperative. Even when solutions can be found, securing the secondary legislation, especially if it is affirmative, takes time and this can mean that societies plans are delayed and market opportunities possibly lost: the position is worse (and particularly expensive) for societies if they then have to wait until their AGM (or call a special meeting) to adopt new or modified powers. Moreover, the constant need to deal with these problems is seriously impeding the Commission's performance of its primary role of supervising societies.

6. The frustration of some of the larger societies is made worse by the constraint on their wholesale borrowing which the 20% limit in the Act imposes. We have just received the BSA's submission on this and will be dealing with it separately. But these two frustrations coming together are leading to a lot of angry talk about conversion being the only available course for societies, even among societies for which it is unlikely to be a sensible market option. It would be unfortunate if some were to move precipitately early next year, when the opportunity becomes available, for inappropriately negative reasons.

7. This combination of circumstances has led the Commission to a unanimous view that it would be desirable to commence at once a review of Schedule 8, in consultation with the Treasury and the BSA, with a view to recommending considered proposals for implementation by next Easter. They

believe the timing (for the reasons explained in the two preceeding paragraphs) is vitally important. The Commission also believe that an announcement of their willingness and that of the Teasury to contemplate and discuss possible changes which can be achieved by secondary legislation will be seen as a positive move which will defuse a lot of the criticism.

8. The Commission has given some consideration to how the structure of schedule 8 could be changed. At present some of the powers in Part I are narrowly expressed, which leads to the presumption that anything not included is outside a society's powers. In the view of the Commission it would be feasible to express powers more widely in Part I and to provide specific restrictions in Part III. This would change the presumption about anything not expressly covered: moreover it would be more consistent with prudential considerations, since activities which the Commission considered that societies could not prudently undertake would be expressly forbidden in Part III. The activities implicitly ultra vires at present as cited in paragraph 4(a) above, and probably many others, in the view of the Commission, carry little or no prudential risk. Restructuring in this way would carry the further advantage that changes, as they become necessary, could be achieved by negative order amending part III, rather than affirmative order amending Part I. The structure change itself would however involve an affirmative order, but need not in itself make any major change in building societies powers. There might be implications in this approach for the nature and intensity of supervision but that will be a factor to be taken into account in the review and in the precise wording of any restructured schedule.

9. In addition to a structure change which should eliminate the frustrations arising from unintended restrictions, the Commission does, however, believe that there is a need in the changed situation in financial services and greater competitive environment, to reconsider the boundary between what building societies can and cannot do, at least to remove obvious anomalies in the Act. For example, they agreed at a recent meeting that there were no prudential objections to the power to deal in investments, which societies already have in respect of PEPs and unit trust based pensions, being extended to dealing on behalf of individuals generally, that is to act as agency brokers: and we have just received a letter from the BSA arguing that building societies should be allowed to run unit trusts for other than pension purposes. The Commission decided

that these possible extensions of powers should be considered, together with any others put forward by the BSA, as part of the proposed review.

10. I should be grateful on behalf of the Commission for your agreement to a review on the lines proposed above. If you agree I will discuss with Treasury officials the terms on which we should make this proposed review known to the BSA, and the detailed arrangements for carrying it out.

G W WATSON

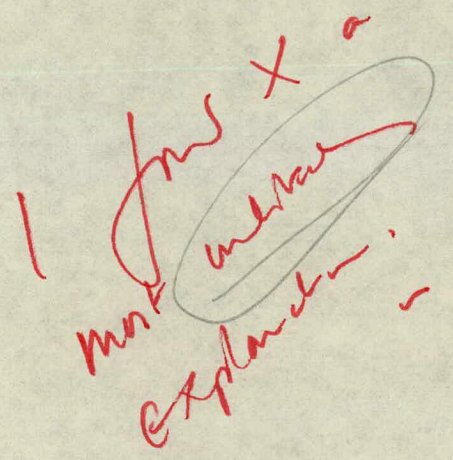
2/160987

FROM: G W WATSON
DATE: 18 SEPTEMBER 1987

1. MISS NOBLE
2. ECONOMIC SECRETARY

cc Chancellor
Sir P Middleton
Mr Cassell
Mrs Lomax
Miss Noble
Mr Murphy

Mr Bridgeman (or)
Mr Devlin
Mr Davis
Mr Hotson
Mr Starkey
Mr Mathews (or)
Mr Perkins
Mr Wood



BUILDING SOCIETIES ACT 1986: INVESTMENT SERVICES

The Building Societies Commission considers that the investment services power in Schedule 8 to the 1986 Act needs to be amended. This will require an affirmative resolution Order. They therefore seek your agreement to sponsor such an amendment. The effect of the amendment would be to permit building societies to pass customers' orders direct to unit trust managers rather than through agency brokers; and also to permit them to provide investment advice to individuals.

2. Both problems arise from the provision in Schedule 8, paragraph 6 of Part I:

> "Arranging for the provision of services relating to the acquisition or disposal of investments, whether on behalf of the investor or the person providing the service."

Unit trust orders

3. Since the power in Schedule 8 is specified as "arranging" for a third party to provide "services", not actual investments, societies cannot pass customers' orders directly to a unit trust manager. This anomaly was recognised during the passage of the Bill but the government ran out of time to consider and make the necessary amendment. Although an individual must use an agency broker to deal in stocks and shares, he can deal directly with unit trust managers. Thus the effect of the restriction is to put a building society, acting on behalf of a customer, in a worse position than the customer himself. Moreover, the society has to share commission with the agency broker. There are no prudential reasons why a society should not pass orders direct; indeed we believe that many societies may already be doing so, unaware that this is ultra vires. The problem is discussed more fully in Annex A. Removal of this unintended restriction can be characterised as a non-contentious tidying-up of the primary legislation.

Investment services

4. The new powers given to building societies in schedule 8 were intended to allow them to extend their activities into areas closely related to their mainstream business, and in which they already have some experience and expertise. Investment services were restricted to intermediation on the grounds that giving personal advice on, and trading in, investments (especially equities) were somewhat more removed from their competence, and carried risks which they did not have the capacity to assess, especially at branch level. The line had to be drawn somewhere. However, during the passage of the Bill, the line was breached by the late addition of the powers to establish and manage personal equity plans and unit trusts for pensions (paragraphs 7 and 9 of part I of the schedule). These powers include the power to give advice on, and to trade in, those particular investment products (but no others). The anomaly was recognised while the Bill was before Parliament.

5. This particular power has already given trouble. Towards the end of last year, a number of societies questioned the prohibition on giving advice and participating in stockbroking activities. To put the matter beyond doubt, the Commission amended part III of the schedule (SI 1987/172) to specify that the power to arrange for the provision of

investment services does not include power to give advice or to buy or sell any investment.

6. This clarified the situation on stockbroking activities in a manner consistent with the policy at Bill stage. However, the subsequent enactment of the Financial Services Act, and in particular the Securities and Investment Board's decision on polarisation, has significantly changed the situation. The continuation of the prohibition on giving investment advice will effectively close off to building societies the option (which most prefer) of acting as independent intermediaries, since the SIB have pointed out that, with their present powers, building societies would be able to advise only on insurance based products and unit trusts for pension purposes, and not unit trusts generally. In fact, as the SIB point out, there is no clear dividing line between the different products. To meet the SIB's point it would not be sufficient simply to repeal the earlier statutory instrument: not only would this lead to confusion, but it would not, because of the structure of part I of Schedule 8, give societies the clear power to give investment advice. It would, however, be strictly possible to limit the extension to cover all types of unit trust. But this would simply produce a different anomaly, between what societies can already do in relation to PEPs and what they would be able to do for customers generally. Moreover, here again the Commission see no prudential reasons for restricting societies in this area.

7. The problem is explained more fully in Annex B. This power would be restricted to societies with over £100 million assets.

Conclusion

8. Both these problems are pressing: unit trusts because it is an unintended anomaly which is leading many societies unwittingly to act ultra vires and we would be open to ridicule if we had to intervene; and investment advice because societies powers need to be extended to allow them to operate consistently with the Financial Services Act and the polarisation rules.

9. In both cases societies will need to adopt the new powers at a general meeting before they can exercise them. Two major societies have their AGMs in November/December, although the majority do not have AGMs until April/May. Twenty-one days notice must be given of special resolutions to

adopt new powers, and societies need reasonable time to plan ahead. These considerations point to an Order as soon as possible after Parliament returns from the Summer Recess. There could be advantage in arranging for it to be discussed at the same time as the order on credit cards.

10. I should be grateful, on behalf of the Commission, for your agreement to this course of action. I am minuting you separately about how the Commission considers it and the Treasury should respond to the wider problem of societies powers, of which the two problems discussed in this minute are merely the most pressing examples.

G W WATSON

ANNEX A

BUILDING SOCIETIES COMMISSION

INVESTMENT SERVICES: UNIT TRUSTS

The problem

Schedule 8, part I, paragraph 6:

> "Arranging for the provision of services relating to the acquisition or disposal of investments, whether on behalf of the investor or the person providing the service"

gives building societies the power to act as intermediaries between their customers and providers of services, but not with providers of investments. This means that societies may pass customer orders to agency brokers who provide the service of instructing market makers to buy or sell stocks. On the other hand, they may not pass orders directly to unit trust managers, because the managers do not provide a service, they provide the actual investment - units in the unit trust fund.

2. The wording of paragraph 6 is specific, "arranging for the provision of services". While the interpretation in paragraph 2 above may be open to argument, there is clearly a very grave doubt whether societies would be acting within their powers in passing customer orders to unit trust managers. This problem was, in fact, recognised during the passage of the Bill, but it did not rank high enough in the order of priorities to be dealt with in the rush to complete legislation before the summer 1986 Recess.

Discussion

3. This problem has surfaced as a result of business proposals put by a society to their supervisor. The legal difficulty has been explained to them, and they are preparing to seek Counsel's Opinion. It is quite clear from press reports and advertisements that many societies are already offering to place money with unit trusts without going through a broker. The use of brokers for this business is unnecessary, needlessly expensive, and therefore most unusual. It would be perverse to force building

societies, uniquely, to refer unit trust orders through brokers. Moreover, the anomaly would be accentuated if the proposals in Annex B on investment advice are accepted.

4. There are two possible solutions to the problem: determination proceedings; or, amending secondary legislation. Given the very strong doubt that paragraph 6 permits societies to pass orders to unit trust managers, it must be equally doubtful that determination proceedings, or subsequent proceedings in the Courts, will provide the desired solution. Moreover, such proceedings will take some time. Meanwhile, it would seem that many societies, unaware of the legal difficulty, are preparing in good faith to offer to place money directly with unit trusts. The quickest and cleanest solution is to correct the anomaly by amending schedule 8.

Conclusions

5. The power to arrange investment services is worded so that there is the strongest possible doubt that societies have power to pass customer orders directly to unit trust managers. Instead, they will have to act through brokers. This indirect arrangement would be unique to building societies and would, therefore, make unit trust business unattractive to them, and to their customers. Many societies seem to have gone ahead in good faith with plans to offer to place cusotmers' money directly with unit trusts. The anomaly will be more strongly emphasised if societies are empowered to offer investment advice on unit trusts.

ANNEX B

BUILDING SOCIETIES COMMISSION

INVESTMENT SERVICES: ADVICE

The Building Societies Assocation (BSA) argue that the present restriction puts building societies at a disadvantage, and that they should be subject only to the same regulation under the Financial Services Act as their competitors in this field. They point out that the Schedule 8 restriction on giving advice does not apply to personal equity plans and personal pension schemes (paragraphs 7, 9 and 10 of part I). Neither does it apply to insurance where giving advice is a specific power (paragraphs 11 and 12 of part I). Moreover, these activities will be regulated under the Financial Services Act 1986 by SIB rules and SRO regulations. For PEPs and unit trust pensions the SIB rules oblige a society to give advice if it opts for authorisation as an independent intermediary. Under the present restriction, a society can advise on an investment which is linked to insurance, but cannot properly do so without making comparisons with similar products which are not linked to insurance.

2. The SIB has also expressed its particular concern to the Commission. A building society cannot advise on the acquisition of units in an authorised unit trust or shares in other recognised collective investment scheme (other than schemes related to pensions) but, "there is no clear divide between these investments and life assurance contracts, and the thought of a society being able to advise on one but not the other rests uncomfortably with the Boards' rules relating to best advice and suitability of investment recommendations". The SIB fears that this situation could create an incentive for building societies to channel their customers into insurance products rather than into more tax efficient unit trusts. While "best advice" involves subjective judgements on the part of the adviser, the SIB believes that investor protection would be seen to be adequate "if the Commission were to permit societies to advise on life assurance and on units in unit trusts and collective investment schemes", when "societies would have a similar range of investments under their belts as many other firms of independent intermediaries will choose to take unto themselves".

3. The Commission finds the arguments put by the BSA and the SIB

persuasive in relation to unit trusts and other collective investment schemes. The SIB is not seeking to discriminate against building societies, but simply to apply the polarisation rules even-handedly to all institutions wishing to register as independent intermediaries. The problem, which arises from the present restriction on building societies powers, is not a sufficient reason to seek to reopen the polarisation argument.

4. To meet the problem posed by the Financial Services Act and polarisation it would be sufficient to extend building societies powers to give advice to cover unit trusts collective investment schemes. But this would be merely to replace one anomaly with another, and will lead immediately to pressure to go further. In the case of personal equity plans societies are already empowered to give advice on other investments (eg gilts equities, bonds and other financial instruments). It is therefore logical to extend their powers to allow societies to give advice to customers generally on the same range of investments. The Commission considers that it would be right to go for the full extension view.

1316/2

COMMERCIAL IN CONFIDENCE

FROM: MRS R LOMAX
DATE: 21 September 1987

ECONOMIC SECRETARY

cc: Chancellor
Sir P Middleton
Mr Cassell
Miss Noble
Mr Murphy
Mr Bridgeman)
Mr Watson) BSC
Mr Devlin)

BUILDING SOCIETIES: REVIEW OF SCHEDULE 8

I strongly support Gerald Watson's recommendation of a review of Schedule 8 of the new Act. There is no doubt that this schedule is causing considerable practical difficulties both for the Commission and for societies. Mr Watson's submission, and the record of my six-monthly meeting with Michael Bridgeman, which you have recently seen, set out some of the more serious difficulties.

2. There have also been more trivial but nonetheless irritating problems. For example, the Britannia Building Society would like to market the new Royal Mint Britannia coin over their counters. The Commission have been obliged to tell them that, while they have the power to accept customers' orders and payments (which they can pass on to the Mint), they cannot hold a stock of coins and allow customers to pick up those coins from branches. Rather, the coins must be sent direct to customers from the Mint. Understandably, the Britannia Building Society regard this outcome as commercial nonsense.

3. There is a danger, I think, of Schedule 8 bringing disrepute on the Act as a whole and a very real risk that it will poison relations between societies and the Commission. This would be a pity, not least because Schedule 8 was meant to be intrinsically permissive and liberalising. Some of the difficulties with it might be got round with some fairly

straightforward redrafting (which would, nonetheless, require affirmative orders). Others will require more thought. The main need, though, is to reconsider the general approach to building societies' powers on which Schedule 8 is based. As Mr Watson observes, the attempt to specify precisely what societies can do carries with it the presumption that they cannot do anything not so specified - whether or not it is in keeping with the broad intentions of the Act. The price, for societies, is a quite unjustifiable loss of commercial flexibility, at a time when they are under severe pressure from competitors not so inhibited. The Commission, for their part, are having to waste scarce time and resources in responding to problems that are legalistic rather than prudential.

4. There is a distinction between this issue - which concerns the flexibility with which societies can use their new powers and arises from the way Schedule 8 is drafted - and the wider question of the intended scope of the new powers under the Act. There has been occasion to look again at the latter, too, in recent months - most recently over the range of investment services provided by societies. The review would be primarily addressed to the way Schedule 8 powers are defined, but there would need to be some reconsideration of their scope, to take account of existing pressures from the BSA (for example, to include agency broking and all types of unit trusts).

5. What is not being proposed, at this stage, however, is a far reaching review of the Act itself: clearly that would be premature. The aim, rather, would be to administer some timely first aid, to increase the life-expectancy of the 1986 legislation.

6. I hope you will agree to a review, on the lines proposed. This would be largely a paper exercise, although some consultation with societies would clearly be both valuable and necessary. I would expect the review to be widely welcomed both by societies and by commentators, and we should be able to present it convincingly as a sensible response to changing market pressures - we have, after all, always said that the Act will need to be kept under careful review.

7. If you agree, we would want to make a low key announcement (perhaps in the form of a letter to the BSA) as soon as possible, in any event well before the Commons debate on credit cards and investment services. It would also be a natural topic for the talk which you are going to give at the conference organised by Salomon Brothers on 15 October.

RL.

RACHEL LOMAX

3764/82

COMMERCIAL-IN-CONFIDENCE

RBL

FROM: G R WESTHEAD
DATE: 22 September 1987

MRS LOMAX

cc PS/Chancellor
PS/Sir P Middleton
Mr Cassell
Miss Noble - o/r
Mr Murphy - o/r

Mr Bridgeman - BSC
Mr Watson - BSC
Mr Devlin - BSC

BUILDING SOCIETIES: REVIEW OF SCHEDULE 8

The Economic Secretary has seen and was grateful for your minute of 21 September and for Mr Watson's minute of 18 September which it covered.

2. The Economic Secretary agrees that there should be a review of Section 8 of the Building Societies Act as you propose. He thinks there is less reason to be low-key about this issue, than about credit cards.

3. As far as the announcement is concerned, the Economic Secretary wonders whether it would be possible for him to announce the review in his Salomon Brothers speech on 15 October, or whether that will be liable to raise parliamentary hackles?

Guy Westhead.

GUY WESTHEAD
Assistant Private Secretary

MR 3/7

COMMERCIAL IN CONFIDENCE

FROM: CATHY RYDING
DATE: 22 September 1987

PS/ECONOMIC SECRETARY

cc: Sir P Middleton
Mr Cassell
Mrs Lomax
Miss Noble
Mr Murphy
Mr Bridgeman - BSC
Mr Watson - BSC
Mr Devlin - BSC

BUILDING SOCIETIES: REVIEW OF SCHEDULE 8

The Chancellor has seen Mrs Lomax's minute to the Economic Secretary of 21 September.

2. The Chancellor has noted in paragraph 2 that the Commission have been obliged to tell the Britannia Building Society that while they have the power to accept customers orders and payments for the Britannia, they cannot hold a stock of coins and allow customers to pick up those coins from branches. The Chancellor has commented that this is ridiculous.

CATHY RYDING

3765/22

2/10

CONFIDENTIAL

FROM: G R WESTHEAD
DATE: 25 September 1987

MRS THORPE

cc PS/Chancellor
Mrs Lomax
Mr Murphy, o/r
Mr Watson, BSC
Mr Forman, MP

CHANCELLOR'S LUNCH WITH THE BUILDING SOCIETIES ASSOCIATION: 2 OCTOBER 1987

The Economic Secretary has seen your minute of 24 September and noted that the Chancellor is to be luncheon guest of the Building Societies Association on Friday next week.

The Economic Secretary thinks the BSA will probably want to discuss building society conversion with the Chancellor and wonders whether the Chancellor might want to raise a couple of specific aspects on this:

i. the undesirability of building societies converting in pique at constraints of the Building Societies Act before adequate management structures are in place to run the new organisation as a bank;

ii. the desirability of anyone who does convert using the opportunity to extend equity share ownership to all their investors.

The Chancellor might care to have a copy of the note of the Economic Secretary's own lunch with the BSA on 29 June to hand. I attach a copy for ease of reference. The key issue at that lunch was the question of raising the limit on wholesale funding from the present 20 per cent. The Building Societies Commission are at present considering the BSA's proposal to increase the limit from 20 to 30 per cent.

Guy Westhead

GUY WESTHEAD
Assistant Private Secretary

3756/051

FROM: G R WESTHEAD
DATE: 30 June 1987

NOTE FOR THE RECORD

cc PS/Chancellor
PS/Sir P Middleton
Mr Cropper
Mr Cassell
Mrs Lomax
Miss Noble
Mr Murphy

NOTE FOR THE RECORD : LUNCH WITH THE BUILDING SOCIETIES ASSOCIATION (BSA)

The Economic Secretary attended a lunch yesterday given by Mr Stoughton-Harris, Chairman of the BSA. Also present were the Deputy Chairman Mr Strickland, Director-General Mr Boleat and Mr Armstrong, Head of Legal Department.

Wholesale Funds

2. The BSA raised two building society issues with the Economic Secretary worth noting. The most notable of these was wholesale funds. Mr Stoughton-Harris said that societies needed an increase in the present 20 per cent limit under the 1986 Building Societies Act. He did not specify to what new level, but agreed it would not be appropriate for societies to have more than 40 per cent wholesale funding without converting into a company [40% is of course the upper limit in the Act in any case].

BSA said that societies were finding it increasingly difficult to compete in the retail sector with the rates of interest that they were currently able to offer. Returns for investors did not compare well with other savings products, particularly unit trusts. Mr Boleat mentioned that inflows into unit trusts had been £1 billion in May, compared with about £600 million for building societies, the first time unit trusts had taken more of the market than building societies. Mr Stoughton-Harris pointed out that one of the problems with the 20 per cent limit was that it did not actually amount to 20 per cent. In order to allow a margin for short-term

flexibility and to prevent the danger of breaches, societies were rightly keeping to a limit of around 15 per cent, permitting fluctuations up to 18 per cent.

3. Mr Stoughton-Harris said that the BSA would be submitting a case for increasing the limit to the Treasury in September. They had found sympathy for their case with both the Building Societies Commission and the Bank of England. If an increase was not permitted, societies would be unlikely to move into new areas of socially-based lending, as the Government, particularly the DOE were hoping. They would simply not have the resources for any novel, fringe lending.

4. The Economic Secretary said that he would consider the case for an increase on its merits but could give no prior commitments. When the Building Societies Act had become effective, Ministers had been anticipating the 20 per cent limit to remain in place for some considerable time to see how it works before considering a change. He would want to consider the case very carefully.

Credit Cards

5. Mr Stoughton-Harris said that at the time of the 1986 Act the assumption had clearly been, even if it had not been stated explicitly, that building societies would in due course be permitted to produce their own credit cards. This was a vital area of business that societies could not afford to miss out on. Technical problems with the Act were now causing problems, but BSA thought these could be ironed out.

6. The Economic Secretary said that there was a political dimension to this and it was not merely a technical question. It would need careful handling since rightly or wrongly people were concerned about the growth of consumer credit.

Other issues

The Investor Protection limit was not discussed at the lunch and capital adequacy and conversion only in passing. Mr Stoughton-Harris

said that the BSA were striving to improve relations with the Building Societies Commission (BSC), and were now adopting a less confrontational stance with the Securities and Investment Board (SIB).

Guy Westhead.

GUY WESTHEAD
Assistant Private Secretary

ECONOMIC SECRETARY

FROM: G W WATSON
29 September 1987

cc. Chancellor ✓
Sir Peter Middleton
Mr Cassell
Mrs Lomax
Miss Noble
Mr Murphy

Mr Bridgeman
Mr Devlin
Mr Mathews

BUILDING SOCIETIES : REVIEW OF SCHEDULE 8

In his minute of 22 September Mr Westhead asked whether it was possible for you to announce the review of Schedule 8 in your Saloman Brothers' speech on 15 October. Given the topic on that occasion I am sure it is an excellent opportunity for you to explain the background and reasons for the review: I would expect this (combined with an appropriate press release) would get reasonable media coverage. The review could be set in the context of the working of the Act generally and in particular emphasising the structure of the Act which lends itself to amendment as the situation develops of the kind which is likely to emerge from the review.

2. It would however be helpful if your speech at Saloman Brothers was not the first building societies heard of the review because I am anxious that we should get ahead with the preparations before then. Although it looks now to be some time before next Easter there is quite a lot to be done, particularly by the BSA in consulting their members, and I suspect we shall in the event find little enough time for both the policy formulation and the legal drafting. So, if you agree, I should like to let the BSA know formally later this week in a low key way, that is a simple letter dealing with the existence of the review and how we want to proceed with the BSA, but without any press release. The BSA will want to pass this information to their members but I very much doubt whether it will get any publicity at this stage.

3. There are a number of other reasons it would be desirable to tell the BSA early.

(a) the Chancellor is lunching with the BSA on Friday and if they do not know that a review of section 8 is in prospect he will certainly receive a barrage of complaint about the way it is constraining societies. It seems better to avoid this;

(b) societies are not likely to get an answer to their request for a higher percentage of wholesale funds until about the end of October. They are currently feeling frustrated both on the wholesale funding front and by section 8. The sooner we can give them some good news on section 8 the better;

(c) I doubt whether parliamentary hackles would be raised by your announcing the review for the first time on 15 October but if it has already been announced (albeit it low key) as part of the normal business between the Commission and the BSA there is even less likely to be any substance in such a complaint.

4. Are you content for us to proceed in this way?

G W WATSON

37 [redacted]

PWP.

FROM: G R WESTHEAD
DATE: 30 September 1987

MR WATSON - BSC

cc PS/Chancellor
PS/Sir P Middleton
Mr Cassell
Mrs Lomax
Miss Noble
Mr Murphy

Mr Bridgeman - BSC
Mr Devlin - BSC
Mr Mathews - BSC

BUILDING SOCIETIES: REVIEW OF SCHEDULE 8

The Economic Secretary has seen and was grateful for your submission of 29 September. He agrees with your proposals concerning the announcement of the review.

Guy Westhead.

GUY WESTHEAD
Assistant Private Secretary

35/47

Nigel things

C/See also note from EST's office below

FROM: MISS G M NOBLE
DATE: 30 September 1987

CHANCELLOR

CR 1/10

c c Economic Secretary
Mrs Lomax
Mr Murphy o/r

Mr Watson BSC
Mr Forman MP

CHANCELLOR'S LUNCH WITH THE BUILDING SOCIETIES ASSOCIATION : 2 OCTOBER 1987

You are lunching with Mr Tony Stoughton-Harris, Mr Frank Strickland, Mr Peter Birch and Mr Mark Boleat. Mr Stoughton-Harris is Chairman of the Building Societies Association, and also Executive Vice Chairman of the newly merged Nationwide Anglia Building Society. (Mr Stoughton-Harris is from the Anglia side.) Mr Strickland is Deputy Chairman of the Association and also Director and General Manager of North of England Building Society. Mr Birch is Chief Executive of Abbey National and a Council member of the Association. I attach some general background on the three of them and their building societies, which the BSC have provided. I understand you already know Mark Boleat. (He is, incidentally, now designated as Director General of the Association.)

2. I attach a copy of the BSA's latest bulletin, which always gives a good indication of their current preoccupations. I asked Mr Boleat if there are any particular topics they wish to raise with you; he says not. The presence of Abbey National's Chief Executive is as much an attempt to try to bring Abbey National back in to the BSA fold as to indicate a wish to talk about conversion. But that, along with the associated issues of the wholesale funds limit and the constraints of the Building Society Act are certain to come up in discussion. The societies are increasingly quoting the last two as pushing them unwillingly towards the first; and we have noticed that Mark Boleat in particular is starting to peddle a "doomsday scenario" in which there are no building societies at all left in 5 to 10 years.

The Wholesale Funds Limit

3. You will find the Association quietly confident that the Government is going to give way on the 20 per cent limit on wholesale funding. They have now put in their formal submission requesting that the limit be raised from 20 per cent to 30 per cent with effect from the beginning of 1988. The formal position is that the Building Society Commission have to consider that submission, and then decide what proposal to put to Ministers. (If the limit is to be changed, it is done through a Commission regulation, made with the agreement of Treasury, and subject to negative resolution.) It is likely that the Commission will want two meetings on the subject before reaching a final conclusion and so it is unlikely that the issue will be put formally to Ministers for decision until the end of October. Subject to any views the independent part time Commissioners may have, the advice is likely to be, as the BSA expect, that the present limit, although not biting yet in general, is likely to constrain the development of societies in an unhelpful way; and the limit should therefore be increased. Whether it should be increased to 30 per cent or some other number is a more open question. Before taking a final decision, however, you will wish to consider fairly carefully what the actual or perceived monetary or economic effects of such a change might be. The advice we have received from the Bank, so far, supports an increase in the limit and suggests that they feel the wider implications are not likely to be either significant or overriding. But we are looking at this internally with MG Division, and will put up separate advice. I suggest you simply listen to the arguments put; say you will have to wait until the Commission have considered the submission fully; and make enough mild warning noises about needing to look at this in the broader context and having to consider possible market reaction to such a relaxation, to keep the options fully open.

The Act : Review of Section 8

4. By Friday, the BSA will have been told formally that the Economic Secretary has decided to initiate a review of Section 8 of the Act, which defines what a building society can and cannot do, and which has been causing so much difficulty at the margin.

Mr Watson's submission explained the background and what we have in mind. The societies should be extremely pleased with this news. (It should also spare you from having to listen to a good deal of whingeing.)

5. The review is intended to do two things. Firstly, we will look at whether we can rewrite Section 8, through an affirmative order, so that it specifies what a society cannot do, rather than attempting to say what it can do, changing the presumption at the margin and therefore removing a lot of the present irritation and uncertainty. This need not, of itself, extend the scope of building societies activities to any significant extent; but the second part of the review will be to look at whether there are new areas we should allow societies to expand into. The Act was, of course, originally intended to allow such flexibility in response to developing markets and greater experience of the societies in handling the new services. We had not expected to have to do such a review quite so soon; but on the other hand the pace of development has been markedly faster. Nevertheless, it is likely the societies will ask us for more than we are prepared to offer. You can obviously give no assurances at this stage about significant extensions in the scope of their activities (e.g. into insurance), and I suggest you simply take the line that the Association will be consulted and given every chance to put its case which will be carefully considered. You can also point out that we have just agreed to extend their powers (by separate affirmative orders when Parliament reassembles) in relation to investment advice, unit trusts, credit cards and agency broking.

6. If you are asked about the timing of the Review, and in particular whether the new powers would be available for societies to adopt in their Spring Annual General Meeting, you should make the point that the last thing we want to do is rush this and get it wrong again. Many of the current problems were caused by trying to get too many new provisions into the Act at the last minute without time for careful consideration, and we must not make that mistake again. The aim will be, therefore, to get the BSA to consult their members and report back to us in

about December; a submission will be put to Ministers for policy decisions around about Christmas; then the lawyers will be asked to draft a text which will be put out for further consultation so that hopefully all the bugs will be spotted this time, and then an affirmative order will be laid possibly in March or immediately after Easter. This means the powers will not be available for the Spring AGM.

Conversion

7. You have seen the Economic Secretary's report of his lunch with Kleinworts and are aware of the main issues on this subject. The detail is extremely complex and you will not wish to get deeply involved in it. I would suggest that you concentrate on more general issues and try to draw the association on how they see societies developing in the future, what are the commercial pressures driving them in that direction, how many societies are likely to wish to convert, will they be the major societies or smaller ones whose continuing existence in highly competitive market may be in question and which will look like attractive propositions to banks like Citicorp looking for a retail outlet. Mr Birch may be prepared to talk further about the Abbey option, and what he sees as the advantages over the option set out in the BSC consultation paper, which was basically defining the minimum necessary to comply with the 1986 Act.

Credit Cards

8. On more minor issues, the Association may raise the question of the £5,000 limit on personal lending. You may recall from the discussions on credit cards that the Act imposes a limit of £5,000 on the total amount of unsecured borrowing which an individual can have outstanding with any society. The affirmative order which we will be putting through in the autumn makes it clear that this limit includes borrowing on a credit card, but removes the risk of a society acting ultra vires if someone temporarily overspends their credit limit, providing the society takes immediate steps to rectify the position. The societies are now starting to argue that the limit puts them at a competitive disadvantage compared with banks, whose lending is not constrained in that way. We are not convinced by this case, nor for the need

for further relaxations. If the issue is raised, I suggest you point out that it may yet prove difficult enough to get the affirmative order on credit cards through the House, given the present concern in some quarters about consumer credit, without compounding the problem by attempting to raising this limit.

N.J. Rob

MP. MISS G M NOBLE

BIOGRAPHICAL DETAILS

TONY STOUGHTON-HARRIS FCA FRSA

Chairman of the Council of the Building Societies Association.

Age: 55 Married with 3 children

Qualified as a Chartered Accountant in 1956 and joined Norton Keen & Co as a Partner. He specialised in local authority and public utility finance.

In 1967 he became a Director of the Maidenhead and Berkshire Building Society, renamed the South of England in the same year. He became Managing Director of the society in 1975. The society eventually became the Anglia Building Society and until recently Mr Stoughton-Harris was a Director and the Chief General Manager of the society. Following the recent merger with the Nationwide, Mr Stoughton-Harris has become Executive Vice Chairman of the new Nationwide Anglia Building Society. The new society ranks 3rd in terms of size with assets of £18·5 billion.

Other positions held in the bulding society industry:

(i) Chairman of the Metropolitan Association of Building Societies 1979-80

(ii) Member of the Council of the BSA since May 1979, appointed Chairman in May 1987

(iii) Director and Chairman of Electronic Funds Transfer Ltd (MATRIX).

Other appointments:

(i) In 1981 he was appointed a part-time member of the Southern Electricity board

(ii) In 1982 he became a General Commissioner of the Inland Revenue

Leisure interests: gardening, DIY, sport.

BIOGRAPHICAL DETAILS

FRANK STRICKLAND OBE FCBSI MBIM

Deputy Chairman of the Council of the BSA
Chairman of the BSA European panel

Age: 59 Married

Joined the Chorley and District Building Society in 1951. Following positions in other societies he has risen to become a Director and the General Manager of the North of England Building Society. The society ranks 36th in terms of size, with assets of around £472 million.

Other positions held in the building society industry:

(i) At various times Chairman or Hon. Secretary of regional centres of the Chartered Building Societies Institute (CBSI). Since 1983 he has been a Member of Council of the CBSI

(ii) Hon. Secretary, Northumberland & Durham Association of Building Societies 1967-71 and Chairman 1975-77

(iii) Chairman Scotland and North of England Association of Building Societies

(iv) Regional Member of Council of the BSA 1971-78 and National Member since 1978. Elected Deputy Chairman 1987

Leisure interests: Sunderland Rotary, MCC.

BIOGRAPHICAL DETAILS

PETER BIRCH

Nominated member of the BSA Council.

Age: 49 Married with 4 children

Since 1984 Chief Executive and Director of the Abbey National Building Society, the 2nd largest building society with assets of more than £23 billion.

Previous appointments:

(i) 1958-65 Nestlé

(ii) 1965-84 Gillette (Australia, N. Zealand, SE Asia, Africa, Middle East, Eastern Europe, UK).
Managing Director 1981-84

Leisure interests: active holidays, swimming.

The Building Societies Association 3 Savile Row, London W1X 1AF.

BUILDING SOCIETY NEWS

A MONTHLY NEWSLETTER FROM THE BUILDING SOCIETIES ASSOCIATION VOL: 7 NO: 9 SEPTEMBER 1987

BSA REQUESTS INCREASE IN WHOLESALE FUNDS LIMIT

On 14 September, The Building Societies Association sent a submission and detailed report* to the Building Societies Commission requesting that the limit on funds which building societies can raise from non-retail sources be increased, from 20% to 30%, with effect from the beginning of 1988, and that minor modifications should be made to the definition of non-retail. The submission is reproduced below.

The Statutory Position

Section 7(3) of the 1986 Act introduces the concept of the limit for non-retail funds, and section 7(15) provides that that limit shall be 20% of shares, deposits and loans. This figure can be increased by statutory instrument but to no more than 40%.

The 20% Limit in Practice

The term "non-retail" has been defined in such a way as to include certain accounts which have all the characteristics of being retail funds, in that they are beneficially owned by individuals and have been placed with a particular building society as a result of the conscious decisions of those individuals. These accounts amount to 1% of societies' funds on average.

No society would wish to get very close to the 20% limit because this would reduce its room for manouevre and a number of societies will make comparatively little use of non-retail funds. In reality, a 20% limit is likely to mean that no more than 15% of the industry's total funds would be in non-retail form.

Societies' Experience with Non-Retail Funds

Building societies have been able to use non-retail funds to a significant extent only since 1983. Since that time they have gained considerable experience of funding instruments and techniques, and have made particular use of certificates of deposit, time deposits, Eurobonds and bank loans.

Wholesale Funds and Societies' Competitiveness in the Mortgage Market

The mortgage market has become much more competitive over the past few years. In particular, a number of new lenders have emerged, funding their loan portfolios from the wholesale markets. The mortgage rate has settled down at a modest premium over money market rates. Meanwhile, societies' traditional retail savings market has become more difficult, largely because of the success of unit trusts and equities.

Building societies are therefore facing a squeeze on the volume of the funds which they can attract and also a margin squeeze as a result of competition from other lenders. Use of the wholesale markets helps societies deal with these circumstances. If societies are constrained in their ability to use the wholesale markets, then they will lose business to other lenders. Societies would also be encouraged to use off balance sheet techniques for their lending, which could change their characteristics as much as any increase in the non-retail funds limit.

Societies now need to pay greater attention to profitability and this factor, combined with an increasingly competitive mortgage market, means that societies must actively seek the most profitable parts of mortgage business. In the event of societies being constrained by a shortage of funds, then increasingly they will look to serve the top end of the market first, rather than giving priority to the lower end of the market which they have traditionally done. This would be done with considerable reluctance as it would adversely effect housing policy initiatives. Other lenders often ignore the lower end of the market, for example by having lower loan limits of £30,000.

Societies' Management of Wholesale Funds

Societies have demonstrated their ability to manage wholesale funds over the past few years and, moreover, the Commission requires that they demonstrate such ability. A limit on non-retail funds is not an appropriate policy instrument here, but rather the Commission should use its prudential notes and its powers of control. The statutory limit is a nature limit, not a prudential control.

Amending the Definition of Non-Retail

There should be a re-definition of funds counting as non-retail so as to exclude funds placed with a society by an institution, where the investment is the result of conscious decisions by a number of individuals.

IN THIS ISSUE

Building Society News is published Monthly on the third Friday of each month by The Building Societies Association.
Enquiries about items in this publication should be put to the Editor. Editor: Tricia McLaughlin

ISSN 0261-5304

Non-Retail Funds and Mutuality

The question may legitimately be raised as to the relationship between the non-retail funds limit and mutuality. No conflict can be seen between mutuality and raising non-retail funds. Mutuality implies working for the benefit of members and societies cannot be working for the benefit of their borrowing members unless they are using the lowest cost funds to finance mortgage loans. Investors and borrowers now need to be seen as separate categories of members with whom building societies deal. There is nothing in the concept of a building society to suggest that societies should not only make loans largely to members, but that they should also fund those loans largely from savings of members.

The Act provides for a 40% upper limit on the proportion of funds which can be raised through non-retail sources and this is what Parliament has considered to be the nature limit.

Conclusion

Building societies need as much certainty as the market will allow to plan their operations. A number of societies are already influenced in their planning by the limit on non-retail funds. If they are to compete in an increasingly competitive mortgage market, societies need to have access to all the sources of funds to which their competitors have access. An increase in the non-retail funds limit to 30% would give societies the necessary freedom of manouevre and would facilitate greatly their medium-term planning.

* * * * * *

** Limit on Non-Retail Funds Raised by Building Societies, Submission and Report by The Building Societies Association,* is available from the Association's Information Department.

GOVERNMENT DELAYS IMPLEMENTATION OF PARTS OF THE FINANCIAL SERVICES ACT

On 26 August the Department of Trade and Industry announced details of the Government's decision to delay the implementation of important parts of the Financial Services Act. A separate DHSS press release simultaneously announced that, as a result of these delays, the start date for the new personal pensions, introduced by the Social Security Act 1986, had been put back by six months – to 1 July 1988.

The Government now intends to bring section 3 of the Financial Services Act into force early in April 1988 – this was originally timetabled for 1 January 1988. When section 3 has effect it will be a criminal offence for an individual or a firm to conduct "investment business", unless it is authorised to do so by the Securities and Investments Board or a self regulating organisation (SRO).

All investment businesses intending to seek authorisation will need to ensure that their applications to SIB or an SRO are submitted by an appointed day – to be known as "P-day", which is likely to be a date in the middle of January. Companies which submit applications by "P-day" will be able to conduct investment business after section 3 comes into force, notwithstanding the fact that their applications may not have been determined by that time.

In its announcement on the delay in introducing the new personal pensions, the DHSS explained that the delay of six months was necessary because of the delays to the Financial Services Act and the decision by the Securities and Investments Board to delay the implementation of key investor protection rules – notably the illustration of benefits, disclosure of product particulars and commissions on life assurance and unit trusts – until 1 July 1988.

Michael Portillo, Parliamentary Under Secretary of State for Social Security, said –

> "When we decided that personal pensions as an alternative to the State earnings related pension scheme should be available from January 1988, it was on the premise that we expected that the new Financial Services Act framework would be in operation by that date. It is now clear that the main provisions of that Act cannot be in force before April. Moreover, the recent announcement by the Securities and Investments Board that certain key rules affecting consumers' rights will be brought into force on 1 July 1988 makes it prudent for us to set the same start date for the new personal pensions. The Government must ensure that anyone taking out one of the new personal pensions should benefit from the investor protection measures introduced by the Financial Services Act, or equivalent safeguards ...."

COMMISSION TO RESOLVE CREDIT CARD DIFFICULTY

The Building Societies Commission intends to ask the Treasury to amend part of the Building Societies Act to resolve an unintentional technical point which, effectively, prevents building societies from offering Visa and Access credit cards, as principals, to their customers.

As a consequence of this technicality, which results from a drafting error in the Act, the Commission found itself unable to make an order designating the Access and Visa organisations, so that societies could join them, when requested to do so earlier this year. Two societies, as a result, had to withdraw such resolutions at their general meetings.

The Commission believes that the most effective way of resolving this problem is for the Treasury to use its powers to amend the Act to extend societies' class 3 assets to include accounts with the characteristics necessary to cover typical credit card operations. The Treasury has agreed to bring forward such an order at the earliest opportunity – the start of the next parliamentary session.

BSA RESPONDS TO COMMISSION PAPER ON CONVERSION TO PLC STATUS

On 23 July 1987 the Building Societies Commission published a consultation paper which outlines the regulations it proposes to make relating to the conversion of building societies to public limited companies. Responses to the consultation paper were requested by 14 September. Early in September the Association submitted its response* to the Commission.

COMMISSION PUBLISHES LIQUID ASSETS REGULATIONS

The Building Societies (Liquid Assets) Regulations 1987*, made under section 21 of the Building Societies Act, were laid before Parliament and published on Thursday 27 August. The regulations, which come into effect on 1 October, set out which assets building societies can hold as liquid assets. The Commission simultaneously published its response to the consultation on its proposals for these regulations. A summary of the two documents is set out below –

The Commission had proposed that the regulations should, in the main, be a conflation of the powers of societies under the previous (1962) Act, with minor updating. That was generally accepted during the consultations. The regulations now do that.

Comments during the consultations focused on two issues – the avoidance of concentration of a building society's holdings with banks and other authorised institutions, and the extent of the powers to hold paper issued by other societies. The Commission had originally proposed that, with certain exceptions e.g. for holdings with clearing banks, a building society should limit its holdings with a bank to the lower of 10% of the society's capital and 10% of the bank's capital. The Commission has accepted the representations that this would be too rigid if applied universally. It has accordingly decided to require each society to prepare an exposure policy setting its own limits on its exposures to other institutions. Significant limits and exposures will be monitored by the Commission. In particular any exposure over the 10% thresholds will have to be reported.

The general presumption has hitherto been that a building society does not invest in another society. The main exception has been that a society has been able to hold CDs issued by other societies, up to a limit of 2½% of the total assets of the holding society. The Commission originally proposed to continue this. It has now accepted that the regulations should also permit a society to hold Floating Rate Notes (FRNs) issued by another society. But this has to be within the same limt of 2½%, which will in future apply to the sum of CD and FRN holdings. Such inter-society holdings add to the liquidity of the holding society in isolation, but not to the liquidity of societies collectively.

However, the Commission does see a need for further development of thinking about the nature of liquidity for societies and the links to the liquidity of the rest of the financial system, and said that it will look again at the 2½% limit in the context of that wider review.

Isle of Man Order also Published

On 27 August the Commission also published and laid before Parliament an order** allowing societies to make secured loans in the Isle of Man, with effect from 15 November 1987.

This was the first of the orders to be made under section 14 of Building Societies Act, enabling societies with commercial assets of at least £100 million to make secured loans outside the United Kingdom. It is believed that other such orders (dealing for example with the Channel Islands and Gibraltar) will follow.

* * * * * *

**SI 1987 No 1499,* HMSO ***SI 1987 No 1498,* HMSO

BUILDING SOCIETY RECEIPTS REACH £667 MILLION IN AUGUST

BSA figures, released on 18 September, show that in August building societies enjoyed their best month in the savings market since April, attracting £667 million from retail savers. Normally receipts in August are depressed by the car sales associated with the introduction of the new registration letter and, also, the Association had expected the second calls on TSB and Rolls Royce shareholders, both due in September, to reduce societies' inflow during the month. The relatively high inflow is probably explained by three factors –

(a) Returned funds from the British Airports Authority (BAA) flotation – although a proportion of these funds would have been included in the July figures.

(b) The gradual edging upwards of the rates paid to investors by building societies.

(c) The concern during August that the rise in Stock Exchange prices may have come to an end could have led some investors (particularly those "new" to the market) to cash in their shares, take their profits, and return the funds so released to societies.

In the mortgage market societies lent £3,093 million to an estimated 92,000 borrowers – a slight reduction on the July figure of £3,386 million.

Regional House Prices

The Association also published regional house price data for the second quarter of 1987 on 18 September. The average price paid by building society borrowers was highest in the Greater London region at £63,626 – 60.9% above the national average. The average was lowest in the Yorkshire and Humberside region, £26,949 – 31.9% below the national average and 57.6% below the Greater London average. Between the second quarters of 1986 and 1987, prices rose most rapidly in the South East area and least rapidly in Northern Ireland, as the following table shows.

Regional House Prices at Mortgage Completion Stage

Region	Average House Price 1987 Q.2		1987 Q.2/ 1986 Q.2/
	£	Index 1980 = 100	% change in index
Northern	27,016	155	7
Yorks and Humber	26,949	165	6
East Midlands	31,826	180	11
East Anglia	40,516	192	15
Greater London	63,626	225	21
South East (excl GLC)	55,204	206	22
South West	42,938	183	16
West Midlands	32,503	158	16
North West	29,161	154	8
Wales	29,155	161	12
Scotland	30,997	166	7
Northern Ireland	28,076	139	5
United Kingdom	39,551	185	16

The response, and the original paper, are technical in nature and are not covered in this article. The concluding paragraph of the Association's response is reproduced below –

> "The conversion of any building society to plc status will be a very complex operation. Furthermore, the provisions in the Act are themselves complicated. The major obstacle for any building society wishing to convert will be to obtain the support of its members, and it is important that any regulations should help to ensure that the wishes of members should not be frustrated. Legal and tax problems are bound to arise the more a society looks seriously at a conversion option, and as far as possible the regulations should allow such problems to be dealt with in a fair and efficient manner."

* * * * * *

* The full response is available on request from the Association's Information Department.

JIMMY MALONE

Jimmy Malone, a well known figure in the building society world, died peacefully in his sleep in the early hours of Friday 28 August.

Mr Malone was an accountant by profession and all his early working life was spent with a professional firm of accountants in which he rose to be the senior partner. In 1966 he was appointed to be Secretary of the Irish Building Societies Association, a position he held until his death, whilst carrying on his practice as an accountant in the Irish firm of Touche Ross, with which his firm merged in the late 1970s.

Mr Malone was very involved with the international building society scene. He was Secretary for the European Federation's 1973 Dublin Congress, President of the Federation in 1976/77 and its Managing Director between 1982 and 1985. He was also Assistant Secretary-General for Ireland for the International Union of Building Societies and Savings Associations.

Mr Malone leaves a widow, Gaye, 4 sons and two daughters.

MERGERS INTENSIFY CONCENTRATION OF ASSETS

A new building society, Nationwide Anglia, was formed on 1 September 1987, following the merger between the Nationwide and Anglia societies. In terms of total assets, the new society is the third largest in the UK – the position hitherto occupied by Nationwide. However, the merger has intensified the degree of concentration of assets held by the largest societies and, furthermore, the announcement made on 16 September, that the Woolwich (currently fifth largest) and Gateway (15th) societies plan to merge during 1988, will also affect the position. The following tables show the proportion of assets held by the largest ten societies, using end-1986 data at three points in time –

(a) At 31 December 1986

(b) At 1 September 1987, incorporating the Nationwide Anglia merger

(c) At 1 June 1988, incorporating the planned Woolwich/ Gateway merger

Total Assets, Largest 10 Building Societies

End 1986

Society	Total Assets £m	% of Industry	Cumulative % of Industry
Halifax	28,694	20.4	20.4
Abbey National	23,041	16.4	36.8
Nationwide	12,202	8.7	45.5
Alliance & Leicester	8,101	5.8	51.3
Woolwich Equitable	7,827	5.6	56.9
Leeds Permanent	7,775	5.5	62.4
Anglia	6,085	4.3	66.7
National & Provincial	6,048	4.3	71.0
Bradford & Bingley	4,417	3.1	74.1
Britannia	4,212	3.0	77.1

1 September 1987 (Estimated)

Society	Total Assets £m	% of Industry	Cumulative % of Industry
Halifax	28,694	20.4	20.4
Abbey National	23,041	16.4	36.8
Nationwide Anglia	18,287	13.0	49.8
Alliance & Leicester	8,101	5.8	55.6
Woolwich Equitable	7,827	5.6	61.2
Leeds Permanent	7,775	5.5	66.7
National & Provincial	6,048	4.3	71.0
Bradford & Bingley	4,417	3.1	74.1
Britannia	4,212	3.0	77.1
Cheltenham & Goucester	3,854	2.7	79.8

1 June 1988 (Estimated)

Society	Total Assets £m	% of Industry	Cumulative % of Industry
Halifax	28,694	20.4	20.4
Abbey National	23,041	16.4	36.8
Nationwide Anglia	18,287	13.0	49.8
Woolwich (inc Gateway)	9,584	6.8	56.6
Alliance & Leicester	8,101	5.8	62.4
Leeds Permanent	7,775	5.5	67.9
National & Provincial	6,048	4.3	72.2
Bradford & Bingley	4,417	3.1	75.3
Britannia	4,212	3.0	78.3
Cheltenham & Gloucester	3,854	2.7	81.0

Notes: 1. With the exception of figures for the (then) Anglia Building Society, all total assets figures have been taken from building societies' latest published AR11's – ie, for year ends falling between 1 February 1986 and 31 January 1987. For the first table, an estimated 31 December 1986 figure was used for the (then) Anglia Society and this has subsequently been used for the estimated Nationwide Anglia data.

2. The total assets of the industry stood at £140,603 million at the end of 1986.

As can be seen, the largest ten building societies, accounted for 77.1% of the total assets of the industry at the end of 1986. The Association estimates that this had risen to 79.8% by 1 September 1987 and, if the proposed merger between the Woolwich and Gateway societies takes place as planned, the proportion will increase to an estimated 81% by mid-1988.

1532/006 C/

S. Pickford thinks that in the light of this we sd put out a press notice presenting the whole thing in a favourable light - probably pegged on your lunch today. He will try and have a draft for you to look at in the car on the way back from lunch

PS/CHANCELLOR

CR 2/10.

PS The EST is not in the office today so he can't clear it.

Nigel Thanks

FROM: MISS G M NOBLE

DATE: 1 October 1987

cc: Economic Secretary
Mrs Lomax
Mr Murphy o.r
Miss O'Mara
Mr Gunton
Mr Watson BSC

LUNCH WITH THE BSA : REVIEW OF SECTION 8

I should add one gloss to the brief I put up. I understand from Mr Watson that the Building Societies Association offered to cut down the time they would normally need to consult their members, in order to speed up the timetable of the review and hopefully allow the affirmative order to be laid and debated in time for the societies to adopt the powers in their Spring AGMs. The Commission have given no assurance and made it clear they will not be pressed into doing the job faster than they think prudent; but they will do their best to ensure that the Order is ready sooner rather than later, and if possible in time for the AGMs.

2. The Chancellor ought also to be aware that the Daily Telegraph know about the review of Schedule 8, and no doubt the others will know very quickly. The Press Office have been warned. The general line to take should be that the review is not a major rethink of the Act or anything like it; it is to see whether we can do anything through secondary legislation to resolve some of the legal problems societies have been having at the margin with the section of the Act which defines what they can do (Section 8); and also to look at some of the requests societies have made for substantive extensions of their powers in a coherent rather than peacemeal way. It was always intended that the Act should allow a flexible response to developing market conditions. We have not expected to look at Schedule 8 quite so quickly but the pace of change has been faster than might have been expected.

P Collins

PP MISS G M NOBLE

Part 5 p 52

15 OCT 1987

COMMERCIAL IN CONFIDENCE

FROM: G W WATSON

DATE: 14 OCTOBER 1987

1. ECONOMIC SECRETARY

2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Paymaster General
Sir P Middleton
Sir G Littler
Mr Cassell
Mrs Lomax
Mr Ilett
Miss Noble
Mr Murphy

BUILDING SOCIETIES CONVERSION

You asked in your response to the Economic Secretary's note of his lunch with Kleinwort Benson for a note on the proposals for building society conversion over the next three years.

2. Building societies will, under the terms of the 1986 Building Societies Act, be able to convert to plc status after 1 January 1988. At present the Commission are considering the comments on their consultation paper (issued in July) and propose to publish in draft about mid-November the regulations which are necessary to supplement the provisions in the Act. Provided these are well-received the Commission expect to make them by early January. They require the consent of the Treasury and are subject to the negative resolution procedure.

3. Very few building societies and only a handful of merchant banks responded to the consultation document. Apart from Kleinwort Benson (who are advising Abbey National) and Morgan Grenfell (who do not seem

to have any particular building society client, but are clearly hoping for business), the merchant banks and their lawyers did not reveal in their comments much about their own thinking about conversion, or who their potential clients might be.

4. Building societies themselves professed to be studying conversion more as a policy option than as an immediate operational matter. Nor have building societies revealed their thinking much to us (or to the Bank of England). So what follows is based on limited information and to some extent on building society and City gossip. My general information is that there is a good deal of quiet research work going on in societies, merchant banks and among some banks who are considering the possibility of acquiring building societies; a certain amount of informal discussion between possible players; but few firm proposals emerging as yet.

Self-conversion

5. One route for conversion is for a society to form a special company of its own: for this to happen, 75% of at least 20% of the investing members have to vote in favour.

6. This is the route which the Abbey National are studying and is the route which could give a boost to wider share ownership. So far the Abbey board has only authorised study and recently the rate of activity seems to have slackened. Top management and some of the board are thought to be enthusiastic, but it is not certain how the whole board will decide. After discussions in the summer with the Bank of England, the Abbey have not taken further the question of authorisation as a bank (which would be vital for conversion). There are also some difficulties in reconciling the Kleinwort Benson scheme for a scrip issue of shares with the priority liquidation account (obligatory under the Act) which will be a prior charge on all the Abbey's present reserves. My view is that it will be some time into 1988 (at the earliest) before Abbey will be ready to make a public move.

7. A number of other large societies, among them the Halifax,

Nationwide Anglia, Alliance and Leicester and National and Provincial are studying conversion with varying degrees of intensity: but so far as we know it is at this stage as a policy option (probably to be exercised if another large society led the way) rather than with a present intention to convert.

Takeover

8. The other route to conversion is to merge with an existing bank (or an institution which can gain authorisation by the Bank of England); this route requires the approval of 75% of at least 50% of the investing members.

9. It is more difficult to discover with any precision what is going on here. Clearly there is interest in Citibank (who have spoken to us and to Treasury officials and make no secret of their ambitions) and Standard Chartered (who have publicly stated their interest). Beyond that there is little hard evidence, but TSB, a Canadian financial institution and other Europeans and Americans are rumoured to be active; there is no evident sign of Japanese interest at present. Among building societies a number of the smaller nationals and semi-nationals (with assets between, say, £2 billion and 500 million) are known to be taking an interest in this route: they see themselves as too small to compete with the nationals and less able than some of the smaller societies to fulfil a regional role. They are certainly having discussions with possible partners: but none has yet reached the stage where they are prepred to talk to us about what they are doing. Nor has the Bank of England any solid information from the banking end.

10. Nevertheless, at an anecdotal level there is evidence that some of the discussions may be quite serious, and possibly well advanced, at least in terms of formulating propositions. There are stories of some very generous offers of compensation being made to chief executives and senior management. Given the high voting requirements for approval of such a conversion, some fairly generous payments to investing members may also be offered.

11. My own view is that it is in this area where we may well see the first moves, perhaps early next year. But given the vague basis of the information available, it is difficult for this to be more than a guess.

12. It is very difficult to see far into the future. To some extent societies are likely to be influenced by the extent to which we can enable societies to compete effectively within the terms of the 1986 Act: the review of Schedule 8 and the decision on whether societies can raise more funds on the wholesale market are very important - as much for their psychological as their practical effect, even though the latter is very important. Even more important will be the extent to which societies can themselves effectively compete over the next year or so - and this depends on more radical thinking and determined marketing efforts than many are showing at present.

G W WATSON

ps7

UNCLASSIFIED

FROM: N G FRAY
DATE: 20 October 1987

MISS NOBLE

LUNCH WITH THE BSA

The Chancellor was grateful for the briefing submitted for his lunch with the BSA, contained in your minutes of 30 September and 1 October.

N G FRAY

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

FROM: A J G ISAAC
30 November 1987

CHANCELLOR OF THE EXCHEQUER

THE WOOLWICH

1. At your meeting last week you asked me how we are with the Woolwich.

2. On the main case, there is nothing new. We have lodged a protective appeal. The papers are with Counsel to advise. There is nothing to be done until we have his advice.

3. On the claim for interest, I understand that a hearing is due to begin in the High Court on Friday 18 December, and is expected to last for two days.

A J G ISAAC

---

cc Financial Secretary

Mr Battishill
Mr Isaac
Mr Corlett
Mr Munro
PS/IR

83/G/MAD/1319/14

FROM: MRS R LOMAX
DATE: 1 December 1987

ECONOMIC SECRETARY

cc: PPS
Sir P Middleton
Mr Cassell
Miss Noble
Mr Murphy

THE FUTURE OF BUILDING SOCIETIES

This is the first of what we hope will be regular six monthly meetings with the Commission. It provides an opportunity for you to meet the Commission and discuss with them where they see the building society movement going, how they see societies' business developing in changing markets, and how fast that development should be. These are issues which will crystallize in proposals which will be put to you very shortly in relation to the Schedule 8 Review. You should have a paper from Mr Bridgeman, summarising the Commission's thinking.

2. You may find some members of the Commission in a radical frame of mind. Judging by their approach to the Schedule 8 review, they seem to have convinced themselves that societies should be given the widest possible powers within the Act, subject only to individual prudential constraints and the relatively few absolute "nature" limits. We expect them to propose that building societies should be given powers to manage all forms of investment, to own controlling interests in stockbroking firms and insurance companies, and maybe (though they seem more hesitant about this) to move into providing services to companies as well as individuals.

3. This approach may be right. But it bears thinking about very hard indeed. It is, after all, less than a year since the Act came into force, eventful as that year has been. It was always envisaged that societies would be allowed to evolve. But we are almost certainly talking about a much more rapid extension of societies' powers than Parliament had in mind.

You will be told that the market has changed beyond recognition: and that the Financial Services Act has modified the legal framework within which societies are operating. There is truth in both propositions. But you will want to satisfy yourself that the Commission are taking a balanced view of last year's events, and giving due weight to the stock market collapse as well as the effect on societies of the preceding boom.

4. Equally relevant is the societies' - and the Commission's - capacity to handle a faster pace of change. Do societies have enough capital? Or the right management skills? And are the Commission equipped to exercise proper supervisory oversight as societies move further outside their mainstream business? (It is easy to draw the wrong conclusions from the savings and loans disaster in the United States. The seeds of the problem were peculiar to the time and the place: but this episode provides a vivid illustration of the dangers of reacting to market pressures by liberalising specialised institutions too rapidly, without providing an adequate framework of supervision.)

5. It is not difficult to see why both the societies and, to a lesser extent, the Commission, might be feeling a little rattled at present. Societies have not acquitted themselves gloriously in the face of their first real experience of competition. And while some of the pressures on them will be eased by the lifting of the wholesale funds limit and the collapse of the equity market, the fact is that life will never be the same for them again. The Commission have taken a bit of a pasting over the last year too - sometimes for features of the Act that were not their fault. It is hard not to sympathise with them for wanting to get ahead of the game.

6. Our job is to make the Commission justify anything that looks like a radical change in direction. For one thing, you will need to have a good story to tell the House. And we have a responsibility to see that the Commission discharge their statutory duties properly. To help us form an independent view, Kieran Murphy has produced the attached paper. It has not been discussed with anyone in the Commission. We are very conscious

that we need to go on developing our ideas. You should treat the paper as purely background briefing, for the purposes of your meeting.

Agenda for Thursday's meeting

7. I suggest you might usefully structure the discussion with the Commission around the following questions:-

(a) **Has the Act been overtaken by events?**

- What changes have occurred since the Green Paper which might affect our approach to building society development and the Schedule 8 services in particular?

- Is there a continuing role for specialist housing/personal savings institutions as envisaged in the Green Paper? If so, does the Act provide the right overall framework to foster such institutions? Are there merits in having mutual institutions performing that role?

(b) **What criteria should we apply in considering changes to societies' powers?**

- Do societies have the management skills to cope?

- What implications are there for societies' capital position?

(c) **What consequences do these changes have for the style and form of supervision currently applied to building societies?**

- Does the BSC have the resources to cope with a more flexible supervisory style? Should we be looking for quicker convergence between the Bank and BSC?

(d) **What attitude should we take to conversion?**

- Are societies more or less likely to convert if the services they can provide are extended?

- Is there any merit in extending the scope of their new

services in order to stave off conversion?

- Or should we leave a restrictive regime for those who want to remain as building societies and encourage the others to convert?

RL

RACHEL LOMAX

THE FUTURE OF BUILDING SOCIETIES

1. The Government's approach to the development of building societies was set out in the Green Paper. They should retain their primary role as specialists in the housing finance and personal savings market. And they should remain mutual institutions. But they should also be allowed to offer new services, which would further competition in the financial services industry, without prejudicing this primary role.

2. Societies main role would continue to be in housing; particularly housing finance. The Act therefore allows them to own and develop land, to manage housing investments and to take on new forms of lending. The Green Paper also stressed the need for societies to be competitive in attracting savings, in a rapidly changing financial services sector.

3. But the Green Paper recognised the potential conflict between diversification and safety of investors funds. It said that any move by societies into new services should not detract from their traditional security for investors and that the scope for diversification should therefore be limited and subject to proper prudential control. It should also not create significant conflicts of interest.

4. The Government envisaged that societies would expand into new areas of business over time. The Act therefore allows the Commission and/or the Treasury to expand the range of services societies can undertake and assets which they can acquire. The intention was that societies development would be evolutionary.

5. Developments since the Green Paper call into question some of the assumptions underlying this approach. To what extent is there still a role for mutual housing finance specialists funded predominantly from personal savings? How significant have market and other changes been since the Green Paper was published? Is it appropriate to widen the "new" services societies can provide as a consequence of the review of Schedule 8? If

so, what criteria should determine that widening? And how does this affect the way societies are supervised?

What changes have there been since the Green Paper was published?

(a) Present powers

6. The activities permitted to societies under Schedule 8 as enacted are something of a hotchpotch. This reflects, at least in part, the speed at which the Bill was passed and the late addition of a number of powers, (in particular, personal equity plans and personal pensions), which had as much to do with the Government's wider objectives for these products as it had to do with building societies' powers. There is no obvious logic in allowing societies to manage personal equity plans but not any other form of equity investment. One objective of the review of Schedule 8 might be to improve the coherence of societies' powers.

(b) Subsequent legislation

7. Since the Building Societies Act was passed the SIB have made rules under the Financial Services Act which require societies to polarise in respect of their investment business (insurance and pensions). Polarisation requires societies to be independent intermediaries, or to be tied agents either to a specific provider, or to themselves. The last of these three options is, at present, commercially unattractive, since societies are not permitted (under Schedule 8 as enacted) to own insurance companies.

8. The effect has been that, while all but one (NatWest) of the clearing banks have become tied to their own products, all but one (Abbey National) of the large societies have opted to be independent intermediaries. Societies argue that the interaction of polarisation and the restriction on their owning insurance companies is a distortion of competition relative to the clearers. This is true; were they able to offer their own insurance products, it is likely that fewer, if any, would opt to be independent intermediaries. But it is not clear that this results in significant commercial damage to societies. Nor is

it clear that consumers interests are not better served by the split into tied agents and independent intermediaries.

(c) Market changes

9. Arguably, the most compelling reason for considering a change in societies new activities is the degree of change in their mainstream markets in the past few years. This has affected both sides of their balance sheets.

(i) Funding

10. Since the early 1980s the growth in individuals liquid assets (bank and building society investments plus national savings) has been slower than their borrowing, particularly mortgage borrowing. Societies coped with this, until late 1985, by offering high interest rate share accounts, thus taking an increased share of retail savings at the expense of banks (and national savings).

11. During 1986, however, societies' inflows were hit particularly hard by two factors:

a. increased investment by individuals in unit trusts and privatisations;

b. increased competition from banks both on price (eg. high interest cheque accounts and free banking) and non-price (eg. Saturday opening) factors.

12. Societies have responded in two ways. First, they have run down their stocks of liquid assets, from an average 18% at end 1985 to 15½% at end 1986. Second, they have increasingly relied on the wholesale markets, which have become more widely available since the implementation of the 1986 Act. Societies use of wholesale money has increased very sharply from an average 6½% in mid 1986 to nearly 10% at June 1987.

13. Because of the large expansion in mortgage borrowing, these strategies have been insufficient for societies to keep step

with mortgage demand. They have therefore competed more fiercely in the retail savings market, forcing up certain retail savings rates to above wholesale market rates.

(ii) Lending

14. This increase in societies total cost of funds has been reflected in the cost of their lending. Society mortgage rates have drifted upwards relative to base rates and to the rates charged by banks and the new mortgage corporations, which have a higher proportion of wholesale funds in their overall funds mix. This has made societies less competitive on price in the mortgage market.

15. They have also become uncompetitive on non-price factors. A number of the new mortgage corporations advertise the speed with which they can offer mortgage loans to prospective customers. Societies have been relatively slow to respond to this, which may have been particularly damaging to them in the South East where competition among housebuyers is fiercest.

16. Societies have also been slow to diversify their mortgage products. Many still offer the same straightforward repayment or endowment mortgage regardless of the size of loan or the relative ability of the customer to repay it. They have lost business to those banks which have offered, even if on a limited scale, fixed rate mortgages. Nor have they developed products with interest rate differentials (perhaps with a lower rate for larger loans) or more marginal products such as mortgages for the self-employed (taking into account bonus payments etc) or equity mortgages, where a proportion of the ownership of the house is vested, initially, in the lender.

17. In consequence, societies' share of the mortgage market has fallen sharply. In 1984, societies took 80% of the market in new mortgages. In the first three-quarters of 1987, this figure had fallen to around 55%. Corresponding figures for the banks are 16% and 33%. The new mortgage companies have risen from nil to 12% or so this year. Societies have to some extent

been insulated from this by the rapid growth of the mortgage market as a whole; societies advances by value in the first three quarters of 1987 are 14% higher than in 1986.

Future market changes and societies response

18. It is reasonable to conclude that societies have not coped very well in the face of this competition, more serious than they have faced hitherto. Recent events, in particular the falls in equity markets and the raising of the statutory limit on their wholesale funding, may relieve some of the pressure on the funding side. Prior to the fall in the stock market, unit trusts were receiving over £500 million of net personal sector funds per month. This seems unlikely to continue, at least in the short term. After the last substantial fall in equity markets in 1974 unit trust inflows were substantially affected for several years. It may be, however, that individuals' increased wealth may make the impact on unit trusts less severe than before. So unit trusts may continue to represent a more significant factor than in the early 1980s, but not so severe as earlier this year. Future successful privatisations must be expected to result in a loss of funds from societies, as in the past. But even if societies are still forced to compete hard for retail savings, the increase in their wholesale funds limit must allow them to reduce, at least over the medium term, the average cost of their funds.

19. On the lending side, however, there is no reason to assume that the competition will be any less intensive over the forseeable future. As societies cost of funds falls and their awareness of the need to develolp new products rises, it may be that they will compete more effectively in the market. Conversely, however, the new mortgage corporations will retain an advantage on price, partly because of their funding mix, but also because they do not have large branch networks. And banks are able to sell a greater range of products than societies through their, rather larger, branch networks.

20. Faced with this, societies might choose either to rationalise their branch networks, or to use them to greater effect, by

offering their new (Schedule 8) services through branches, thus generating more income by cross-selling of products, so that a society might sell to an individual not only a retail account and a mortgage but also insurance, investment management and advice and a range of other services. These "new" activities are, however, themselves fiercely competitive. Some unit trust and insurance companies are increasingly regarding building societies' mainstream business as one way of expanding in the light of that competition (and recent market falls). The scope for societies to cross-sell may not be as substantial as they believe.

21. Nonetheless, this may well be a natural development for many societies. The degree to which they can undertake it is restricted by the provisions of Schedule 8. How far should we go in widening the services which societies can provide? And what criteria should we use in determining the answer to this question?

What criteria should underpin a review of Schedule 8?

22. Section 34 of the Act (which is the enabling power for Schedule 8) stakes out the limits of possible diversification. It permits the Treasury to extend the services societies can provide but only if they are financial services (defined as services of banking, insurance, investment, trusteeship and executorship) and services relating to land. Clearly, any service with falls into either of these two categories cannot prejudice some ultimate perception of the nature of building societies. But if a society were to undertake all of these functions it would be virtually indistinguishable in product terms from a bank. Is it desirable to move now to a position where societies could offer a much wider range of activities than at present? These activities might include stockbroking, (including acting as a market maker), insurance underwriting and full unit trust management powers (at present these are restricted to the provision of pensions). In practice, only the largest societies will wish to get involved in any of these activities and only perhaps the largest half dozen at most will undertake every function.

(a) Speed of change

23. The speed with which societies change has an important political dimension. The Act is, in this respect, quite a conservative document. Building societies had a public image quite distinct from that of banks. To what extent has the public perception of societies changed? And is that change reflected in the sorts of services which the public requires of societies? There has been no conclusive market or other research on this.

24. The trend towards the creation of large financial conglomerates has become more apparent in recent years. Until the 1986 Act, societies were statutorily barred from this route. There must be a limit to the number of large essentially retail based financial conglomerates which can survive. Only three societies (the Halifax, Abbey National and Nationwide Anglia) can, at present, realistically argue that they have the national base to compete with the clearing banks. Whether they have the necessary capital or management expertise is more doubtful.

(b) Services to Individuals

25. A common thread in the Act is the notion that building societies for the most part offer services to individuals, not to the corporate sector. For example, societies may only provide investment services and arrange for the provision of insurance or credit to individuals. It is hard to imagine societies offering financial services to ICI and other plcs or lending to other countries or companies abroad. Services to individuals might be a criterion, distinguishing societies from banks, to be preserved in the revised list of Schedule 8 services. It would, of course, produce difficulties at the margin (eg distinguishing individuals from unincorporated businesses and being able to offer credit cards to individuals but not business credit cards). These marginal difficulties do not of themselves justify a power to lend to ICI. But the definition of the retail/individual sector could be widened to allow societies to offer services to sole traders, or to unincorporated businesses or even to small and medium sized businesses not quoted on the Stock Exchange. This might allow smaller societies in particular to provide

services to emerging businesses in their local area.

(c) **Respectability**

26. Societies are widely perceived as respectable institutions. This notion is to a certain extent preserved in Schedule 8. For example they can arrange credit, but only on behalf of supervised institutions. This was intended to ensure that societies do not become involved in financial transactions with loan sharks. Whether we should preserve this notion in legislation is doubtful. If the Cheltenham and Gloucester chooses to refer its customers to a loan shark or arranges a dubious or unsatisfactory stock market transaction, it is C & Gs image that suffers. Why should legislation prevent this?

(d) **Safety**

27. Another criterion might be that societies are, or are at least perceived to be, "safe" havens for retail investors. Arguably this again is not something which should constrain the types of business societies can undertake. We do not constrain the commercial activities of banks in the interests of the safety of their deposits . "Safety" is more a matter of adequate prudential control. Risk to the institution can be managed through capital and liquidity requirements. Do we need to go further, on safety grounds alone, to prevent, say, property speculation, insurance underwriting and stock broking? Or should we distinguish societies from banks because societies are regarded as "safer"?

(e) **Conflicts of interest**

28. A final criterion, not related to "nature", is avoiding conflicts of interest. This is why estate agency services must, at present, be provided through subsidiaries. We have arguably already breached it by giving societies full investment advice powers. It is not sufficient to say that restrictions based on conflicts of interest shold not apply to societies merely because, rightly or wrongly, they do not apply to banks or insurance companies.

Prudential aspects

(a) Management skills

29. If societies are given a much wider range of powers in the review, they will in effect become financial conglomorates like banks supervised to a much greater degree than at present by a number of different supervisors. There must be some doubt as to societies management experience and capability to cope with this. Do the Commission think that society managements have the necessary skills? If not, how do they think this can be dealt with? Do the Commission have the necessary powers to prevent societies from engaging in new activities, such as insurance underwriting, on grounds of lack of management experience alone?

(b) Risk of Contagion

30. One of the issues which arises in the supervision of financial conglomerates is the risk of losses spreading from one activity throughout the group as a whole. For example, losses incurred in a stock broking or insurance underwriting subsidiary might, for either capital or liquidity reasons, require the parent building society to donate cash or capital to the subsidiary in order to keep it afloat. Insurance and stock broking are, however, supervised, by the DTI and the TSA respectively. The DTI's supervision is not as thorough as the regimes for building societies and banks mainstream business; in particular, it does not take much account of management experience, but relies more strictly on solvency and liquidity ratios. And the recent stock market falls demonstrate that stock-broking is a cyclical business where losses can and do occur. Supervision cannot of itself prevent this.

31. To what extent is this a problem for building societies? The first point is one of perception. Building societies are perceived to be safe havens for retail savings. The recent inflows

of retail funds illustrate that a number of people have decided that their money is safer with their building society than in another riskier if higher return form of investment. To what extent will this continue to be the case if societies offer these other riskier services and have to stand behind them?

32. The other question is how societies can cope with the risk of contagion from one subsidiary into the group as a whole. Building societies are required by law to stand behind their subsidiaries. In practice, however, even if these activities were undertaken by associated bodies where the society has a minority equity interest, it is unlikely that societies would be able to stand back and see the subsidiary go under. Societies might therefore be required to inject capital into subsidiaries or associated bodies in times of crisis. One prudential solution to this might be to require societies to carry more dedicated capital against these activities than is required by the relevant supervisor. This would provide a cushion for societies, at least to some extent, from losses incurred by subsidiaries. Such supervision would mean that societies would have greater costs in offering these sorts of services than their competitors and wou ld be at a competitive disadvantage in doing so. Would societies want to offer such services in these circumstances? Would there be pressure for the Commission to allow, say, insurance underwriting on the same basis as the DTI?

33. In addition, societies are currently relatively short of capital. And a major difference between societies and other financial institutions is that societies, at least at present, cannot raise capital quickly. Will societies be able to engage in a range of new activities without a significant increase in capital and other resources? Shortage of capital may prove to be the major reason for societies to convert to plc status. Is it possible that allowing societies to undertake new activities, but only with substantial capital penalties, may result in greater pressure to convert to plc status?

(c) <u>Commission resources</u>

34. The final prudential question is whether the Commission

has the skills to supervise societies undertaking this wide range of activities and even whether the Commission is an appropriate body for such a task. The Commission's supervisory regime is, at present, predicated on the assumption that societies are relatively homogenous in terms of the business they can undertake and they are restricted by statute from entering many business fields. The Commission's supervisory regime is, therefore, much less intrusive than, say, that of the Bank. But, if societies , or at least the larger ones, were to engage in a wide range of activities, some of which are subject to supervision by other bodies, the Commission would be obliged to consider the adequacy or otherwise of management skills and contral systems to a much greater degree that hitherto. The supervisroy system would gravitate towards that of the Bank.

35. Two questions arise. Do the Commission have the staff members and expertise to supervise in this way? The Bank have a larger number of staff dedicated to supervision than do the Commission. Arguably the quality of those staff is higher also. More radically, however, if the legislative differences between banks and societies are to be significantly weakened, and the supervisory systems brought more into line, what is the case for having two different supervisory bodies at all? Should we not consider moving the Bank and Commission closer together, perhaps by having common staffing arrangements between the two?

Will societies convert to be plcs?

36. The Act allows societies to convert, either to become freestanding banks or to be taken over by existing banks. A number of societies are considering the option. We believe that none have yet decided to do so. Their motives are mixed and confused. There is a suggestion that if Schedule 8 is not significantly widened, societies may choose to convert so as to have freedom to offer the services they wish to offer. This is characterised as the "wrong reason for conversion". There is clearly a certain amount of sabre rattling in this. But those societies which have serious longer term plans may find some

of the Act's constraints real. How, for example, should the Halifax plan in relation to the 5% class 3 assets limit if it cannot be sure that the Government will raise this limit before the Halifax reaches it?

37. It may, however, be that societies will choose to convert primarily in order to raise more capital (sometimes described as the "right reason for coverting"). Societies can only raise capital at present through transferring operating surpluses to reserves. And most societies have relatively little "free" capital over that needed to cover their present activities. Widening their Schedule 8 powers would, if they were to take up the services available to them, increase these capital constraints and bring into sharper focus the issue of conversion.

RM6.98 UNCLASSIFIED

FROM: MISS M P WALLACE
DATE: 2 December 1987

PS/ECONOMIC SECRETARY

cc Sir P Middleton
Mr Cassell
Mrs Lomax
Miss Noble
Mr Murphy

THE FUTURE OF BUILDING SOCIETIES

The Chancellor has seen Mrs Lomax's minute of 1 December. He has commented that it is somewhat odd that Building Societies are so anxious to diversify away from provision of home finance when banks clearly recognise that this is the best business to be in.

MPW.

MOIRA WALLACE

83/G/MAD/1319/37

FROM: MRS R LOMAX
DATE: 11 December 1987

ECONOMIC SECRETARY

cc: Chancellor
Sir P Middleton
Mr Cassell
Mr Scholar
Mr Peretz
Mr Ilett
Miss Noble
Mr Murphy

Ch
Rachel feels v strongly that EST should not be bounced on this. It does seem absurd to rush into major decisions so hastily

I entirely agree with Rachel.

BUILDING SOCIETIES: SCHEDULE 8 REVIEW

I attach a submission from Mr Watson setting out the Commission's proposals in the light of the review of Schedule 8. In effect, it asks us to extend building societies' powers to the maximum extent that is possible by secondary legislation under the 1986 Act. The Commission would like us to lay the (Affirmative) Orders early in February, so that those societies who wish to can adopt wider powers at their next annual general meetings (typically in April). To give the lawyers time to consult on the drafting of these Orders, Mr Watson would like you to reach a view on the results of the review before Christmas, and preferably make an announcement in general terms by means of Written Answer before the House rises for the Recess.

2. I am only submitting this paper tonight because I feel I should not close off these options. But my advice is that you should refuse to be rushed in this way. I imagine you will wish to discuss Mr Watson's paper as soon as possible; but even if you are fully in agreement with his recommendations, I doubt very much whether it would be feasible or sensible to announce a decision before the end of next week.

3. Your meeting with the Commission last week on the future of building societies was, of course, highly relevant to some of the general issues underlying the Schedule 8 review. And Miss Noble and Mr Murphy have been involved, to some extent, in the review itself. But we have only received the Commission's

detailed proposals this morning and have therefore not had an opportunity to discuss them with Mr Watson and Mr Bridgeman. The Bank have not seen them at all. And consultation with DTI officials has been both partial and at a relatively junior level (Commission officials have seen the insurance side of DTI, but not the financial services side). There seems to have been fuller consultation with SIB, IMRO and TSA, but we have not been party to it. Nor have we had an opportunity to reach a view on the supervisory implications of the Commission's proposals.

4. Neither MG nor the Bank have had an opportunity to consider the implications for monetary policy/presentation of, inter alia, a sharp increase in the limits on unsecured lending (class 2 and 3 assets). I also think you may want to consult Ministerial colleagues in DTI and DoE before making an announcement.

5. We clearly do not want to hold this up unnecessarily. But I cannot see how we can possibly go through all these hoops next week and be sure of getting the decisions and the presentation right. Nor am I convinced that we need to.

6. What I propose is that you should hold a small meeting with Mr Bridgeman and Mr Watson early next week to familiarise yourself with the detail of their proposals and to identify the wider issues of substance and presentation which will need further consideration. In the light of that meeting, we should talk to the Bank and DTI. Mr Peretz may want to talk to his opposite number at the Bank. You may wish to speak to the Chancellor, before writing to Mr Maude and Mr Waldegrave.

7. If you would find it helpful, we will submit an annotated agenda for your meeting with Mr Bridgeman.

RL.

RACHEL LOMAX

FROM: G W WATSON

DATE: 11 DECEMBER, 1987

1. MRS LOMAX
2. ECONOMIC SECRETARY

cc Chancellor
Sir P Middleton
Mr Cassell
Mrs Lomax
Miss Noble
Mr Murphy

Mr Bridgeman
Mr Devlin
Mr Davis
Mr Mathews
Miss Mayson
Mr Crosbie

BUILDING SOCIETIES ACT 1986: REVIEW OF SCHEDULE 8 POWERS

You announced on 2nd October that the Commission and Treasury officials, in consultation with the Building Societies Association, should carry out a review of Schedule 8 of the Building Societies Act 1986 which sets out the financial and housing related serivces which societies can undertake. The review had two aims. The first was to see whether the Schedule could be redrafted to remove some of the problems societies had been experiencing using their new powers. The second was to consider in a more coherent way the various requests, which societies had made for substantive widening of their powers.

2. The review has now been completed. This minute reports our conclusions, and the views of the Commissioners, who have been consulted, and seeks your agreement on a number of key policy issues. It also seeks your agreement that we should start detailed consultation with the BSA on the drafting of the affirmative order immediately.

The Structure of the Schedule

3. The present schedule is attached at Annex A. Section 34 empowers societies to provide "financial services" and "services related to land". Part I of Schedule 8 defines in fairly narrow terms which "financial services" can be provided, and the remaining parts impose additional restrictions on these powers. The lawyers have concluded, and Mr Rippengal, Counsel to the JCSI has provisionally confirmed, that we can use an affirmative order to make the list in Part I very broad and general with the remaining parts used to list specific exclusions. The effect will be that within a very broad definition of financial services, societies could do anything that we did not specifically prohibit. More detailed work is needed on the drafting. But changing to a more positive structure in this way, in which the presumption is reversed from the present version, and only those activities which are specifically banned are ultra vires, would on its own go a long way to removing the uncertainty and delays in making changes to accommodate societies plans, which have characterised the situation in the last few months.

The Scope of Societies' Powers

4. The Commissioners have considered whether to recommend that the order should also include a substantial widening of societies' powers and concluded that they should for three main reasons. First, the financial services scene has developed far more quickly than could have been foreseen two years ago and in particular societies have been subject to far fiercer competition in their traditional activities: second, the polarisation rules under the Financial Services Act, and societies' restricted powers, particularly in relation to running unit trusts and underwriting life insurance, combine to limit the options open to them compared with banks in areas whose customers can reasonably expect the same range of services: third, the frustration of restrictions on powers is diverting too much senior management time from the main business of competition and, in some cases, pushing societies to serious consideration of conversion for negative reasons. The third point affects in particular the larger societies: very few

of the smaller ones are using many of the present powers and are likely to use few, if any, new ones, and then probably as off-balance sheet, fee earning services.

6. The approach which the Commission favours is to extend the powers permitted to building societies as far as possible under Section 34, subject only to the maintenance of the essential characteristics of societies - mutual institutions with their main asset being secured loans on owner-occupied residential property - and the exclusion of specific activities which are inconsistent with this, or are inconsistent with the public perception of their role as providing an essentially retail service primarily to individuals. Moreover, while the Commission expects only comparatively few societies to make use of these powers, and these to move only progressively into new areas, it considers it essential, to allow them to plan ahead sensibly and prudently, that they should know now what the constraints on them may be four or five years hence. The approach outlined below is intended to achieve this - essentially allowing societies to decide rationally whether their future plans can be contained within the widened constraints of the Act, or, if not, whether they should convert.

Proposals from the Building Societies Association

7. The BSA submitted a substantial paper with a number of detailed proposals, following consultation with individual members. The BSA's main areas of concern are that societies, like banks, should be enabled to offer the full range of stockbroking, insurance and fund management services. They recognise that societies will have to operate through subsidiaries and other associated bodies in these areas. The BSA is particularly concerned that societies should be able to match the response of their competitors to the SIB polarisation rules. Banks which opt for registration as independent intermediaries can offer, through their branches, the products of other institutions and also of their own subsidiaries and associates. Building societies, however, will have to choose between offering either the limited range of own products presently available to them or the products of others. Allowing building societies to set up similar group/associate structures as banks for all kinds of personal

financial services would enable them to compete on equal terms. The remainder of the BSA's proposals are largely concerned with allowing incidental activities and straightening the boundaries of the present powers.

Proposed New Powers

8. A number of the BSA's detailed proposals can be met automatically by the sort of restructuring described above. There are four substantive points on which a decision is needed: stockbroking, fund management, insurance and company finance. On the first three the general case for liberalisation now is that the full impact of the Financial Services Act and the polarisation rules early next year will otherwise put building societies at a competitive disadvantage with the banks. Particular factors in each case are:

Stockbroking

You recently agreed to allow societies to give advice on investments. The arguments for going further and allowing societies to acquire, or take a stake in, broking firms are that this will enable societies to provide their customers with a faster more integrated service with better informed advice. It will also allow them to cement brokership arrangements. These arguments meet the counter argument that societies lack the experience and skills to invest in brokerage since the acquisition of specialist brokers will bring the necessary skills. The Commission therefore recommends that building societies be allowed to invest in stockbroker associates for the purpose of providing services mainly to individuals.

Fund Management

At present, societies are restricted to fund management for PEP and personal pension purposes only. This is anomalous, and the Commission recommends that the power be widened to include unit trusts generally. Again, this business would be conducted only through associated bodies. The Commission proposes that societies

be banned from running investment trust companies.

Insurance

At present, societies are restricted to providing insurance advice and arranging for insurance to be provided by others. Insurance is a major part of societies business, where the polarisation rules cause particular difficulties. The Commission recommends that you allow societies to acquire or take a stake in life insurance companies, but that their interest in general insurance is restricted to a minority (less than 15%) participation in an independent company. Societies interest is mainly in property and contents insurance, whereas, to provide a reasonable spread, general insurance companies normally cover a much wider range of risks. The Commission are reluctant for societies at this stage either to attempt to set up limited operations themselves, or to get into the position of standing behind a general insurance company exposed to a wide range of risks, distant from building societies concerns or experience. Nonetheless it is reasonable for them to be in a position to cement a relationship with a general insurance company with an equity stake, provided it is below the level at which they have an obligation to stand behind it.

Company Finance

Societies are presently restricted to providing services mainly to individuals. This was a recurrent concern during the Parliamentary debates on the Bill, when Ministers gave assurances that societies would remain providers of services primarily for personal customers and not for corporate businesses. The Commission agrees that this is right. However, it has some sympathy with the BSA's point that when an individual turns himself into a small business his society, which may have been doing business with him for some years, then has to refer him to its competitor banks. The Commission therefore suggests that 'individuals' should be defined so as to include small businesses as specified in section 248 of the Companies Act (that is, upper

limits on: annual turnover £1.4 million, balance sheet total £700K, employees 50).

Proposals

9. Subject to your agreement to the above, the Commission recommend that Schedule 8 be restructured to provide societies with broadly stated general powers within the envelope of financial and land services permitted by section 34 on the lines below. The broad shape and main effects of this change would be as follows:

(i) banking. Remove restrictions on money transmission services, credit cards, guarantees and indemnities, distribution of UK currency and share prospectuses;

(ii) investment (including pensions). Allow stockbroking and fund management;

(iii) insurance. Allow underwriting;

(iv) trusteeship and executorship. New powers enabling societies to act as trustee and executor and to manage trust funds;

(v) land services. Mainly boundary straightening to make it clear, for example, that societies can offer a house movers' 'package' including arranging removals and storage, providing information about local amenities, and providing property for sale listings;

(vi) conveyancing. No change.

The Schedule attached at Annex B, which is a working document, sets out the present position and the proposals in greater detail.

10. The general powers above would be subject to three general restrictions and a number of specific exclusions.

11. First, the powers should be restricted to providing services mainly to individuals defined to include small businesses as explained above.

12. Second, some powers should be exercisable only through a subsidiary or other associated bodies. This is necessary to reflect the requirements of other legislation (eg the Insurance Companies Act) or desirable to meet the requirements of other supervisors (eg The Securities Association). The particular activities concerned are mainly in the areas of investment and insurance. In addition, the present restriction limiting estate agency work to subsidiaries only (that is, more than 50% owned) should be relaxed to allow societies to take a minority stake in an associated body: a number of societies are believed to be interested in setting up joint bodies with other societies, or in taking a minority stake in a local estate agents to cement a brokership arrangement. But the other restrictions on estate agency services (which are designed to ensure that the subsidiary is mainly engaged in estate agency work, and to preclude conflicts of interest) should be retained.

13. Third, the small societies below the 'qualifying asset holding' (£100 million) should be banned from certain activities. Although the Commission thinks that statutory restrictions should not be used as a substitute for prudential control, it does believe there is a good case for retaining the present restrictions on small societies' activities. Neither the BSA nor any individual society has made any representations about this. The restriction would save the Commission from getting into arguments of 'principle' about activities which small societies have no need, nor management capacity to get into. The present restrictions cover: estate management, PEP management, land development, mobile home loans and unsecured lending. The Commission would add stockbroking and insurance underwriting to this list. In each case, it should be open to a small society to arrange for the service to be provided by others.

14. The Commission would also propose to ban societies from a number of specific activities which are either contrary to, or too remote from, their nature as mutual institutions whose predominant business

is to raise retail funds for lending on owner-occupied residential land. These restrictions include: lending to foreign governments and corporate bodies, factoring debt, underwriting share issues, market making in the securities markets, and owning or taking a stake in investment trust companies.

15. Use of these new powers by individual societies would continue to be subject to the prudential supervision of the Commission in the same way as existing activities: the new structure of the Schedule will, however, give it increased importance. The new activities fall into three categories:

(a) Some increase in the extent and type of unsecured lending by the society. As this develops, and to the extent that societies do it on balance sheet, this will require increased attention by the Commission.

(b) Some new activities, such as insurance and stockbroking, involve new financial risks. The subsidiaries carrying out these activities will be subject to the financial and conduct rules of the relevant regulator, such as DTI or TSA. In respect of financial monitoring the Commission, as lead regulator, will negotiate arrangements such as we have already reached with SIB on present activities. The Commission will retain responsibility for the building society group and, in respect of the subsidiary, will carry out financial monitoring to the other regulators rules. Ultimate regulatory responsibility for the subsidiary will remain with the other regulators, but if problems arise action will be the Commission's responsibility for the group as a whole.

(c) Most of the additional powers do not imply financial risk beyond the operational risks (such as poor documentation or negligence) implied in any business operation.

Societies will be constrained in what they can do by the capital available to them and for that reason, if for no other, few if any societies (even the biggest) can be expected to attempt to move forward on all fronts in the short term. The Commission therefore considers that, subject to resolution of its longer term staffing problems, it will be able to cope with any additional workload as lead supervisor for societies.

Likely Reactions

16. There are two possible lines of opposition to what is proposed. First, it may be argued that an extension of powers of this kind will allow societies to move too far from their traditional role - or to do so too fast. The Commission believe this can be countered by reference to the changed environment in which societies have to compete and the need for them, in order to do so effectively, not to be at a statutorily imposed disadvantage to their competitors. It is also possible to point out that the essential nature limits for societies laid down in the Act - mutuality, primarily retail deposits and owner-occupied mortgages - are retained: moreover the new proposals specifically exclude activities such as corporate finance which are outside societies traditional fields.

17. Second, it may be argued that extension of societies' powers will disadvantage other member intermediaries - particularly in respect of investment services and insurance. This argument is difficult to sustain as a general proposition against a general background of competition in the financial services area: more specifically the ability to undertake activities such as life insurance on balance sheet will not affect the relationships between societies and brokers who, where they introduce business, will still have the opportunity to sell related insurance. Allowing societies the additional option of taking a minority stake (as opposed to control) in estate agency businesses could be a positive step towards enabling smaller businesses to remain in existence.

18. The Building Societies Association are, however, likely to

welcome the proposals, provided we respond positively on stockbroking, fund management and insurance. They would give the BSA most of what it asked for. The exceptions are:

(a) General insurance underwriting where the BSA proposed only to ban marine and aviation risks. Restricted to a maximum 15% shareholding in an associated body.

(b) Estate agency where the BSA want all restrictions removed. Keep present restrictions except that other associated bodies are added to subsidiaries and societies will be allowed to offer a property listing service.

(c) General restriction, in section 18, on secured lending and onward investment by subsidiaries and other associates, which the BSA would remove. It is doubtful that the Commission has power to do that, but it is ready to consider specific cases which might justify designation orders.

In none of these instances has the BSA presented evidence of any real problem, neither has it made out a case against the restrictions. The Commission proposes to maintain its position unless the BSA can come up with compelling arguments to the contrary.

Related Provisions

19. Reform of Schedule 8 on the lines proposed above will need to be accompanied by complementary and consequential changes made by Orders under other sections of the Act. New assets will be created, and will have to be clasified as class 3 commercial assets by an Affirmative Order under section 19. Designation Orders will be needed under section 18 (negative procedure) to define descriptions of bodies (eg stockbrokers, insurance companies, estate agents) which qualify for investment or support by building societies for specified purposes. There may be other complementary changes which will emerge during the process of drafting the new Schedule 8.

Asset Limits and Limit on Unsecured Lending

20. Widening societies powers has implications for the asset limits in Section 20 and that on unsecured lending in Section 16.

21. There is power in Section 20 of the Act to raise, by affirmative order, the limits on Class 2 and Class 3 assets, as a percentage of total assets, from 10% to 25% and 5% to 15% respectively: the link between the two is that the Class 3 limit has to be accommodated within that for Class 2.

22. There is as yet no pressure on these limits from current activity. But widening societies powers will increase their potential for acquiring Class 3 assets and hence some increase is logical. The main case for an increase now is the need for societies, particularly the larger ones, to be able to plan some years ahead without uncertainty about whether or when the limits will be raised. The Commission are pesently encouraging all societies to adopt and monitor five-year business plans. Societies cannot reasonably be expected to make realistic plans if there is uncertainty about business activity limits half-way through the planning period. The only safe assumption they could make would be that the limit would not be changed. They will be obliged to trim their short-term plans accordingly.

23. The Commission favours an increase to the full 15% for Class 3 (and, as a consequential, to 25% for Class 2) permitted by the Act. The main constraint on societies' ability to acquire Class 3 assets is likely to be shortage of capital.

24. There is also a limit of £5,000 at present on the amount which can be lent unsecured to any individual. The limit is already a constraint. It would not, for example, accommodate a loan for a first time purchaser to furnish a house, or a modest loan for a car, plus a reasonable limit on a credit card.

25. There is a strong case for abolishing this limit altogether on the grounds that the extent of exposure to one individual is a matter

of prudential judgement for a society, as it is for a bank - and their overall exposure is limited by their capital base. Subject to confirmation by Mr Rippengal, Counsel to the JCSI, our lawyers believe it would be possible, by an affirmative order under section 19, to redefine the categories of unsecured debt so as to abolish the limit. The Commission recommend this course. As a matter of prudential supervision the Commission intend to pay increased attention to societies systems of unsecured debt management as their activity in this area increases.

Procedure and Timing

26. The proposals above would require Affirmative Orders to amend Schedule 8, to empower societies as a consequence to hold additional commercial assets under section 19, and to amend the commercial assets limits in section 20 on the lines set out in this minute. There will also be various negative orders for which Treasury consent will be necessary.

27. Drafting the orders will be a major operation and it is essential that we consult as widely as possible to reduce the risk of unintended restrictions of the kind we have been experiencing. If we are to meet societies' wish to be able to adopt wider powers at annual general meetings in April (when most occur) we shall need to lay the orders early in February. To achieve this, consultation with the BSA and societies needs to start as soon as possible.

28. If therefore you are content with these proposals an early announcement of the general lines of change would enable the necessary open consultation to take place. The proposals will need to be cleared with Mr Maude first, however, because many of them relate to his responsibilities and this may rule out any announcement to the House. If you are content, we could nevertheless start work with the BSA on a confidential "without prejudice" basis, though there are serious risks that the substance of them will leak.

29. You may however wish to discuss these proposals with us first, and in particular the extensions into stockbroking, fund management, insurance and the increases to the asset limits. If so we are ready to do so.

R. Farey

pp G W WATSON

ANNEX A

Building Societies Act 1986 as amended by The Building Societies (Provision of Services) Order 1987, SI 1987/172, Banking Act 1987, c.22, The Building Societies (Banking Institutions) Order 1987, SI 1987/1670, The Building Societies (Provision of Services)(No.2) Order 1987, SI 1987/1848, The Building Societies (Provision of Services)(No 3) Order 1987, SI 1987/**1976** and The Building Societies (Provision of Services)(No 4) Order 1987, SI 1987/**2019.**

SCHEDULE 8

POWERS TO PROVIDE SERVICES

PART I

THE SERVICES

1. Money transmission services.
2. Foreign exchange services.
3. Making or receiving of payments, as agents.
4. Management, as agents, of mortgage investments.
5. Management, as agents, of land.
6. Arranging for the provision of services relating to the acquisition of disposal of investments, whether on behalf of the investor or the person providing the service.

6A. Giving investment advice.

6B. Arranging for the provision of units in a unit trust scheme. **SI 1987/1976**

7. Establishment and management of personal equity plans.
8. Arranging for the provision of credit, whether on behalf of the borrower or the person providing credit, and providing services in connection with current loan agreements to the party providing credit.
9. Establishment and management of unit trust schemes for the provision of pensions.
10. Establishment and, as regards the contributions and benefits, administration, of pension schemes.
11. Arranging for the provision of insurance of any description, whether on behalf of the person effecting or the person providing the insurance.
12. Giving advice as to insurance of any description.
13. Estate agency services.
14. Surveys and valuations of land.
15. Conveyancing services.

PART II

GENERAL RESTRICTION ON SERVICES ABROAD

(1) Subject to sub-paragraph (2) below, no power to provide a service of a description specified in Part I of this Schedule includes power to maintain a place of business in a country or territory outside the United Kingdom for that purpose unless the society also conducts the principal business of a building society in that country or territory.

(2) This paragraph does not apply to the power to provide estate agency services.

PART III

RESTRICTIONS IN RELATION TO CERTAIN SERVICES

Money transmission

1. No guarantee arising out of the operation of an account by means of which money transmission services are provided shall exceed, for any single operation, the prescribed limit.

Foreign exchange

2. The provision of foreign exchange services is restricted to their provision to individuals.

Estate management

3. Management of land is restricted to management of land which is or is to be used primarily for residential purposes or for purposes incidental to the use of adjoining land managed by the society which is or is to be used primarily for residential purposes.

4. The power to manage land is not available to a building society which does not for the time being have a qualifying asset holding.

Arranging for investment services

5.(1) Arranging for the provision of investment services is restricted to their provision to individuals.

(2) The power to arrange for the provision of investment services does not include power -

(a) to buy or sell any investment, either as principal or agent, or

(b) to give advice concerning any investment. SI 1987/172

Giving investment advice

5A. The power to give investment advice is restricted to giving advice to individuals. SI 1987/1976

Personal equity plan management

6.-(1) The power to establish and manage personal equity plans is available only to a subsidiary of the society.

(2) The power to establish and manage personal equity plans is available only while the society has a qualifying asset holding.

Arranging for provision of credit

7. Arranging for the provision of credit and connected services is restricted to their provision by -

(a) any [authorised institution] SI 1987/1670
[or building society]; SI 1987/1848

(b) any body corporate connected with the person arranging for the services to be provided; or

(c) any other body [or description of body] SI 1987/1848
for the time being approved for the purpose of this Schedule by the Commission, whether in relation to all building societies, to specified classes of building society, or to a particular building society. SI 1987/172

8. Arranging for the provision of credit is restricted to its provision to individuals except where the loan to the borrower is to be secured by -

(a) a mortgage of a legal estate in land in England and Wales or Northern Ireland; or

(b) a heritable security over land in Scotland,

being a mortgage or heritable security to which no other, or no more than one other, mortgage or heritable security, as the case may be, will have priority.

Pensions management etc.

9. The power to establish and manage unit trust schemes is available only to a subsidiary of the society.

Arranging for insurance

10. Arranging for the provision of insurance is restricted to its provision primarily to individuals; but this restriction does not apply to, nor in determining whether over any period insurance is being provided primarily to individuals is any account to be taken of income derived from, insurance relating to land which is to secure advances by the society.

Estate agency

11. The power to provide estate agency services is available only to a subsidiary of the society.

12. For the power to provide estate agency services to be available to the subsidiary of a building society, the following conditions must be fulfilled as regards the subsidiary and its business, that is to say -

(a) the subsidiary must have been formed in one of the following countries or territories, that is to say, the United Kingdom, a relevant British overseas territory or another member State and the principal business of the society must, at the time the society forms or acquiries the subsidiary, be conducted in that country or territory;

(b) 40 per cent or more of its total income in any financial year (wherever arising) must be derived from estate agency work done in countries or territories in which the society, at any time in that year, carried on the business of making advances secured on land; and

(c) its business must not include the lending of money, secured or unsecured, on its own account or the provision of any service which is a financial service for the purposes of this Schedule other than one which is for the time being specified in Part I of this Schedule.

(d) its business must not include any activity which the society could not undertake by reason of the fact that -

(i) the society has not adopted a particular adoptable power, whether because the power is not available to it or for any other reason, or

(ii) the activity would be in contravention of a restriction upon the extent of a power the society has adopted, being either a restriction specified in this Part of this Schedule and relating to a power to provide a financial service or a restriction assumed by the society.

13. No employee of a building society whose duties include -

(a) making a report on the value of land which is to secure an advance,

(b) making an assessment of the adequacy of the security for an advance to be secured on land, or

(c) authorising the making of an advance to be secured on land,

shall perform any service for any subsidiary of the society which provides estate agency services.

PART IV

SUPPLEMENTARY

Guarantees

1.-(1) The Commission, with the consent of the Treasury, may by order prescribe a limit of such amount as it considers appropriate for the purposes of paragraph 1 of Part III of this Schedule and in that paragraph "the prescribed limit" means the limit for the time being in force under this paragraph.

(2) The power to make an order under this paragraph shall be exercisable by statutory instrument and any instrument so made shall be subject to annulment in pursuance of a resolution of either House of Parliament.

2.-(1) Without prejudice to any other implied incidental power, the power conferred in Part I of this Schedule to provide money transmission services implies (subject to any specified restriction) power, as regards members as well as others, to give guarantees in relation to, or to permit occasional overdrawing on, accounts with the society.

(2) It shall be the duty of a building society which has become obliged by virtue of the provision of money transmission services under this Schedule to fulfill a guarantee on a person's account or has permitted an account to become overdrawn to recover as soon as practicable from the person the amount paid by it under the guarantee or, as the case may be, the amount due to it on the overdrawn account and any instrument embodying the guarantee.

Status as bankers

3.-(1) So far as regards the provision by it of a service which is a qualifying banking service for the purposes of this paragraph a building society shall be treated for all purposes as a bank and a banker and as carrying on the business of banking or a banking undertaking whether or not it would be so treated apart from this paragraph.

(2) A building society provides a qualifying banking service for the purposes of this paragraph if, with or without any restriction, it provides either or both of the services falling within paragraph 1 or 3 of Part I.

(3) This paragraph does not affect the determination of any question as to the status of a building society as a bank or banker for other purposes.

Foreign exchange services to individuals

4.-(1) For the purpose of determining whether a transaction consists in the provision of foreign exchange services to an individual it shall be presumed that a transaction does so consist if the value of the transaction is less than the standard amount.

(2) The standard amount is, subject to sub-paragraph (3) below, £5,000.

(3) The Commission, with the consent of the Treasury, may by order amend sub-paragraph (2) above so as to substitute for the amount for the time being specified in that sub-paragraph such other amount as it considers appropriate for the purposes of this paragraph.

(4) For the purposes of sub-paragraph (1) above the value of a transaction consisting in the provision of foreign exchange services is, where the society is selling the foreign currency, the sum paid to it and, where the society is purchasing the foreign currency, the sum paid by it.

Provision of credit by connected bodies

4A.-(1) For the purposes of paragraph 7(b) of Part III of this Schedule, a body corporate is connected with a person arranging for credit and connected services to be provided if and only if -

(a) one is a building society and the other is a subsidiary or relevant associated body of that society; or

(b) both are subsidiaries of the same building society.

(2) For the purposes of sub-paragraph (1) above an associated body of a building society which is not a corresponding European body as referred to in section 18(2)(b) of this Act is a relevant associated body of that society.

Subsidiaries providing estate agency services

4B. For the purpose of determining whether the condition in paragraph 12(d) of Part III of this Schedule is fulfilled as regards a subsidiary of a building society, the continuation, during the first fifteen months following the date on which an undertaking became or the business of an undertaking was transferred to a subsidiary of the society, of any activity carried on as part of the business of the undertaking immediately before that date shall be disregarded. SI 1987/172

5. If a person performs any service in contravention of paragraph 13 of Part III of this Schedule he shall be liable on summary conviction to a fine not exceeding level 4 on the standard scale. SI 1987/172

Interpretation

6. This Schedule is to be construed as relating only to the capacity of building societies to provide the services for the time being specified in it and not as making lawful any activity, whether of a building society or a subsidiary or other associated body of a building society, which would not be lawful apart from this Schedule.

7. In this Schedule -

"authorised institution" means an institution which is authorised under the Banking Act 1987; 1987 c.22

"conveyancing services" has the same meaning as in Schedule 21 to this Act;

"estate agency work" has the same meaning as in the Estate Agents Act 1979;

"investment" means any asset, right or interest falling within any paragraph in Part I of Schedule 1 to the Financial Services Act 1986(a), and "investment advice" means advice of the kind specified in paragraph 15 of Part II of that Schedule; SI 1987/1976

"mortgage investments" means investments consisting of rights arising out of secured lending where the security comprises or includes land; SI 1987/1848

"pension scheme" means -

(a) a retirement benefits scheme within the meaning of, and approved or capable of being approved by the Commissioners of Inland Revenue for the purposes of, Chapter II of Part II of the Finance Act 1970(b) (occupational pension schemes), or

(b) a personal pension scheme within the meaning of, and approved or capable of being approved by the Commissioners of Inland Revenue under, Chapter II of Part I of the Finance (No.2) Act 1987(a) (personal pension schemes),

and the "provision of pensions" means the provision of benefits which are "money purchase benefits" within the meaning of the Social Security Act 1986(b) (or, in relation to Northern Ireland, the Social Security (Northern Ireland) Order 1986(c)). SI 1987/2019

"personal equity plan" means a personal equity plan for the purposes of Schedule 8 to the Finance Act 1986;

"the principal business of a building society" means the business of raising funds (whether by the issue of shares or receiving deposits) for the purposes of the society or of making advances secured on land;

"the prescribed limit", in relation to guarantees, has the meaning given by paragraph 1 of this Part;

"relevant British overseas territory" means any of the Channel Islands, the Isle of Man and Gibraltar; and

"unit trust scheme" has the same meaning as in the Financial Services Act 1986.

SCHEDULE 8 AND RELATED PROVISIONS: NEW STRUCTURE

7th Edition

POWERS (extends beyond Sch.8 where other powers available)		RESTRICTIONS		PRUDENTIAL REQUIREMENTS	BSA PROPOSAL	CONSEQUENTIAL CHANGES		COMMENTS
PART I	ACTIVITIES	EXISTING	PROPOSED			S.18&19	OTHER ss.16, 20, 35, 64/5, 73&83	
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
LAND SERVICES (C'tnd)	Removals and storage	Banned	For individuals etc(1) only. Associates only (but not subsidiaries) QAH(3) arranging only.		New power	? minority share in removal/storage company.		
	Estate management, as agents, including services in relation to individual properties	Limited to primarily residential and to acting as agents QAH(3) ban.	Existing restrictions, but relaxed to cover acting as independent contractor as well as acting as agents.		Remove restrictions. Include care, maintenance & fuel economy services.			Consider "independent contractor" status - direct or as agent.
	Acquisition and disposal of land as agent	Limited to primarily residential. QAH(3) ban.	Keep existing restrictions.		Clarify "chain breaking" power		Already in s.17	No evidence of any real problems with s.17 powers.
	Development (ie design, planning and construction) of land for others:	Banned.	Limit to primarily residential QAH(3) ban.		New power			
7.CONVEYANCING	Residental Commercial	None	None					Not yet authorised by other legislation
RELATED MATTERS	S.15 Mobile Home Loans	£10K limit	No limit					Abolish s.15 & 16 lending limits, subject to clearance with House authorities
	S.16 Other lending	£5K limit	No limit		£25K limit	S.19		
	S.20 Asset limits: Class 2&3 Class 3	10% 5%	25% 15%		25% 15%			
	S.18 Associated bodies	No secured lending or deposit taking in UK; restricted onward investment.	Keep existing restrictions		Allow secured lending and onward investment.			No evidence of any real problems, or or case for change.

NOTES

(1) "Individuals etc" to be defined as including small UK-registered companies (Companies Act s248), Friendly Societies, Industrial and Provident Societies, Charities and Clubs. Small companies measured at last balance sheet date and aggregating companies in common or linked ownership. Where small company moves over the s.248 limit, no new facilities to be granted, nor further lending of principal or leasing of property after the time it moves over limit.

(2) Other statutory or regulatory restriction to be reflected. Associate includes subsidiary unless otherwise stated.

(3) QAH means societies below the qualifying asset holding.

SCHEDULE 8 AND RELATED PROVISIONS: NEW STRUCTURE

7th Edition

POWERS (extends beyond Sch.8 where other powers available)		RESTRICTIONS		PRUDENTIAL REQUIREMENTS	BSA PROPOSAL	CONSEQUENTIAL CHANGES		COMMENTS
PART I	ACTIVITIES	EXISTING	PROPOSED			S.18&19	OTHER ss.16, 20, 35, 64/5, 73&83	
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
3.INSURANCE	General insurance and reinsurance underwriting	Banned	Associate(2) only (less than 15% shareholding) QAH(3) arranging only	Additional capital	New powers, not restricted to individuals	S.18 &/or 19 insurance underwriting companies for the purposes specified in col.(4). Plcs only for general insurance.		Insurance companies may hold mortgages. Consider "infinite area" of activities.
	Life insurance and reinsurance: underwriting: (a) Term insurance (b) Endowment (c) Annuity	Banned	Associate(2) only (including subsidiary) QAH(3) arranging only	Additional capital	New power			
	Acting as agent	Primarily for individuals, except where it relates to property mortgaged to the Society	None					
	Acting as broker		None					
	Advice on Insurance		None					
4.TRUSTEESHIP	Family trusts (including trustee under wills) Corporate trusts Pension fund trusts Charitable trusts	None Banned	Associate(2) only. Not to act as trustee in bankruptcy	Contingent liabilities	New powers			Further investigation needed to see whether restriction to associates only is in fact consistent with practice of financial institutions. If not, remove restriction.
	Agents for trustees	Banned						
5. EXECUTORSHIP	Executor for wills		Associate only	Contingent liabilities	New power			
6. LAND SERVICES	Estate agency	Subsidiary only - 40% income as estate agent. Territorial & conflict of interest restrictions.	Associate only, otherwise keep existing restrictions.		Remove all present restrictions	S.18 Estate agents for col.(4) purposes.		Infinite area outside s.34 which does not constrain original sch.8
	Property listing	Only permitted where incidental to other activities.	None					
	Surveys and valuation of land.	None	None					

SCHEDULE 8 AND RELATED PROVISIONS: NEW STRUCTURE

7th Edition

POWERS (extends beyond Sch.8 where other powers available)		RESTRICTIONS		PRUDENTIAL REQUIREMENTS	BSA PROPOSAL	CONSEQUENTIAL CHANGES		COMMENTS
PART I	ACTIVITIES	EXISTING	PROPOSED			S.18&19	OTHER ss.16, 20, 35, 64/5, 73&83	
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
BANKING (C'tnd)	Administration of share issues Share registration Administration of prospectuses	Banned	None		New power			
	Arrangement of wills	Banned	Not to be added as a specific power. Insofar as it can be justified as an incidental power, no restrictions.		New power			
2.INVESTMENT	Stockbroking: (a) agency broking	Arranging for individuals only	For individuals etc (1) only. Associate only(2). QAH(3) arranging only.	Additional Capital	New power	S.18 stockbrokers for purposes of (a)&(b) only; QAH ban		
	(b) principal dealing	Banned			New Power			
	(c) market making	Banned	Ban (except own treasury operations).					
	Portfolio management	Banned	For individuals etc (1) only QAH(3) arranging only		New power			
	Acting as nominee	Banned	For individuals etc (1) only. Associate only. QAH(3) ban.		New power			
	Establishing and managing: (a) PEPs	Subsidiary only. QAH (3) ban.	Associate only(2). QAH(3) ban	Contingent liabilities				
	(b) Unit trusts	Subsidiary only and limited to pensions	Individuals etc(1) only. Associate only(2). QAH(3) ban.		Wider power			Removes QAH ability to manage unit trusts for pensions.
	(c) Pension schemes (except UTs) (i) personal (ii) occupational	Trusteeship limited to associates	None					
	(d) Investment trusts companies	Banned	Ban					
	Investment agents Investment advice.	For individuals only. "Investments" as in Financial Services Act.	For individuals etc(1) only. "Investments" as in Financial Services Act.					

SCHEDULE 8 AND RELATED PROVISIONS: NEW STRUCTURE

7th Edition

POWERS (extends beyond Sch.8 where other powers available)		RESTRICTIONS		PRUDENTIAL REQUIREMENTS	BSA PROPOSAL	CONSEQUENTIAL CHANGES		COMMENTS
PART I	ACTIVITIES	EXISTING	PROPOSED			S.18&19	OTHER ss.16, 20, 35, 64/5, 73&83	
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
BANKING (C'tnd)	Money transmission & clearing	Guarantees limited to guarantees arising from operation of accounts and to £100 per transaction.			Abolish guarantee limit			Guarantee limit in relation to circumstances and amount to be abolished (Sch.8 Pts III & IV).
	Guarantees & indemnities: (a) Individuals (b) Bodies Corporate	Limited to money transmission and subject to those limits	Individuals etc(1) only			S.19 guarantee debtors accounts (not to count towards the class 3 limit - S19(6))		
	Distribution of UK currency	Banned	None					
	Foreign exchange: (a) Individuals (b) Corporate bodies:	Individuals & unincorporated businesses only, except where transaction amount is less than £5K and society not aware that applicant is another type of business.	Individuals etc(1) only		Abolish £5K "standard amount" disregard			Leaves societies to judge vires without £5K rule of thumb.
	Making/receiving payments as agents.	None	None	Contingent liabilities				
	Tax and financial planning	Banned	None		New power			
	Safe deposit facilities	Banned	None		New power			
	Acquisition of mortgage-backed securities	Banned	Class 1&2 equivalents			S.19 mortgage debt	Liquid assets	Include mortgage-backed securities as liquid assets.
	Receipt of transferred mortgages	Class 1&2 assets & s13 procedure, or class 3 if within limit	Class 3 with provision to reclassify to class 1 and 2					
	Factoring debt.	Banned	Ban					
	Underwriting share issues	Banned	Ban					

SCHEDULE 8 AND RELATED PROVISIONS: NEW STRUCTURE

7th Edition

POWERS (extends beyond Sch.8 where other powers available)		RESTRICTIONS		PRUDENTIAL REQUIREMENTS	BSA PROPOSAL	CONSEQUENTIAL CHANGES		COMMENTS
PART I	ACTIVITIES	EXISTING	PROPOSED			S.18&19	OTHER ss.16, 20, 35, 64/5, 73&83	
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1. BANKING	Deposit taking	In general, to be carried out by society only (not subsidiaries, etc) if in UK	As at present					Power to remove existing restrictions is not available except in specific cases.
	Non-class 1&2 lending to: (a) Individuals (b) Unincorporated businesses (c) Corporate bodies: (i) Small UK public & private companies (at last balance sheet date).	Individuals & unincorporated businesses only. Maximum of £5K, or £10K less unsecured loan if for mobile home. QAH(3) ban.	Individuals etc(1) only. Continue QAH(3) ban.			S/19 Banking assets. S.19 abolition of lending limits	S.15&16 limits	Other powers available for secured and other lending (s.16). Abolition of s15 & 16 lending limits subject to clearance with House authorities.
	(ii) Other UK public & private companies	Banned	Ban					
	(iii) Foreign & BOT bodies	Banned	Ban					
	(iv) Other (inc. NIs)	Banned	Ban					
	(d) Sovereign debt	Banned	Ban					
	Leasing	Banned	Individuals etc(1) only. Aggregate value of property with amounts lent so that total exposure in any one case is within lending limits. QAH(3) ban.			S.19 leased property		
	Hire purchase	Banned						
	Arranging and managing loans or credit provided by others.	Limited range of "respectable" lenders for whom society can act. Individuals only, except where secured by land mortgage.	Individuals etc(1) only, except where secured by land mortgage.	Contingent liabilities	Remove all present restrictions			

mjd 3/27m

FROM: MOIRA WALLACE

DATE: 14 December 1987

PS/ECONOMIC SECRETARY

cc Sir P Middleton
Mr Cassell
Mr Scholar
Mrs Lomax
Mr Peretz
Mr Ilett
Miss Noble
Mr Murphy

BUILDING SOCIETIES: SCHEDULE 8 REVIEW

The Chancellor has seen Mrs Lomax's minute of 11 December. He entirely agrees with Mrs Lomax's advice that we should not be rushed in this way.

MOIRA WALLACE

53/2/LPD/3745/013

APS/CHANCELLOR

FROM: G R WESTHEAD
DATE: 15 December 1987

cc PS/Sir P Middleton
Mr F Cassell
Mr Scholar
Mrs Lomax
Mr Peretz
Mr Ilett
Miss Noble
Mr Murphy

BUILDING SOCIETIES ACT : SCHEDULE 8 REVIEW

The Economic Secretary has seen your minute of 14 December as well as Mr Sargent's of the same date.

2. The Economic Secretary very much agrees with the Chancellor and Sir Peter Middleton that no hasty decisions should be taken about the Review of Schedule 8 of the Building Societies Act. He has, however, had an initial discussion with Treasury officials, including Mrs Lomax, and will be having a more detailed discussion with the Building Societies Commission later this week. However, it has been made clear to the Commission that there is no prospect of immediate decisions and an early announcement on this.

Guy Westhead.

GUY WESTHEAD
Assistant Private Secretary

COMMERCIAL IN CONFIDENCE

FROM: K F MURPHY

DATE: 8 January 1988

1. **MISS ~~NOBLE~~** GN
2. **ECONOMIC SECRETARY**

cc PPS
PS/Financial Secretary
Mr Scholar
Mrs Lomax
Miss Sinclair
Mr Watson (BSC)

Mr Reed (IR)

LETTER FROM SCOTT DURWARD

The Chief General Manager of the Alliance and Leicester Building Society, Mr Scott Durward, wrote to the Financial Secretary on 18 December on a tax point affecting building society conversions. I understand that you will be replying.

2. Mr Durward attaches a letter which has been sent to the Inland Revenue drawing our attention to the fact that, with the tax legislation as it presently stands, any society which chose to convert would be obliged to pay Capital Gains Tax on a substantial proportion of the society's assets. This could be a very substantial tax bill indeed. But the most important point of Mr Durward's letter is the emphasis he gives to addressing this problem in time to change the law if Ministers so wish in the 1988 Finance Bill. Mr Durward and some of his advisors came in to see us late last year. It is clear that they are very keen indeed on conversion, perhaps keener than any other society at present. They quite clearly believe that it would be possible to convert during 1988. They therefore attach considerable importance to any changes in tax law being undertaken in the 1988 Finance Bill, if this is not to hold up their commercial plans.

But they may yet lose interest when they have studied the implications further GN

3. You will today be receiving advice from the Inland Revenue on the specific point which Mr Durward has raised and a number of others to which he alludes. (One of there other points is on stamp duty, where the Revenue have discovered that while there are detailed conversion routes which will <u>not</u> attract a transfer duty charge, the Alliance and Leicester's proposal - which has been discussed in confidence with the Revenue Solicitors - <u>will</u>,

unless the law is changed. The Revenue submission discusses this issue.) That submission will also address the question of timing. In reply to Mr Durward, you cannot of course discuss the substance of these issues. His letter asks whether the Financial Secretary would be willing to meet him and colleagues to discuss these points. I think it would be better to turn down this offer. I doubt if Mr Durward has more to say than he already said to us; we understand the problem quite clearly. And if you were to agree to see Mr Durward you might then be obliged to see others. I think you can write him a reassuring note saying that you know that officials have grasped the points that he makes both on the substance and the timing, that you are expecting a submission in the very near future which you will consider in the context of the 1988 Bill, but that you cannot now commit yourself any further.

4. I attach a draft reply along those lines.

K F MURPHY

DRAFT LETTER FROM THE EST TO:

A S Durward Esq
Chief General Manage
Alliance and Leicester Building Society
Chief Office
49 Park Lane
LONDON
W1Y 4EQ

January 1987

Thank you for your letter of 18 December to my colleague Norman Lamont about tax issues arising on the conversion of building societies. I am replying as I have primary responsibility for building society matters.

2. I was interested to read a copy of the letter which your society has sent to the Inland Revenue. I understand that this particular issue was discussed at a meeting held late last year between the Inland Revenue and representatives of the Building Societies Association. I expect to receive advice from officials on this and other taxation issues arising from conversion in the very near future. I am sure that, given the proximity of the Budget, you will not expect me to comment further on the substance.

3. So far as timing is concerned, I can assure you that I quite understand your society's desire to be able to take advantage of the conversion provisions of the 1986 Act at the moment which appears most commercially advantageous. I will of course take account of that in considering the timing of any change in the law which we might believe to be appropriate.

4. I am sure that you will appreciate the time pressures on Treasury Ministers' diaries at this time of the year. I do not think therefore that it will be possible to meet with you to discuss these issues. But, in the light of this letter, I hope that you will accept that officials and Ministers fully understand your concerns.

[P.L]

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

FROM: J H REED
DATE: 8 JANUARY 1988

1. MR McGIVERN 8/1 See note at end.

2. ECONOMIC SECRETARY

CONVERSION OF A BUILDING SOCIETY TO A PLC

When the Building Societies Act was being passed it was recognised that under existing tax law there might be some disincentives to conversion of a building society to a PLC. But Ministers have not given any undertakings that existing tax law might be changed. Since then we, and the Treasury (FIM 1), have been in touch with the Building Societies Association (BSA) and have had a meeting with them. A number of tax obstacles have been identified and we agreed to put them to Ministers together with suggestions for possible Finance Bill legislation to overcome them. This note reflects FIM's views.

2. The BSA would prefer to have any legislation in the coming Finance Bill. The BSA say that Finance Bill 1989 would probably be an acceptable alternative if the 1988 Bill

---

cc PPS
Chief Secretary
Financial Secretary
Paymaster General
Mr Scholar
Mrs Lomax
Mr Culpin
Miss Sinclair
Mr Riley
Miss Noble
Mr Murphy
Mr Bridgeman (BSC)
Mr Watson (BSC)
Mr Cropper
Mr Jenkins (OPC)

Mr Painter
Mr Isaac
Mr McGivern
Mr Pitts
Mr Corlett
Mr Johns
Mr Cleave
Mr Whitear
Mr Marshall
Mr Willis
Mr Munro
Mr O'Connor
Mr Creed
Mr Cayley
Mr Reed
Mr McNicol
Mr Huffer
PS/IR
Mr Beighton
Mr Calder

was overcrowded but in that case societies would find it helpful to have advance notification of what was proposed. FIM 1 doubt that the BSA view is entirely representative of those societies which are most keenly considering conversion who would no doubt very much prefer legislation in 1988. Indeed the Alliance and Leicester have written to the Financial Secretary specifically seeking legislation in 1988.

GENERAL

3. There are two ways in which a conversion might take place. The first is the transfer of the business to a specially formed company possibly accompanied by a public issue of shares in order to raise capital. Such a share issue might come before but more likely after the asset transfer. The other way is for the transfer of the business to an existing company under separate ownership. Such a company would in effect be a bank. The BSA recognise that the taxation consequences could differ according to the precise way in which a conversion took place. They would be content provided that there was at least one reasonable, commercial way of achieving the desired result without adverse tax consequences. However, again it might well be that not all their members would agree with this. Neither was this Ministers' intention in putting the conversion provisions in the 1986 Act; they were explicitly seen (and recognised as such in the December 1985 consultative paper) as a framework within which the details of each conversion would be left to societies' commercial judgment.

CAPITAL GAINS

4. Whatever method of conversion is adopted, there will be a capital gains charge in respect of the gains accruing up to the date of the disposal to the successor company. Profits on the Societies' disposal of liquid funds (gilts etc) are treated as part of their trading income, but even if these are ignored there is the prospect of capital gains charges on the other assets (such as premises and goodwill) that will pass on

conversion. We have been told that large amounts are involved - figures given us by the Abbey National suggest that in their case alone we might be talking of tax of well over £m100. The Societies argue that the tax liabilities on their gains would be a major deterrent to conversion. They suggest that the charge on accrued gains should in effect be deferred until the successor company disposes of the assets.

5. There are precedents for removing capital gains charges to enable a public share issue to take place - notably with privatisations and the TSB flotation (although the former were, by definition, moving from the public sector and the status of the latter was unclear - whereas building societies are already in the private sector). On the other hand, if a concession is made, others - for example the management buy-out lobby - may use it as a precedent to press for capital gains relief on the transfer of a company's assets. Ministers may however consider that the Building Society case can be distinguished on 3 grounds.

6. Firstly, the case of societies converting is sui generis, and cannot be read across to changes in conventionally capitalised organisations (although there may be other organisations which also have an unconventional capital structure, for example mutual organisations, which might consider themselves analogous). Secondly, Ministers decided to include conversion in the Building Societies Act so as to allow societies themselves to decide on their commercial future but the application of existing law would be a major deterrent and would probably preclude conversion in many cases. Thirdly, unlike normal companies, but like the TSB, Building Societies have to convert to normal corporate form to make a general share issue: an ordinary company can do so without altering its structure, so the effect of the concession would be to put the Societies in the same starting-point as companies at large. (This is of course the reason that there are special provisions to prevent a capital gains charge occurring when the business of a nationalised industry is vested in a PLC before privatisation.) By

contrast a management buy-out for example is just one situation where an existing company is sold, and the normal capital gains position should apply. In other words, any concession for Building Societies could be presented as helping to put them in the same starting-point, when it comes to raising risk equity capital, as ordinary companies.

7. If Ministers do decide to make a concession here the question arises as to whether the concession should run where what is happening is a takeover of the society by an existing company. The first two arguments above are still relevant but the third clearly is not. However any take-over of an existing society by a bank might well be so as to rescue an otherwise ailing society. This was indeed the original rationale for these provisions (although they are more likely to be used for takeovers of "healthy" societies). Such a take-over would undoubtedly be impeded by a heavy tax bill which would almost inevitably in these circumstances be paid out of the 'healthy' bank's funds. We would, therefore, recommend against introducing the complications of a restriction on any concession in these circumstances.

8. A completely separate point arises in relation to existing Building Society shareholders. On the conversion, we are told, some or all of them may receive either a cash bonus in the form of a top-up to their accounts, or a preferential right (which may have a value) to subscribe for shares. In either event, the shareholders could well have capital gains (although these are unlikely to be significant in amount except in the case of a take-over of a society). In practice these gains will in the vast majority of cases be below the annual CGT exemption, but the BSA would like the gains to be exempt. For our part, we can see little justification for exempting the shareholders from what are tantamount to windfall gains on the conversion, even though the possibility of these gains is specifically provided for in the legislation.

9. Against this background we would be grateful for

i. guidance on whether Ministers would wish to remove capital gains charges on the transfer of assets to the successor company, and instead to provide that gains accrued up to the date of conversion should not be taxable until the successor company disposes of the assets;

ii. confirmation that normal CGT rules should apply to Building Society investors in respect of any gains they receive as a result of the conversion.

STAMP DUTIES

10. The BSA want relief from:

a. transfer duty (at a 1% rate) on the transfer of property to a PLC; and

b. capital duty (also at 1%) on the PLC's equity capital.

a. <u>transfer duty</u>

11. The BSA had thought that Section 109 of the Building Societies Act 1986 would ensure that no stamp duty is payable on the transfer of a Society's assets to a PLC. They are now not sure, and seek confirmation that there will be no charge.

12. The BSA cannot give us firm and detailed information about how societies will make their conversions. So we cannot give a firm view on whether or not conversions will be liable to transfer duty. The most we can say is straightforward conversions to a new or existing company will not be sales, and so will be free of duty. More complex arrangements (eg involving the transfer of assets to a company in return for shares prior to the conversion) might involve duty at 1% on the society's real property, shares and goodwill.

13. Legislation would be needed to give the societies absolute certainty. The legislation would break new ground because there is no general relief from stamp duty on the conversion of a business to a company. It could therefore lead to pressure for a general relief for incorporations, on the lines canvassed in the consultative document on stamp duty in 1983.

14. There are special factors which might be used to justify an exemption for building societies: they are a special group; their conversions are not unlike the TSB which was given a stamp duty exemption (although there the conversion was compulsory under the Act and akin to a privatisation); and the exemption would be for a "vesting" by virtue of the Building Societies Act. (The BSA also argued that 1% transfer duty would use up their 25% of societies' reserves. This is wrong. The main assets which would attract duty are property, shares and goodwill which for a large society might give a stamp duty bill of £10 million. While large this is of course not proportionately more than any business would pay on a sale.)

15. The decision on transfer duty therefore depends on whether or not building societies need a free hand to chose how they convert to companies, and whether an exemption can be confined to them. We cannot say whether the societies definitely need more room for manoeuvre because they have only just started to consider in detail the tax implications of different routes. But at present we think the balance lies with legislation to remove the uncertainty if there will in any event be legislation on CGT.

b. <u>capital duty</u>

16. Representations from the building societies have asked for relief from capital duty on their conversion to PLCs and on new capital raised by public offers.

17. There is no case for a special relief for new PLCs which raise new capital. They should be treated in the same way as any other company coming to the market for equity. The BSA now accept this.

18. Capital duty on the conversion of a society is more difficult. There could well be a 1% charge on the net value of the assets contributed in exchange for shares in the society (eg £20 million for a society which gets a market capitalisation of £2,000 million) although much depends on precisely how each society arranges conversion.

19. The BSA's main argument for exempting conversions from capital duty is that it is a heavy burden. This is obviously a matter of judgement: £20 million may be only some 2-3% of a society's reserves. And it is not an argument unique to building societies. Any business which incorporates faces the same charge. Relief for building societies would add to the pressure for a general relief.

20. Building societies might also argue that it is inconsistent to charge capital duty when there is no transfer duty, and point to the fact that TSB had exemptions from both charges. FIM see force in this. We do not find these arguments convincing. Capital duty is in practice a separate tax from transfer duty and is payable on the formation of a company rather than the transfer of assets to it. The TSB was more clearly a special case. Building societies are more akin to other businesses which chose to incorporate, and have to pay capital duty as the fee for becoming a capital company. For example Ministers declined requests for relief for Stock Exchange members when they incorporated. But the arguments could be slanted either way according to whether or not you felt the societies were a deserving special case.

21. Whatever the strength of the case it would not be possible to give the BSA any promises at this stage. Capital duty is governed by a European Communities Council Directive which defines what is and is not a transaction subject to capital duty. There is a provision in the Directive for a

Member State to exempt (wholly or partly) transactions which would otherwise be chargeable for social considerations, or to achieve fairness in taxation, or to deal with special situations. But any such proposal has to be referred first to the Commission.

Conclusion on stamp duties

22. There is a case for legislation to clarify the position on transfer duty by exempting the vesting of a society's assets in a successor company. On capital duty the BSA's case is not strong, and the potential repercussions greater. Having regard also to the EC dimension we recommend no action.

SAYE SCHEMES OPERATED BY BUILDING SOCIETIES

23. At present, Section 415 of the Taxes Act 1970 provides an across-the-board tax exemption for sums of capital or income payable under certain contractual savings schemes operated by building societies. In general, contracts under these schemes run for 5 years and provide the saver with a lump sum at the end of the period. In many cases, this sum is used to take up options on shares in the company employing the saver under Revenue-approved share option schemes operated by the saver's employer.

24. If building societies are to have a smooth transition to PLC status, we need to ensure that the tax exemptions on any SAYE contracts outstanding at the date of conversion are preserved until maturity. This requires an amendment to Section 415 to ensure that:

- a building society on conversion to a PLC can take over the existing SAYE contracts

- the existing savings, which must at present build up in a building society share account, can be transferred to a deposit account with the PLC.

25. We strongly recommend this transitional measure which will not widen the scope of the present exemption. In other words, as with banks now, a converted building society would not be able to enter into any new SAYE contracts.

CONCLUSION

26. We think there is a good case for making some tax changes to facilitate the conversion of building societies. They, like nationalised industries which are being privatised, are at a tax disadvantage in comparison with existing PLCs and it is not unreasonable that they should be placed in a broadly similar position. The extent of the changes necessary to achieve this is a matter of judgment; although the removal of the capital gains charge on the transfer of assets is by far the most important candidate.

27. At our meeting with the BSA they agreed that we need not raise with you various points (summarised in the annex) which did not require primary legislation, or were minor, or could be avoided if the conversion was carried out in the appropriate way. It is not possible to guarantee that these are the only tax problems which might arise on conversion. Although the BSA have done a considerable amount of work, and we in the Revenue have examined a number of possible different tax difficulties, few if any societies have considered the conversion option sufficiently seriously to be confident that all the possible tax problems have been dealt with. There can therefore be no guarantee that individual societies might not press for further change (either in the coming Finance Bill or Finance Bill 1989) on top of this package. But that is not, of itself, a particularly good reason for delaying action on those points already found. There may be no others. But, if there are, they will need to be considered on their merits as they arise.

28. Conversely if a building society does incorporate there may be increased pressure from unincorporated societies to obtain some of the tax benefits that an incorporated society would enjoy. In particular, we would almost certainly have to

recognise an incorporated society as a "bona fide bank". This has the consequence that the society could receive and pay interest gross on a wider range of transactions than its unincorporated competitors. We would not suggest these are grounds for not facilitating incorporation: if unincorporated building societies want such powers to pay and receive interest gross they will press for them anyway and again the arguments will need to be considered on their merits.

Treasury's views

29. So far as the substance of the package is concerned, FIM 1 division in the Treasury would strongly support a change to the CGT regime on the transfer of assets. They believe that the case for such a change appears overwhelming and there is no doubt that tax bills in tens or hundreds of £million will be a substantial disincentive to societies to convert and moreover, one that would be very difficult to defend in the light of Ministers previous pronouncements of conversion as a commercial option for societies. FIM 1 would also strongly recommend the small change to cover SAYE schemes. The case for stamp duty exemption is less clear cut. But there will no doubt be pressure from societies particularly if a CGT exemption is granted, to give an exemption from stamp duty. They will, as they have already done, cite the TSB precedent where exemption from both transfer duty and capital duty was granted. And it is difficult to see that it will be possible to argue with great conviction that a converting building society was substantially different in kind from the TSB. So on balance FIM 1 would be inclined to go for exemption for stamp duty also.

30. FIM 1's view is that a package of legislative changes in the 1988 Finance Bill would be very desirable. Although it may be 1989 before any society could seriously manage a conversion to a free-standing PLC (although some societies themselves are not so pessimistic), it is not so clear that take-overs could not take place during the course of 1988.

Any attempt to change the tax rules in 1989 after some conversions had taken place would run the risk of being accused of changing the rules in the middle of the game.

31. FP appreciate these arguments, but are concerned about the difficulty of this year's Finance Bill and the pressures on Parliamentary Counsel. Because various policy divisions in the Revenue are involved, it has not yet been possible to discuss the legislation which would be involved with Mr Jenkins. We have no reason to believe that it would be long or complicated, but we cannot say this with any confidence until we have spoken to Parliamentary Counsel. If you feel that the arguments for action in the 1988 Bill are strong, we will explore the legislative implications urgently, in the light of your initial views, and report back.

Summary

32. Do Ministers wish to introduce relieving legislation on any of the following points:

i. to prevent a capital gains charge arising as a consequence of the transfer of assets to the successor company (paragraph 9(i));

ii. to prevent a CGT charge arising on any gains made by investors as a result of the conversion (paragraph 9(ii));

iii. to remove the possibility of transfer duty on the conversion (paragraph 15);

iv. subject to obtaining EC Commission approval, to prevent a capital duty charge on the conversion (paragraphs 20 and 21);

v. to allow the exemption for existing contracts under certified contractual savings schemes to continue to apply after conversion (paragraph 25).

33. In our view the case for a concession on at least point v. is strong, while the case for concessions to meet ii. and iv. seems to us pretty weak - but FIM 1 are in favour of a concession on iv. Do you wish any legislation to be in this year's Finance Bill or would you be content for it to be in next year's (possibly with an announcement later this year of what you propose followed by further consultations)?

J H REED

Economic Secretary.

If you agree in principle to legislate in this year's Bill, we would want to discuss what would be involved with Parliamentary Counsel so that we could better advise you on the length/complexity of the legislation. There might then of course be a need for further legislation next year — para 27.

I can understand the BSA's preference for action this year; but I am not sure that a fairly detailed announcement of what you propose on the major points already identified and a promise of legislation on these next year, with further consideration of any new points which the societies raise in the meantime, would not be sufficient given the growing pressure on Parl. Counsel and any clear evidence that legislation in FB 1988 is essential.

12

8/1

ANNEX

CONVERSION OF A BUILDING SOCIETY TO A PLC

POINTS RAISED BY BSA ON WHICH PRIMARY LEGISLATION DOES NOT SEEM NECESSARY

1. Financial Instruments on which interest can be paid gross

The BSA have asked for transitional measures to ensure that gross payments of interest on certain types of instruments issued by a building society can continue, once that society is converted to a PLC. Any changes thought necessary here can be effected by regulations made under existing legislation. No new primary legislation is needed.

2. Capital Allowances

The BSA would like to ensure that when a society transfers its assets to a successor company no balancing charge is made on the society. This could only be made quite certain by legislation on privatisation lines - that is, allowing the PLC to stand in the shoes of the society - thus treating the business as continuing unbroken. However, as we have explained to the BSA, there are other ways in which their aim can be achieved under existing legislation. And, even if the chosen route leads to balancing charges, the tax involved might not be substantial. So the BSA have agreed not to press for a change in legislation.

3. Group relief

The BSA would like the group relief provisions (for trading losses etc and for capital gains) to continue unbroken for subsidiaries of a building society which become subsidiaries of the PLC. The existing rules do not allow this. In discussion, however, the BSA have accepted that this is unlikely to be a significant problem in practice and have said they will not press the point.

4. Carry forward of losses

The BSA have asked for provisions allowing unused trading and capital losses to be carried forward to the new company. There are rules on business reconstructions (not involving a change of ownership) which allow trading losses to roll forward. If the conversion is structured in a suitable way it will be possible to take advantage of these provisions. But the legislation does not cover capital losses. The BSA have acknowledged that these are unlikely and are therefore not pursuing the point.

5. Other matters

The BSA have also discussed with us other points on conversion but their concern here has been more to find out what the tax treatment would be, rather than to argue for changes in legislation. The points are as follows.

6. Interest paid gross

The BSA have asked about the position, for example, of non resident taxpayers who have signed declarations of their status in order that they may receive interest gross. In strictness, if these deposits are switched to a PLC fresh declarations will be required. However, we think it would be unreasonable for the Revenue to demand these and we intend, as a matter of practice or concession, to treat the pre-conversion declarations as still valid. Provided the PLC is recognised as a bank for tax purposes, and we would expect this to be the case, interest would then continue to be payable gross.

7. Bonus distributions

The Building Societies Act provides for "bonus" distributions to be paid to investors not entitled to vote on proposals to convert. We have explained to the BSA that if they are paid by the society, composite rate tax will be accounted for in

the usual way. If paid by the company, however, they will be capital payments and therefore liable to capital gains tax in the recipient's hands.

Interest paid by Building Society and successor company

8. We have confirmed to the BSA that interest which accrues under the building societies scheme and is paid by the successor - in all probability a bank - will come within the composite rate tax scheme for banks.

9. The position on corporation tax is a little different. A building society can claim a deduction for interest accrued up to the point of conversion (though this is a concession). The bank would also get a deduction on an accruals basis from this point - thus retaining symmetry. If the successor is not a bank - thus entitling it to a deduction for interest paid (regardless of when it accrued) - we can avoid the danger of the "double" deduction by restricting any deduction to the building society to no more than the amount "paid or credited" - the strict position under the legislation. We therefore see no need to suggest protective legislation.

10. MIRAS arrangements

We see no problems on the continuation of MIRAS arrangements by the successor company - though we have reminded the BSA that notice needs to be given in good time for the new companies to be prescribed in an appropriate Treasury Order.

11. Treatment for CT purposes of liquid assets (Government Stock)

The BSA have expressed concern that, under the Revenue's view of the law (which is of course open to challenge) a society would be charged on its unrealised profit (at the time of conversion) from gilt-edged investments on the basis of market value. The BSA have contended that the charge should be based on book value. They now accept that the tax treatment will

depend on the precise facts in each case but the point may still be of concern to individual societies (for example, the Alliance and Leicester have raised this).

12. Deduction for cost of conversion

The BSA have asked whether it would be possible to obtain a deduction for CT purposes of the expenses of conversion. We have explained that this will depend on the particular case, under the normal rules for trading expenses - but that a deduction seems very unlikely. The BSA are not pressing the matter.

53/2/LPD/3747/021

FROM: P D P BARNES
DATE: 11 January 1988

MR MURPHY

cc PPS 2
PS/Financial Secretary
Mr Scholar
Mrs Lomax
Miss Sinclair
Miss Noble

Mr Watson - BSC

Mr Reed - IR

LETTER FROM ALLIANCE AND LEICESTER BUILDING SOCIETY

The Economic Secretary was grateful for your submission of 8 January. We spoke.

2. Having also seen Mr Reed's submission of 8 January on Conversion, the Economic Secretary thinks that a meeting with the Alliance and Leicester would be helpful. We will be contacting Mr Durward's office to arrange this.

P D P BARNES
Private Secretary

53/2/LPD/3747/023

CONFIDENTIAL

FROM: P D P BARNES
DATE: 11 January 1988

MR REED - IR

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Mr Scholar
Mr Culpin
Mrs Lomax
Miss Sinclair
Mr Riley
Miss Noble
Mr Murphy
Mr Cropper

Mr Jenkins - OPC

Mr Painter - IR
Mr Isaac - IR
Mr McGivern - IR
PS/IR

CONVERSION OF A BUILDING SOCIETY TO A PLC

The Economic Secretary was grateful for your submission of 8 January.

2. The Economic Secretary thinks that arguments for action in the 1988 Bill are strong, and would be grateful if you would explore the legislative implications urgently. The Economic Secretary's provisional view is that legislation should be introduced to meet the points mentioned in paragraph 32 i, iii and v. The Economic Secretary is undecided on 32 iv, and is inclined against 32 ii.

3. This office will be in touch to arrange a meeting.

RB

P D P BARNES
Private Secretary

CONFIDENTIAL

53/2/LPD/3747/033

CONFIDENTIAL

FROM: ECONOMIC SECRETARY
DATE: 12 January 1988

CHANCELLOR

cc: Sir P Middleton
Mrs Lomax
Miss Noble
Mr Murphy
Mr Bridgeman, BSC
Mr Watson, BSC
Mr Proctor, BSC

REVISION OF SCHEDULE 8

On 2 October last we announced our intention to review Schedule 8 of the Building Societies Act 1986. This note summarises my recommendations.

Summary

Schedule 8 lists the new financial and housing related services which societies are permitted to provide. The list is attached - it covers money transmission and foreign exchange, provision of investment advice, PEPs and personal pensions, arranging for the provision both of insurance and credit and estate agency surveying and conveyancing. Some of these new powers have worked well, and have actively been pursued by societies (eg estate agency). Others have not, and have been a source of confusion and irritation to societies as to the precise powers available to them (eg arranging the provision of credit). We have amended Schedule 8 by secondary legislation several times during 1987.

3. The review has had two purposes. The first was to examine whether schedule 8 could be recast so that it permitted any activities within certain broadly specified areas instead of banning everything except narrowly specified activities. The lawyers are now confident that Schedule 8 can be recast in a permissive form by secondary (affirmative) legislation.

4. The second purpose was to consider opening up certain new areas of activity for which building societies were lobbying. The Building Societies Association has sought what amounts to a radical package of extensions to societies permitted services. My proposals would give them much of what they have asked for. In particular I recommend that societies should be permitted to:

a) own stockbroking firms subject to limitations;

b) own both life assurance and, with restrictions, general insurance companies;

c) undertake a wider degree of fund management directly including all unit trusts (at present societies can only manage unit trusts specifically to provide pensions).

d) lend unsecured up to a limit of £10/15,000) (at present £5,000).

e) undertake a wider range of banking services than hitherto, including share registration services, leasing and currency distribution (although I have yet to consider the details of this);

These changes will result in societies acquiring a wider range of non-traditional assets than hitherto, and will place a strain on the asset limits currently in the Act. I therefore propose that these limits should be progressively relaxed over time. I discuss these changes in more detail below.

5. The changes amount to a radical package. They take up most of the leeway built into the Act for progressive change. But for the reasons I set out below, I believe they are correct. They will place a much greater burden on the prudential supervision of societies. Many of these new areas are primarily supervised

bodies other than the Building Societies Commission. This will continue - for example, life assurance companies owned by building societies will continue to be supervised by the DTI. Subject to adequate lead regulator arrangements being put in place, I am satisfied that the regulatory system should be able to cope with these changes.

6. I have also considered the possible monetary implications of these proposals. Officials have discussed this with the Bank. The changes which would be most likely to have monetary consequences are increasing the asset limits and the limit on unsecured lending. The substantive effects seem likely to be small, but we will need to bear in mind the possible presentational effects in considering how best to announce our decisions.

Background

7. Our approach in formulating the Act was to allow societies a wider range of powers than hitherto so as to improve their ability to compete while preserving their primary role of raising money from the public to lend for home purchase. The intention was to allow societies time to gain experience of the new activities permitted under the Act, and then to use the Act's quite considerable secondary powers to liberalise step by step over a period of years adding or widening one or two powers at a time.

8. It is now clear that this step by step approach has drawbacks. We have always recognised that different societies might develop in different ways as best suited their commercial circumstances. Indeed within the range currently permitted individual societies have been commendably cautious in extending into only a limited number of new areas. Societies have argued, in pressing for liberalisation, that they need to be able to plan a few years ahead knowing what will be legislatively possible. They tend each to want to extend into only one or two new areas. And these differ from society to society. So step-wise liberalisation would arbitrarily meet some societies' wishes whilst frustrating others until their turn came up for their favoured deregulation.

9. The BSA argue that we should therefore replace the step by step approach by a 'little bang' of deregulation, and rely on prudential regulation (with limitations via capital requirements and proven management caution) to prevent any individual society diversifying excessively. The Building Societies Commission agree. So do I.

Stockbroking

10. Societies can already offer stockbroking services through their branches by contractual arrangements with independent brokers. The BSC proposal is that they should be allowed to go further and buy (or establish) stockbroking firms. From the point of view of wider share ownership it would be desirable to see some building societies incorporating 'share shops' in their high street premises. They are unlikely to do so unless they can participate in the ownership of a broking firm. This is because it is difficult to allocate contractually the share of revenues attributable to the retail marketing, research, dealing and settlement aspects of the operation. Under common ownership that allocation of revenues becomes less important.

11. However, stockbroking can be a riskier business than most. There are risks even when brokers are acting purely in their traditional role as agents: settlement risks arising above all from failure of clients to pay but also non-delivery of stock and staff improprieties. These risks should be less for building societies acting for customers with cash on deposit. The BSC could insist on safeguards in excess of what are required for stockbrokers generally.

12. More serious risks arise now brokers can act as principals. One solution would be to prevent societies from being involved in broking as market makers. The BSC so recommend and the BSA seem unlikely to object. However, I suspect there may be problems either in defining a market maker or, more likely, in excluding links with brokers who make markets in one or two small companies' shares. Given the main reason why market-making is risky is that it usually requires resort to borrowed funds it could be that

societies' broking subsidies could be strictly limited in their position taking with borrowed money. This would simultaneously limit high risk position taking by non-market makers.

13. I recommend that societies be allowed to acquire and engage in broking but precluded from market-making and/or geared position taking for themselves or clients, if it is possible to draft this latter restriction under the building society legislation.

Fund Management

14. Societies can currently establish and manage PEPs and unit trusts so as to provide pensions. The BSC proposal is that they should be allowed to offer the full range of fund management services. Given this precedent, I see little problem in allowing this extension.

Insurance

15. Societies can presently advise on and arrange insurance. Commissions provide a significant element of societies' profits, but are under pressure from other intermediaries. The BSC propose to allow societies to take up to a 100% stake in life insurance companies and to take a minority stake in general insurance companies. Life and general insurance underwriting must be carried out in separate companies. Polarisation only affects life insurance - not general insurance.

16. The main objection from the consumers' viewpoint in allowing societies to own life assurance companies is that this is likely to result in societies following banks and becoming tied agents (tied to their own life products). At present most societies have opted to be independent advisers. However, there do not appear to be serious prudential reasons to prohibit societies acquiring Life Offices.

17. In principle it might be desirable to prevent societies from involvement in such irrelevant activities as marine, aviation and

other non-housing related general insurance. In practice virtually all non-life insurance companies spread their risk over a variety of areas. It would be counterprudential to restrict societies to general companies with only a limited spread of risk. Hence the proposal to restrict societies to a 15% stake in general insurance companies.

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.

Asset Limits

22. The BSC propose an immediate increase in Class 3 from 5% to 15% and in Class 2 from 10% to 25% ie. to go to the limits permitted in the primary legislation.

23. In practice few societies are anywhere near their asset limits at present. Some think that their long term plans would bump them up towards the 5% Class 3 asset limit within say 3 to 5 years. This would become more likely if societies were permitted stakes in new activities since the equity in such stakes would represent a Class 3 asset. However the BSC would rightly not permit societies to adopt plans which hit the limit. So those limits are or soon will be affecting planning.

24. Ian Stewart is on record as saying that the asset limits would not be increased for some years. So an immediate rise in the limits would not be politic. In any case the asset limits do act as a useful restraint on the extent to which any society can diversify. If they are progressively relaxed they restrict in a desirable way the speed with which societies can diversify.

25. So I recommend that in conjunction with reforming Schedule 8 (although it would require a separate affirmative SI) we should introduce a statutory timetable for relaxing the limits: Class 3 limit to increase from 5% to 10% in say 3 years' time (January 91) and to 15% in 5 years time (January 93). Likewise the Class 2 limit would increase from 10% to 20% in January 91 and 25% in January 93.

The £5,000 limit on Unsecured Loans (this is not part of Schedule 8)

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.

Likely reaction to these proposals

29. A fair head of steam has built up behind the BSA's proposals in the industry. The Commission is convinced that a package of this size is necessary to allow societies the scope to develop as we envisaged. Although the package I recommend does not give the BSA all that they wanted, it goes much of the way and would I am sure be widely welcomed.

30. Parliamentary reception is less certain. The Opposition may argue that we are effectively abolishing the Building Societies movement as we know it by stealth. We will need to convince them that the changes are necessary so as to preserve the society movement, albeit changed. I will want to discuss these proposals with Chris Smith before the necessary SIs are tabled.

31. Market reaction is more difficult to predict in the current climate. Much will depend on timing and handling. We will need to play down the impact on credit growth and the monetary aggregates.

Timing

32. I will want to discuss these proposals with Francis Maude either before or after his trip to Europe (although I have no reason to think that they will cause him difficulty). I think we should then have an early announcement, perhaps in the first week of February, of the main changes proposed. This will permit officials to discuss the detailed drafting of the secondary legislation in consultation with the BSA. We would aim to table the SIs, in February, before societies' forthcoming AGMs. However, I have publicly warned societies that this may not be possible and that I would prefer to get the Instruments right and later rather than

botched and premature.

PETER LILLEY

ps2/20M

CONFIDENTIAL

FROM: MISS M P WALLACE
DATE: 12 January 1988

PS/ECONOMIC SECRETARY

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Mr Scholar
Mr Culpin
Mrs Lomax
Miss Sinclair
Mr Riley
Miss Noble
Mr Murphy
Mr Cropper

Mr Jenkins - OPC

Mr Painter - IR
Mr Isaac - IR
Mr McGivern - IR
Mr Reed IR
PS/IR

CONVERSION OF A BUILDING SOCIETY TO A PLC

The Chancellor has seen Mr Reed's submission of 8 January, and your minute of 11 January. The Chancellor very much hopes we can do this this year, although he appreciates that we must first see how many Finance Bill Clauses would be needed, and how complicated they would be.

MOIRA WALLACE

CONFIDENTIAL AND COMMERCIAL IN CONFIDENCE

Inland Revenue

Policy Division
Somerset House

FROM: P A MICHAEL
DATE: 21 January 1988

1. MR CAYLEY
2. MR PITTS
3. ECONOMIC SECRETARY

CONVERSION OF A BUILDING SOCIETY TO A PLC

1. At your meeting last Monday on this subject (Mr Reed's note of 18 January) you were strongly of the view that share account holders entitled to shares or rights to acquire shares in the successor company should not suffer CGT charges en route. You saw an analogy here with the provisions which defer tax charges on share exchanges in the course of company reorganisations. At the same time you were content for the normal CGT rules to operate to the extent that share account holders receive cash. Again this would be consistent with the position elsewhere. I undertook to explore what all this would entail in terms of length and complexity of legislation.

---

cc. PPS
Chief Secretary
Financial Secretary
Paymaster General
Mr Scholar
Mrs Lomax
Mr Culpin
Miss Sinclair
Mr Riley
Miss Noble
Mr Murphy
Mr Bridgeman (BSC)
Mr Watson (BSC)
Mr Cropper
Mr Jenkins (OPC)
Mr Painter
Mr Isaac
Mr Beighton
Mr Calder
Mr McGivern
Mr Pitts
Mr Corlett
Mr Johns
Mr Cleave
Mr Whitear
Mr Marshall
Mr Willis
Mr Munro
Mr O'Connor
Mr Creed
Mr Cayley
Mr Reed
Mr McNicol
Mr Huffer
Mr Michael
PS/IR

2. I should perhaps mention that removing any immediate CGT charges on shareholders' rights to receive or subscribe for shares would go somewhat further than what is done with company reorganisations. With a reorganisation, shareholders exchange one shareholding for another: there is no additional asset or right involved. With a Building Society conversion, any immediate CGT charge would arise because members of a Society not only exchanged a deposit in the society for an equal deposit in the successor company but also were given some right relating to shares in the successor which had a value: so where CGT is in point for the shareholder on a Building Society conversion, it is because he is given an additional right to which a value can be attached. This would normally be a potential occasion of charge.

3. It might be convenient to start by looking at the two basis schemes, identified by the Treasury, which have implications for share account holders.

Scheme 1: share account exchanged for deposit in successor company together with a preferential right to subscribe for shares in successor company

4. For technical reasons we are now quite certain that this would not constitute a reorganisation. Accordingly, there would be a disposal of the share account in return for a deposit and a preferential right. If that right has a value, and it may well do (the point has come up recently in another context), then CGT will become payable irrespective of whether or not the right is exercised.

5. Legislation to remove this tax charge should be reasonably straightforward. If the shares in the successor company are taken up their acquisition cost would be the amount actually paid for them.

Scheme 2: share account exchanged for deposit in successor company together with a right to subscribe for shares in successor company at a discount.

6. The position here is the same as for Scheme 1.

Other matters

7. There are two other matters to consider.

8. The first is the "Abbey National" variation (which was mentioned at your meeting). As we understand it - and we have only been supplied with the barest details - what would happen here would be that the share account holders would get deposits in the successor and shares in the PLC would be distributed to them or more likely to some of them. It could be that this distribution would be taxable as a "distribution" (ie, like a dividend) but if it did not a CGT charge would arise. However, we were told by the BSA last year that no such arrangement was envisaged. So there may be some confusion here at the technical level as to what is being tentatively proposed by the Abbey National. Moreover, there are some doubts in our minds as to whether this sort of arrangement is permitted under the terms of the Building Societies Act. Clearly, it would be extremely undesirable to legislate for something which is both not going to happen and which, if it did, would be unlawful. We think, therefore, that as a preliminary matter the Treasury should explore the position with the Building Societies Commission who oversee the operation of the Building Societies Act. This would need to be done urgently.

(FIM think not illegal)

9. The second concerns loyalty bonus arrangements. We are told - again we have very few details - that some Societies are considering the possibility of loyalty bonus shares. The idea, presumably, would be to provide an additional incentive to vote for conversion in the form of periodic "freebie" shares in the successor company. As with the

"Abbey" variation, we are not sure that this is permissible under the Building Societies Act. Assuming that it is feasible we cannot say what the tax consequences would be since it would all turn on the precise mechanics involved. And it is unlikely that this information would even be available at the present time.

10. There are ways in which the Societies could structure loyalty bonus issues so as not to lead to any CGT charges (although it is possible that some Societies would prefer to structure issues in other ways which would lead to potential tax liability). And they have not (at least yet) asked for legislation on such issues. Against this background, Ministers may feel that it is not necessary to legislate on loyalty bonus issues. If Ministers do want to legislate to remove the possibility of charges, it would again be necessary for the Treasury to take urgent advice from the Building Societies Commission as to what type of loyalty bonus arrangements would be permissible under the Building Societies Act - because again it would be undesirable to legislate to remove tax charges on something that is in fact not lawful.

Length of legislation

11. Our best guess, subject to the views of Parliamentary Counsel, is that legislation on any basis should not be more than 2 pages, possibly less.

Summary

12. We would be grateful for Ministers' guidance on the following.

(i) Is it agreed that Counsel be instructed to remove CGT on preferential rights and rights to subscribe at a discount (paragraph 3-5)?

(ii) Should the Treasury explore urgently with the Building Societies Commission whether the Abbey National variation - a free handout of all shares in the successor company to their existing shareholders - is lawful? If it is, is it agreed that the legislation should remove any charge (whether as a "distribution" or as a capital gain) on this handout?

(iii) Given that Building Societies can structure loyalty bonus issues in ways which do not create CGT liabilities, are Ministers content not to include anything on such issues in the legislation? If Ministers do wish to legislate to remove the possibility of charges is it agreed that the Treasury should explore urgently with the Commission what type of arrangements would be permissible?

13. If provisions on all this are to have a chance of being in the Finance Bill as first published, we need early authority to instruct Parliamentary Counsel. We can do this on the contingency basis that we have to cover both the Abbey National arrangement and loyalty bonus shares: but we shall need definite answers from the Building Societies Commission by the second half of February.

14. Finally, I should perhaps mention that the Building Societies have not worked through all the details of conversion, and different Societies might well take different routes. All we can do at the moment is to cover the more obvious possibilities - but we cannot guarantee that at the end of the day the particular route which a particular Society wishes to adopt will not lead to some tax charges on which we have not yet focussed.

PAM

P A MICHAEL

42/2.PTW.4375/41

CONFIDENTIAL

BF to M

FINANCIAL SECRETARY TO THE TREASURY

FROM: MISS S J FEEST
DATE: 25 January 1988

G R WESTHEAD

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Sir P Middleton
Mr Scholar
Mrs Lomax
Mr R I G Allen
Miss Noble
Mr Kroll
Mr Murphy
Mr Watson BSC

CONVERSION OF A BUILDING SOCIETY TO PLC

The Financial Secretary has seen the recent papers on this subject and agrees with the Economic Secretary's views on CGT.

Susan Feest.

SUSAN FEEST
(Assistant Private Secretary)

53/2/LPD/3749/037

BF

FROM: G R WESTHEAD
DATE: 26 January 1988

MR MICHAEL - IR

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Mr Scholar
Mrs Lomax
Mr Culpin
Miss Sinclair
Mr Riley
Miss Noble
Mr Murphy

Mr Bridgeman - BSC
Mr Watson - BSC
Mr Cropper

Mr Jenkins - OPC

PS/IR

Chy content?

Agree
OK. 28/1

CONVERSION OF A BUILDING SOCIETY TO A PLC

The Economic Secretary has considered your submission of 21 January about the taxation implications of a building society conversion. The Economic Secretary recommends, subject to any comments the Chancellor has, that:

(i) Parliamentary Counsel should be instructed to remove Capital Gains Tax on preferential rights to shares and rights to subscribe to shares at a discount;

(ii) that the Revenue, Building Societies Commission and Treasury should discuss details of the proposed schemes for conversion urgently and agree which options should be provided for in the tax legislation. I understand that FIM division in the Treasury advise that the basic Abbey National scheme is legal.

Guy Westhead

GUY WESTHEAD
Assistant Private Secretary

7/5

FROM: K F MURPHY

DATE: 28 January 1988

1. MRS LOMAX

2. CHANCELLOR

cc Financial Secretary
Economic Secretary
Sir P Middleton
Mr Scholar
Mr Gilmore
Mr Revolta
Miss Noble
Mr Flanagan

E(CP): COMPETITION IN THE LEGAL PROFESSION

The Lord Chancellor's paper for E(CP) later today is silent on the subject of conveyancing. I understand that both DOE and DTI Ministers are being briefed to raise the subject. I recommend that Treasury Ministers should do likewise.

Background

2. You will recall that the Building Societies Act 1986 was used as a vehicle effectively to break the solicitors' conveyancing monopoly. It permits building societies and other institutions to offer conveyancing services provided that they are recognised as suitable bodies by the Lord Chancellor. The Act allows the Lord Chancellor to make rules (known as "recognition rules") setting out the conditions which institutions would have to satisfy in order to be recognised as conveyancers.

3. The Government's policy was set out in various PQ's during 1985 and 1986 (see attachment) and reiterated during Committee stage debates on the Building Societies Bill. While accepting that mortgage lenders could offer conveyancing services, they thought that consumer protection demanded that lenders should not be able to offer such services to their own borrowers either directly, or through subsidiaries in which the lender held a majority stake. In practice, this would allow lenders to offer conveyancing to other lenders' borrowers (a notion of doubtful commercial value) or to take a minority stake in conveyancing "companies". I understand (but have not been able to check for myself) that this decision was taken in H early in 1985.

4. The Lord Chancellor's Department have yet to produce draft recognition rules. This is doubtless due, in part, to Lord Hailsham being antipathetic to the whole idea. I am told that the rules may be ready by the summer (ie 2 years after the Building Societies Act 1986 was enacted). This is not a very good performance. I recommend that Treasury Ministers raise the slowness of the timetable and urge the Lord Chancellor to publish rules as soon as he can.

5. As to substance, I am told that the Lord Chancellor's Department are thinking of restricting lenders to a very small (perhaps 5%) stake in conveyancing "companies". It is hard to avoid the conclusion that the Law Society (which is also antipathetic to the whole idea) has been exerting considerable influence behind the scenes. A 5% stake would be of little value to lenders. And it is hardly consistent with a restriction only to a minority stake.

6. For myself, I find it hard to see that the conflicts of interest are so great that majority stakes should be ruled out (it is, after all, common practice for lenders' own solicitors to do conveyancing both for the borrower and the lender). But you may feel that this E(CP) meeting does not offer the opportunity to reopen the general policy. You should, however, press the Lord Chancellor to take as liberal an approach as possible within the constraints of previously announced policy. This might allow lenders to take up to a 49% stake in a conveyancing "company". And we ought to avoid any question of lenders being unable to refer their own borrowers to a conveyancer in whom they hold an equity stake.

7. Less importantly, both DTI and Scottish Office Ministers are being briefed to raise the position of solicitors in Scotland. The Building Societies Act liberalisation did not extend to conveyancing on Scottish land, which is still effectively a Scottish solicitors monopoly. I understand that the Lord Chancellor is considering the degree to which the Scottish

solicitors system (which is more restrictive than the English regime) should be freed from arguably unnecessary restraints. This ought to include conveyancing.

K F MURPHY

Written Answers to Questions

Friday 6 December 1985

NORTHERN IRELAND

Advertising

Mr. Tony Banks asked the Secretary of State for Northern Ireland how much his Department spent on advertising in national and local newspapers, on television and in other printed journals during the financial year 1984-85; and what is the amount budgeted and spent to date in 1985-86.

Dr. Boyson: The information as requested is not available except at disproportionate cost. However, total figures for all forms of advertising for the Northern Ireland Office and Northern Ireland Departments are as follows:

	£
Expenditure 1984-85	2,090,000
Budget 1985-86	2,689,188
Expenditure 1985-86 (to date)	1,595,318

WALES

Library Status

Mr. Best asked the Secretary of State for Wales if he has yet received the report of the panel investigating library status under section 207(5) of the Local Government Act 1972; and when he expects to make a decision on the matter.

Mr. Wyn Roberts: The panel has completed its enquiries and is now finalising its report which I expect to be submitted for consideration early in 1986.

Advertising

Mr. Tony Banks asked the Secretary of State for Wales how much his Department spent on advertising in national and local newspapers, on television and in other printed journals during the financial year 1984-85; and what is the amount budgeted and spent to date in 1985-86.

Mr. Nicholas Edwards: The information requested is as follows:

	£
1984-85 Expenditure	66,300
1985-86 Budget	171,000
Expenditure to date	117,000

ATTORNEY-GENERAL

Distress for Rent Rules

Mr. Conway asked the Attorney-General if he will amend the distress for rent rules 1983 so as to require certificated bailiffs to issue a detailed inventory when levying a notice of distress; and if he will make a statement.

The Solicitor-General: The prescribed notice of distress, in form 5, already requires the goods seized, distrained or impounded by a certificated bailiff to be specified in an inventory, which is part of the form, when the form is issued to a tenant by the bailiff on levying a distress, in accordance with rule 12(2) of the distress for rent rules 1983. Further amendments to the rules are under consideration.

NATIONAL FINANCE

Building Societies

Mr. Michael Forsyth asked the Chancellor of the Exchequer if he will make a further statement about the proposed building society legislation referred to in the Gracious Speech.

The Solicitor General [*further to the answer given by the Minister of State Treasury,* on 7 November 1985, c. *3*]: I can provide the following information.

The Government issued a consultation paper last year seeking views on the way in which conflicts of interest and anti-competitive practices could be avoided if building societies and other financial institutions were to offer conveyancing services to the public. Following that consultation, the Government have concluded that there is no difficulty in principle in such institutions providing conveyancing to persons to whom they are not also offering a loan. However, the Government are not satisfied that lending institutions could safely be permitted to offer both conveyancing and a loan in the same transaction. It is therefore proposed to prohibit lending institutions from providing conveyancing, either directly or through a subsidiary company in which they hold a majority stake, to those who are also borrowing from them.

The Government are also examining the possibility of estate agents providing a combined service of sale and conveyancing to vendors, and of lending institutions providing conveyancing to borrowers from them through associated companies in which the lender holds only a minority shareholding. Consultation on those matters is not yet complete.

It is also proposed to set a number of other conditions to ensure proper consumer protection. In particular, institutions will be required to ensure that their conveyancing work is supervised by a qualified person; and adequate arrangements will have to be made to protect the consumer against negligence or fraud on the part of those providing the service. Details will be announced in due course, after further consultations with the interests concerned.

Investment (GDP)

Mr. Skinner asked the Chancellor of the Exchequer what is the level of investment per person as a share of real gross domestic product in the following countries at the latest available date *(a)* Japan, *(b)* West Germany, *(c)* France and *(d)* the United Kingdom.

Mr. Ian Stewart: The figures requested are as follows:

ps2/51M

CONFIDENTIAL

FROM: MISS M P WALLACE
DATE: 29 January 1988

PS/ECONOMIC SECRETARY

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Mr Scholar
Mrs Lomax
Mr Culpin
Miss Sinclair
Mr Riley
Miss Noble
Mr Murphy

Mr Bridgeman - BSC
Mr Watson - BSC
Mr Cropper

Mr Jenkins - OPC

PS/IR
Mr Michael - IR

CONVERSION OF A BUILDING SOCIETY TO A PLC

The Chancellor has seen Mr Michael's submission of 21 January, Miss Feest's minute of 25 January, and your minute of 26 January. He is content for work to proceed as the Economic Secretary recommends.

MOIRA WALLACE