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Secretary of State for Trade and Industry

21 June 1984

The Rt Hon Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

R Nigel

BUILDING SOCIETIES GREEN PAPER

Thank you for your letter of 12 June, which followed the one Ian Stewart sent to Alex Fletcher enclosing the second draft of the Green Paper.

2 I have taken a close interest in the progress of the Green Paper. This is not only because of the topic's relevance to the developments in financial services and the City, for which I have responsibility, and the potential the building societies have for introducing much-needed competition into a whole host of these services, but more importantly because of the general philosophy and tone of the proposed framework for regulation.

3 Let me say immediately that I agree with the underlying objectives of the Green Paper. It is important that building societies should remain, in fact and in the public's perception, a stable provider of housing finance, and a safe haven for savers' deposits. But I firmly believe that the Government should seek to stand back and give maximum scope for competitive forces to work and that the onus is very much on the regulator to explain why he needs any further powers. Indeed, I think it is common ground that one of the major achievements of Ministers in this Department over the past few years has been to change the whole climate and balance of regulation to one of encouraging firms to give full rein to their entrepreneurial talents within the basic constraints of prudential controls and the requirement that "fit and proper" people are in control.

4 Thus, while I acknowledge and appreciate the significant changes you have agreed to make, particularly in expanding the list of activities which the Government consider may be acceptable for building societies to undertake, I have strong reservations about

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the paternalism inherent in the approach the Green Paper adopts. I cannot help but note that the phraseology of the first two chapters is suffused with the notion that the Government knows best. I would have preferred it to strike a more positive and forward-looking note more in line with our overall philosophy and "anti-nanny" stance! I believe the document should give much closer consideration to the possibility of relying only on asset and prudential controls, leaving it to the building societies to decide on the basis of their own commercial judgement whether they should diversify into new fields. With clear prudential controls strictly enforced to protect the investor and with asset controls designating 90 per cent of base assets to traditional housing finance and a minimum further 5 per cent to other types of housing finance, it is certainly questionable whether further controls are necessary. The element of paternalism that I take issue with is perhaps highlighted in connection with the argument over whether building societies should be allowed to own an insurance underwriting subsidiary (para 3.25). It is precisely the function of prudential and asset controls to ensure that such activity would be kept within reasonable bounds, and this may very well be possible for the largest building societies; I believe the discussion should focus more on the potential conflicts of interest in providing a broking and underwriting service. In any case, any insurance subsidiary of a building society would be caught by our existing supervisory powers. More generally, but also related to the underwriting question, I find it hard to credit that building societies would use the 5 per cent of base assets to change their images to such an extent that they would risk losing their traditional constituents.

5 However, as I mentioned above, I accept that the list of "acceptable" activities has been widened considerably in the second draft; there will, of course, also be order-making powers to widen the role of building societies further should the need arise. Thus, despite the reservations outlined above, I am content for the draft Green Paper to go forward with my support for its objectives. But I would certainly like public opinion when the paper is issued to acclaim our approach to this point as a shining example of our determination to foster competition.

6 I am sending copies of this letter to the Prime Minister and to Patrick Jenkin.

NORMAN TEBBIT

JH2ARJ

cc FST
 Sir P Middleton
 Mr Cassell
 Mr Lankester
 Mr C Allan
 Mr Gordon
 Mr Hall
 Mr F K Jones
 Mrs Lomax
 Mr Portillo
 Mr Saunders
 Mr Devlin - RFS



Treasury Chambers, Parliament Street, SW1P 3AG
 01-233 3000

12 June 1984

The Rt. Hon. Patrick Jenkin MP
 Secretary of State for the Environment

John Patrick

BUILDING SOCIETIES GREEN PAPER

You will be aware that Ian Stewart has been in close touch with Ian Gow about the preparation of this Green Paper, a second draft of which has recently been sent to him for comment.

In order to meet our commitment to publish this before the summer recess, we are having to work to a very tight timetable. It is my intention to show it to the Prime Minister early next week so that she has a chance to comment before it is circulated to colleagues more widely. In so doing, I should like to be able to say that its general approach has your support and that of Norman Tebbit, to whom I am writing separately. I would be grateful therefore if you could confirm by the end of the week that that is indeed the case.

NIGEL LAWSON

John Patrick
Nigel Lawson

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CC Chancellor
FST
Sir P Middleton
Mr Cassell
Mr Lancaster
Mr Allan
Mr Gordon
Mr Hall
Mr F K Jones

Treasury Chambers, Parliament Street, SW1P 3AG

Mrs Lomax
Mr Saunders
Mr Portillo
Mr Davlin - RFS

Alexander Fletcher Esq MP
Parliamentary Under-Secretary of State
for Corporate and Consumer Affairs
Department of Trade & Industry
1 Victoria Street
LONDON
SW1

11 June 1984

Dear Alex,

BUILDING SOCIETIES GREEN PAPER

... Following our very useful meeting about this on 31 May, we have been working on a revised draft of this Green Paper. This is enclosed. It takes account of the views expressed from several quarters on the first draft, including your own and the helpful comments your officials subsequently sent to mine.

In preparing this new draft, we have tried in particular to adopt a more positive tone about building societies competing on a broader front with other institutions in the housing and financial services markets. I think that, as a result, you should find that it goes a long way towards meeting the points you had on the earlier version.

I am aware of only two points where we may not have gone as far as you would wish. The first is on paragraph 3.24, where I understand that some misgivings have been expressed that what we say may be unhelpful to your department's position in EC Company Law negotiations. The revised draft seeks to make the point more clearly that we are talking about moral rather than legal obligations, where I think it is generally recognised that major financial institutions are in a rather special position. I am anxious to make this point clearly for the benefit of the BSA, who have implied that subsidiaries may be used as a device for avoiding prudential control. If your department still has concerns about this, however, I am sure it will be possible for officials to sort them out.

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Second, I think we may be drawing the line at building societies owning insurance underwriting subsidiaries more firmly than you might wish. My concern here is the danger that a relatively small capital investment by a society could easily gear up into quite substantial liabilities. The necessary reserves cover in the building society's balance sheet would need to recognise the possibility of capital injections to maintain solvency margins, and, depending on the relationship between the two, to meet any losses that the insurance company might make. In these circumstances, it is unlikely that a building society could prudently go into this business without a very significant diversion of its resources away from those activities on which we are agreed that the societies should concentrate. I think it would give an entirely wrong signal to provide specifically in legislation for the societies to own an insurance subsidiary.

As you know, we are on a very tight timetable to meet our commitment to publish before the Recess. I should therefore welcome your comments by the end of the week. If you have any major difficulty, I hope you could let me know before then if at all possible.

I am also sending the draft to Ian Gow.

Jones *ew*
Ian

IAN STEWART

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Treasury Chambers, Parliament Street, SW1P 3AG

Ian Gow Esq MP
Minister for Housing & Construction
Department of the Environment
2 Marsham Street
LONDON
SW1

// June 1984

Dear Ian,

BUILDING SOCIETIES GREEN PAPER

I was grateful for your comments on this paper at our meeting on 29 May and in your letter of 8 June. We have now prepared a revised draft of the Green Paper to take account of your comments and others we have received. I enclose a copy.

We have tried in this draft, among other things, to soften both the tone and the substance of the proposals. Thus, we now propose rather fewer statutory controls over building society diversification, and we have taken a more neutral line on many of the proposals. I think this should go a long way towards meeting the concerns you expressed. As discussed at our meeting, for example, there is now proposed a global 5 per cent ceiling on the "Class 3" assets, rather than detailed individual controls.

You will see that we have also been able to incorporate your suggestions, subject only to two points. First, in order to suit the context, we have presented the ideas we discussed about new ways of financing housing ventures in a slightly different way from your draft. But the proposals are, I think, essentially directed to the same ends. Secondly, I have for the moment retained our earlier wording on index-linked mortgages. But I am taking further advice on this question.

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As you know, we are on a very tight timetable to meet our commitment to publish before the Recess. I should therefore welcome your comments by the end of the week. If you have any major difficulty, I hope you could let me know before then if at all possible.

I am also sending this draft to Alex Fletcher.

Yours
Ian

IAN STEWART

CHAPTER 1 - INTRODUCTION

1.1 In its Manifesto for the 1983 General Election the Government undertook to:

".. conduct early public consultation on proposals which would enable the building societies to play a fuller part in supporting the provision of new housing and would bring up to date the laws which govern them."

This document is the first stage in that process. The Building Societies Act 1962 consists in large measure of provisions which are in substance well over a hundred years old. It has not been comprehensively reviewed in that time, and it is now widely accepted that the time is ripe for such a review.

1.2 One reason is the position of importance that building societies have come to assume in both the housing market and the financial system more generally. Their governing legislation was never designed for institutions of the scale and degree of organisation that building societies now exhibit. But also, as the societies have evolved over the years, they have come closer to the limits imposed on their activities by the legislation, and it is by no means clear in all cases that these constraints form a logical and coherent whole. At the same time, building societies have faced growing competition in both the savings and the mortgage markets, which has made them consider how they can broaden or improve the range of their services to meet the new competitive climate. Those markets are now evolving fast, and the societies will expect to play their part in the coming changes.

1.3 These developing forces for change were considered in a Building Societies Association discussion document published in January 1983, which examined a wide range of possible amendments to the legislation. A further document "New Legislation for Building Societies", taking account of comments on the earlier paper, was published in February this year. This has been of valuable assistance in setting the scene for this public consultation. It is also necessary however to consider matters which were not explored in depth in the BSA's documents, like the prudential supervision of building societies and the arrangements for setting building society interest rates. Comments are invited on the proposals in this document by 30 September 1984.

History

1.4 The origins of building societies can be traced back to the late 18th Century, as workers moved from the country to the towns during the industrial revolution. Initially, they were "terminating" societies: a group of perhaps ten or twenty people contributed

regularly until sufficient funds had accumulated to buy land and start building. Members would draw lots to decide the order of allocation of houses; payments continued until all members were housed and the society then terminated. In the early 19th Century, there began to emerge societies who paid interest to attract investors who did not want a house, and permanent societies which did not cease to exist when all members were housed, but continued to borrow money from savers and lend to prospective house owners.

1.5 The societies were first recognised statutorily in 1836, but the major piece of legislation was the Building Societies Act 1874, which followed the report of the Royal Commission on Friendly Societies in 1871. Over the next 85 years this legislation was amended from time to time although its basic structure has been left intact. Previous legislation was consolidated into the 1962 Act.

1.6 Over this period, the structure of the movement has changed a great deal. At the turn of the century, there were over 3,000 societies, the overwhelming majority based on small localities. As terminating societies wound up, as societies merged and smaller ones transferred their engagements to larger ones, the number has steadily reduced over the years until there are about [220] today. Some are still very locally based, but others have strong presences throughout particular regions or - in the case of the [five] largest - extensive branch networks covering the whole of the United Kingdom. The volume of building society business has grown enormously, reflecting in part the growth of home ownership. The assets of the movement as a whole have increased from £68 million in 1918 to £73 billion at the end of 1982, an increase of [100-fold] in real terms. Appendix 1 gives more details about the development and present structure of the building society movement.

The Government's approach

1.7 The Government's starting point is that the societies have over the years been very successful both in offering a safe home for investors' money and in financing the growth of home ownership. Nothing should be done now to prejudice their success in fulfilling those roles. Their role as specialists are the housing finance and personal savings markets, and their mutual constitution, should remain. At the same time it is necessary for building societies to evolve in response to changes in the environment within which they operate and to play their full part in the changes currently under way in the financial services industry. While therefore the essential character of the societies should not be disturbed, their powers need modification and extension to enable them better to carry out their functions in an increasingly competitive world.

1.8 In particular, the Government believes that the building societies' main role is in the housing field. Through their financing of house purchase they have made a vital contribution to the extension of home ownership. The Government is determined to bring home ownership within reach of as many people as possible, and the building societies' role in this should continue undiminished. But there are other ways in which the expertise, resources and public standing of the societies can be applied to the benefit of all. Some societies have already made an important contribution within the constraints of the existing legislation.

1.9 This Green Paper describes some of the ways in which societies could further contribute to the extension of home ownership and to meeting general housing needs. It outlines possibilities for new forms of lending, and for contributing to the provision of new low cost housing and to initiatives for shared ownership. The Government also believes that building societies could help to secure a healthy private rented sector, in particular through the ownership and development of land and property. There would be scope for societies to participate in the direct provision of housing through the management of housing investments. Where a part of societies' considerable resources can be deployed to these ends while protecting their fundamental housing finance and savings roles, and their good name, the legislation should allow them to do so.

1.10 The Government also intends that new legislation should maintain the societies' position as a safe home for people's savings. A new statutory framework would therefore need to ensure that the societies continue to make prudent use of the money that has been deposited with them by investors. It should therefore ensure that the scope for diversification into higher risk assets should be subject to proper prudential control by the authorities.

1.11 It is just as important however that building societies should continue to be a competitive, as well as a safe, home for savings. Building Societies do not operate in isolation, but are part of the wider financial services sector which provides the public with financial and investment services. Major structural changes are now taking place among financial institutions and, though they have not directly involved building societies, they can be expected to have a significant impact on the commercial environment in which the societies operate. The trend towards "one stop" centres for financial and investment services will add a new competitive dimension to which building societies will need to respond. This paper therefore considers the extent to which the societies might be able to expand their range of services within their main role as providers of housing finance. The Government welcomes competition in this market, for it is this which will ultimately ensure the best service to investors. But competition must take place on a fair basis. For example, measures have been taken, notably in the

1984 Budget, which have promoted a much greater degree of fiscal equality between banks and building societies.

1.12 There is however a potential conflict between the attractions of building societies diversifying into new business and the need to ensure prudence and safety. For example, diversification into assets in the form of property rather than loans secured by mortgage on property would be inherently more risky and so may give rise to new prudential considerations. And the free play of competition between financial institutions must always be tempered by the need to maintain prudential standards. Similarly, any ^vmove by societies into provision of new services should not detract from their main role. It is therefore necessary to strike a balance between these different, in some cases conflicting, considerations. Before coming to consider what new powers should be granted to building societies, therefore, the next Chapter discusses what prudential framework should be imposed on the societies which would enable desirable diversification to take place without materially affecting the interests of investors or having other adverse consequences.

Building societies and monetary policy

1.13 As the societies have grown, so they have become more important to the formulation of the Government's monetary policy. Two aggregates incorporating many of the liabilities of the societies are now published (M2 and PSL2). As noted in the Medium Term Financial Strategy, the Government regards building societies' liabilities as "an important element in monetary conditions" and pays particular attention to M2 and PSL2 in interpreting the behaviour of MO and £M3, the measures of narrow and broad money used for target purposes. The Government seeks to influence the growth of various monetary and liquidity aggregates by operating on short term interest rates, funding and fiscal policy. These policies affect the growth of building societies' liabilities, as well as those of the banking system.

1.14 From time to time successive Governments have also sought the co-operation of building societies in the execution of monetary policy. Thus, during the second half of the 1970s, when the banks were subject to direct quantitative controls on their balance sheets, the Government and the BSA agreed a voluntary guideline on the level of societies' mortgage lending. The aim of this guideline was to establish the maximum amount of building society lending, consistent with achieving a high level of private house-building without an unreasonable increase in house prices. The Government also sought the co-operation of banks, insurance associations and the BSA in 1982, at a time when it became concerned that lending for house purchase was being unduly inflated by borrowers realising housing equity to finance other expenditure. There need be no significant change in the way in which building societies are regulated for monetary

X purposes. The Government will, however, remain interested in the growth of societies' liabilities, the pace of their lending and its impact on house prices. Any society which converted to company status and came under the aegis of the Banking Act (see chapter 5) would become subject to the same controls as other licensed deposit takers.

CHAPTER 2 - THE PRUDENTIAL FRAMEWORK

The present financial structure of building societies

2.1 The starting point is the existing financial structure of societies. This not only reflects the business in which building societies engage and the sort of institutions they are, but it also sets limits on their scope for change. It is important to be clear at the outset about the nature of those limits and hence their implications for the various proposals that have been made for extending building society powers.

2.2 Building society balance sheets are essentially quite simple. The main assets are loans to members secured on mortgage (typically about 80 per cent); liquid assets, or "surplus funds" as they are known in the 1962 Act (usually in the range 17-20 per cent); and fixed assets, such as land, buildings and equipment, which average about 1½ per cent of assets. The other side of the balance sheet consists largely of shares and deposits from members of the public, although in the last year or two the larger societies have been raising a proportion of liabilities (up to about 10 per cent in one or two cases) by issuing certificates of deposit or negotiable bonds, or from other wholesale money market sources. The surplus of assets over liabilities is the general reserve, representing accumulated surpluses over the years.

2.3 Within this very simple structure, there are several important points to note:-

- (a) The security of the assets. In normal circumstances, a building society's assets can be considered to be very safe. Fraud and inadequate valuations apart, there are few circumstances where this would not be so. The main possibilities perhaps would be a serious collapse in house prices in circumstances where significant numbers of borrowers had defaulted on their repayments; or if a society imprudently placed a substantial proportion of its liquid funds in medium dated gilt edged stock, which then recorded a capital loss.
- (b) The societies have been able to match interest rates on their revenue accounts by variable rate borrowing and lending. This is in contrast, for example, to the experience of the Savings and Loan Associations in the USA (the nearest equivalent there to UK building societies) many of whom encountered serious problems in the 1970s through being unable to increase their lending rates in response to market forces.
- (c) As a result of the relatively low risk of capital loss, and the absence of any need normally to provide for unforeseen losses on the revenue account a

building society is able to maintain lower reserves as a percentage of assets than do other financial institutions.

- (d) This in turn means that additions to reserves (in other words, profitability) can be relatively small. It is necessary for them to make some profit if only to maintain the ratio of reserves to total assets at a time of growth. At current rates of growth, an addition to reserves of only about $\frac{1}{2}$ per cent of assets per year would be typical. Combined with the absence of any need to distribute profits, all these factors mean that building societies are able to run on narrow interest rate margins.
- (e) The great majority of liabilities may be called in at short notice, while the assets are long term: building societies borrow short and lend long. It is therefore necessary for a significant proportion of assets to be held in readily realisable form, for example, cash, bills, and short dated government stock or short term deposits with local authorities. These are their liquid funds, which are necessary to enable fluctuations in cash flow to be covered without the society becoming illiquid or even to run the risk of appearing so and hence losing investor confidence.

2.4 It will be evident that these principal features of building society financial structures derive ultimately from the nature of their business. It is the very limited range of activities within which they can engage on the assets side that gives the high degree of security, and the ability to maintain relatively low reserve ratios. Their specialisation also leads to relatively low management costs and the capacity to run on narrow interest rate margins.

2.5 While these remarks are of fairly general application to all building societies, their implications for different societies vary with individual policies and circumstances. For any given society, the appropriate reserve and liquidity ratios and the surplus it should aim to achieve depend on a range of factors: the quality of its mortgage book, its rate of growth, the volatility of investors' funds, and so on. Even with the very tight statutory constraints on building societies that exist today, and hence the general uniformity of their financial structures, it is not possible to lay down general quantified rules or targets for all societies. There are certain minimum conditions embodied in statute. For example, a building society may not be authorised to accept money unless it meets minimum reserve requirements ($2\frac{1}{2}$ per cent for the first £100 million assets, reducing on a set scale to $1\frac{1}{4}$ per cent of assets in excess of £1 billion). And, for a society to be designated by the Chief Registrar for trustee investment purposes, it needs to demonstrate a liquidity ratio of at least $7\frac{1}{2}$ per cent of assets. But these are very much minimum requirements, and any society would normally

be expected to be comfortably in excess of them. How much would depend on the nature of its business.

2.6 These points have even more force when it comes to considering wider powers for societies. Any new activity by building societies would, almost by definition, entail greater risk than at present. Any institution undertaking ventures involving risk needs to ensure that it has a capital base which is more than adequate to cover any losses that could conceivably be incurred. This is particularly so for a financial institution receiving deposits from members of the public who have contracted to get their investments back a pound in the pound. In the case of a building society, its capital base is its reserves. For most purposes, however, it is more useful to consider its "free reserves" - its general reserve less fixed assets - rather than total reserves. Reserves may be built up only out of realised profits; a society's capital base cannot be expanded as rapidly as a company's, which may do so by a rights issue, for example. It follows that a building society's free reserves should be reasonably matched to the scale and nature of the risks. Similarly, liquidity needs to be related to conceivable fluctuations in cash flow.

2.7 While none of these concepts is new, they are not reflected comprehensively in existing legislation or the current guidance from the Registry of Friendly Societies. The Chief Registrar will be issuing a series of discussion papers to the societies in the coming year, dealing with these concepts in more detail. This present discussion however forms an important introduction to the Government's consideration of new powers for societies. Any new powers must be compatible with these fundamental financial characteristics of building societies.

General limits on building societies

2.8 The existing statement of building society objects - effectively the statutory definition of a society - is that contained in section 1(1) of the 1962 Act:

"The purpose for which a society may be established under this Act is that of raising, by the subscriptions of the members, a stock or fund for making advances to members out of the funds of the society upon security by way of mortgage of freehold or leasehold estate."

While this definition has served well for a good many years now, it is in need of refinement and expansion so as more adequately both to reflect the nature of building society business as it has developed and to allow the sort of diversification now considered to be appropriate.

2.9 The suggested general approach is to augment section 1(1) by a list of specific permitted activities related to the primary propose of societies and subject to certain quantitative limits. It would be necessary to move away from the present position that

building societies may legally engage only in activities that are ancillary or incidental to their primary purpose. Considerable time now has to be spent on whether proposals are legal or not, with occasional recourse to the courts to remove doubt. This is not satisfactory, and it would be preferable to provide explicitly in the legislation for those related activities which are to be permitted to societies within broad quantitative limits. Both the list of permitted activities and the limits might be variable by order, subject to Parliamentary approval.

2.10 These broad limits would need to be set at levels which would ensure that the main business of societies remained the raising of money from individual members to lend to others on the security of their houses. The following are proposed:

- (a) At least 90 per cent of total assets, other than liquid assets and office premises and equipment, should be in the form of advances to individual members secured by first mortgage on residential property.
- (b) A society should be required to hold liquid assets for at least an amount adequate for its business but not more than $33\frac{1}{3}$ per cent of total assets. The maximum limit would ensure that the money was indeed applied to the primary housing purpose of societies rather than investment in gilt-edged and other stocks.
- (c) At least 80 per cent of funds should be raised from individual members, allowing up to 20 per cent from the money markets and other sources. The purpose of this limit would be to retain the traditional role of building societies as repositories for personal savings. It will however be a limit that may need reconsideration at an earlier date than some others if developments elsewhere in the personal savings and financial sectors so dictate. Some exception to the 80 per cent rule would be needed in particular cases, notably loans from other building societies in accordance with Section 44 of the 1962 Act, which applies in circumstances where a society faces a liquidity crisis. The Chief Registrar would also be able to lift the limit in exceptional circumstances and subject to conditions.

The special advances limit, which prescribes that lending in any one year in the form of loans exceeding £60,000 or of any amount to corporate borrowers should not exceed 10 per cent of total lending, would be repealed.

2.11 The main purpose of this broad framework would be to ensure that the majority of building society activities would continue to be in their traditional role of raising money from members for lending to other members to finance house purchase. But it also provides ample scope for diversification of both assets and liabilities. The precise forms that might be permitted are discussed in the following chapter. To a greater or lesser extent, most

tend to involve new risk and it is therefore necessary to consider the implications for the system of prudential supervision.

Supervisory controls of the Chief Registrar

2.12 The statutory functions of the Chief Registrar of Friendly Societies to protect investors in building societies, and their extension to match the wider powers of societies now proposed, are discussed in Appendix 2.

2.13 The form of prudential supervision which has been exercised over building societies has reflected the fact that building societies are constrained by statute to a narrower range of significantly lower risk activities than those undertaken by other deposit takers, notably recognised banks. The system has therefore differed from that applied by the Bank of England to recognised banks and licensed deposit takers under the Banking Act - with both less intensive monitoring by means of returns and less frequent direct contact between supervisor and supervised. It has, however, been developed over the last decade or so. This has reflected the increase in public concern about the prudential standards applied generally to financial institutions, the particular weaknesses shown up by a series of building society failures, notably the Grays, and by the increased competition over the last few years, both among societies and between societies and other financial institutions. Although the system of supervision will become more akin to that applied to the banking system, it will still differ in degree, and so in the staff which it will require and the burden which it will place on management of societies, because of the general constraints on building societies powers.

2.14 The legislation will place a duty on building societies to keep their activities predominantly to their mainstream business. This will include observing the limits described in paragraph 2.10. A society would be acting ultra vires if it undertook business which it was not permitted to do at all. If a society appeared to be likely to breach the prescribed limits, it would be open to the Chief Registrar to give a direction to the society to prepare and put to its members plans for conversion of the society to a company. If the society failed to do so within a specified time, or if the members rejected that plan, it would then be open to the Chief Registrar to apply to the Court for an order either winding up the society, imposing a reconstruction upon it, or limiting the amounts of certain types of business which the society could do, in order to correct the situation.

2.15. A building society would also have a duty to do certain things in order to protect investors' money. Some of these are already specific requirements. They would include the need:

- (i) to maintain adequate reserves, and more specifically free reserves, for the structure of assets and nature of business which it was carrying on;

- (ii) to maintain adequate liquidity in relation to the type of business it was carrying on;
 - (iii) to observe the prescribed limits on building society activity;
 - (iv) to have adequate management for the types of business it was undertaking, including meeting the specific requirement, at present in the Authorisation Regulations, for effective direction by at least two people of adequate repute and experience;
 - (v) to maintain adequate systems of internal control and inspection;
- and (vi) to have adequate arrangements for independent valuation of mortgaged property.

2.16 The Chief Registrar will be producing for discussion with societies in the next year or so papers on the criteria for assessing the adequacy of reserves and liquidity, similar in character to those which the Bank of England has already produced for banks and licensed deposit takers.

2.17 Failure by a building society to observe these requirements, or in other ways to protect adequately the interests of its investors, would be ground for the Chief Registrar to use his statutory powers to protect the interest of investors. These would include as now a ban on advertisements, either generally or of a particular character, or a ban on taking of further investments, with which would go the revocation of authorisation. [There would also be a new power to substitute an authorisation subject to certain conditions for an existing authorisation.]

2.18 The Government announced in January 1983 that the expertise of the Registry of Friendly Societies was being strengthened by the recruitment of additional professional and other staff, particularly in order to improve the prudential supervision of building societies. The supervision of building societies with these new powers may require some further strengthening of the Registry. This would not, however, add to public expenditure. The legislation will provide for the recovery by the Registry of its full costs from the various groups of societies for which it is responsible.

CHAPTER 3 - BUILDING SOCIETY POWERS DIRECTLY AFFECTING THE BALANCE SHEET

3.1 This Chapter considers possible new building society powers which would involve new forms of assets or liabilities, within the general framework already proposed. New powers that would be in the nature of functions or services - and hence would not affect the balance sheet directly - are discussed in the following chapter. Most of the following discussion deals with building society assets, which are considered in three groups, described as Classes 1, 2 and 3 respectively. These classes essentially group building society activities by the nature of the business in question. They also bear some relation to risk, in that the assets in Class 3 will generally require stricter prudential control than those in Class 2, and most of them in Class 2 will be controlled rather more closely than Class 1. But the classification is in no sense a substitute for prudential control based on reserves criteria, and the limits on the different Classes are not intended primarily to secure a prudential purpose. Rather they seek to set outer limits on the degree of diversification which can legitimately be expected for building societies.

Class 1 Assets

3.2 These would be the type of lending which forms the core of traditional building society business and which will continue to be the main thrust of their activities even after new legislation. They would be defined as advances secured on first mortgage of residential property to individuals who are owner occupiers of the property in question. As discussed in the previous chapter, at least 90 per cent of assets other than liquidity, office premises, etc/ - for convenience described henceforth as "base assets" - would have to be in this form. This class is in theory somewhat narrower than existing building society lending powers allow, since it does not include lending to bodies corporate or lending on property which is not used for wholly residential purposes. But in practice about 99½ per cent of building society advances are secured on domestic property, notwithstanding the theoretical greater freedom open to them. And lending to bodies corporate is already constrained legally by the special advances limit; in practice this too accounts for a very small proportion of building society business. So a limit of 10 per cent of non-liquid assets in other than Class 1 will give societies ample scope for the exercise of new powers.

3.3 It has also been suggested by the BSA that building societies should be able to take into account any additional security offered by the borrower (at present a society may take only certain specified types of additional security, including life assurance policies and guarantees given by local authorities). The Government is prepared to accept this. So long as the advance is within the valuation of the property in question, it is prepared to leave the question of additional security to individual societies. Provided it met the other criteria, such lending would also be in Class 1. It has also been suggested that the requirements for

societies to seek fresh valuations before making further advances on existing mortgages are too onerous, involving full valuations where the sum advanced is clearly well within the value of the security. The Government accepts that there will be many circumstances in which a further valuation is not necessary and is prepared to consider any change in the law that may be required to make this clear.

Class 2 Assets

3.4 These consist essentially of other forms of wholly secured lending. They would be subject to no specific statutory restriction so that they could in theory account for up to 10 per cent of base ^{assets}. Their basic feature is that they represent a less traditional form of lending than Class 1. They would not necessarily be higher risk, although some would entail small additional risks. The restriction on their total amount would be less a prudential matter - ensuring the safety of building societies as a home for investors - than maintaining the bias of building society business towards lending money to those seeking to buy their own homes. Some indeed - like lending to bodies corporate or loans secured on non-residential property - are already within building society powers. If a building society felt able to make a loan to a small business proprietor under its existing powers, for example, this would be likely in future to be within Class 2. But this class would include also certain new powers which are now proposed.

3.5 The first would be a power to lend on the security of second mortgage. This has been suggested by the BSA and others, and the Government accepts their case. A power to lend on second mortgage would give greater choice to consumers wishing to borrow money for home improvements, etc. It would also be of assistance to those whose first mortgage lender - for example, a local authority - was unable or unwilling to make a further advance. In this case, a building society second mortgage would enable the borrower to raise money without having to change his lender. While there is no question of second mortgages being as a rule unsound, they do represent somewhat less good security than first mortgages. The Government therefore proposes that the power should be limited so that a building society loan may not take the mortgagor's total debt above 75 per cent of a recent valuation of his property.

3.6 The Government also accepts that building societies should be given clear powers to make equity mortgages, that is, mortgages where the borrower pays a lower rate of interest but the lender's asset is not a reducing monetary amount but the value of a fixed share in the property, which will generally be expected to appreciate. This again is a secured asset, but does involve some financial risk in that it relies on the appreciation of the asset value to compensate for the lower interest received on the loan. To the extent that corresponding liabilities were in the form of conventional shares and deposits, there would be an income mismatch. These considerations are not however sufficiently serious to warrant a special

control over this sort of lending, but the Chief Registrar will take the extent of any equity mortgages into account in advising societies on the appropriate levels of reserves they need to maintain.

3.7 The BSA have also suggested that the legislation should make clear the powers of building societies to make index-linked mortgages. [The Government does not however consider that a specific power is necessary. The outcome of a recent test case in the High Court demonstrates that an index-linked loan by a building society would be *intra vires*.] Indexed lending should be matched by indexed liabilities -see paragraphs []. But loans to individuals would normally be in Class 1.

3.8 Finally, there may be circumstances in which it would be appropriate for a building society to lend beyond the valuation of the property, so long as the advance is secured by a local authority indemnity. This would be aimed at the situation which sometimes arises, particularly in inner city areas, where a properly cautious valuation of an unimproved property would be below the cost of improvement, but where a local authority is prepared to issue a guarantee under Section 111 of the Housing Act 1980. Such loans would be no less secure than conventional mortgage lending, because of the guarantee, but because they would represent something of a new departure for a building society, they are properly included under Class 2.

Class 3 Assets

3.9 These would involve the exercise of new powers less akin to traditional building society business than the secured lending in Class 2. Much of this new business would involve more risk and would therefore need to be covered by proportionately higher free reserves than the general run of building society business. Indeed, many small societies would have neither the management expertise nor the reserves to engage in much of this business. They would not wish to do so. The power to hold most Class 3 assets would therefore be restricted to societies with free reserves (that is total reserves less fixed assets) of more than £3 million. (This would mean that on the end of 1983 figures, the wider powers would not be available to some [] societies, whose total assets form [] percent of the total assets of building societies.)

3.10 As well as involving rather higher risks, the new assets proposed for Class 3 would represent in some cases quite radically new departures from traditional building society activity. It is therefore suggested that, much as a minimum of 90 per cent is proposed for Class 1, there should be a statutory upper limit of 5 per cent of base assets for Class 3. There is no expectation of societies generally approaching this limit - which, if applied uniformly across the movement, would approach £4 billion at today's prices - for many years to come. But, in the final analysis, the limit would be capable later of amendment by order

if experience suggested that it constrained societies unreasonably. There are three main sorts of business in this Class: unsecured lending, housing and other equity investment. They are considered in turn.

a. **Unsecured lending and money transmission**

3.11 There are two distinct issues in this context, both of which bear on the question whether building societies should be able to lend unsecured to their members.

3.12 First, there is that of providing money transmission services to members. It is by no means clear what precise services the societies will need to offer in future to remain competitive, but it is clear that some at least of them are likely to imply the possibility of accounts becoming overdrawn. The point has already arisen in respect of building society cheque accounts, where it has not been possible within existing law to issue cheque guarantee cards. This is because the giving of such a guarantee would enable ^{a customer} ~~inadvertently~~ or ~~a customer~~ dishonestly to overdraw by repeated use of the card. While building society customers may sometimes overdraw now through counter error, that is totally accidental. The issue of a guarantee card would mean a society promised to meet a payment even if it took an account into overdraft, which is not possible under existing legislation. The same point could apply to certain types of new electronic money transmission systems, for example "point of sale" or automated teller machine networks.

3.13 As discussed in Chapter 1, it is important to ensure that financial institutions are able to compete on more equal terms. Any unnecessary impediment in the building societies legislation should be removed. At present they do not have sufficient powers to enter ¹ properly into money transmission, and this would need to be put right. The legislation might tackle this by providing an explicit power to guarantee payments in certain circumstances, with a power to require a member to make good any debt so incurred within a specified period. It would need to cover debts of up to £1500, thirty times the present limit on current account cheque guarantee cards, which would enable building societies to issue cheque books comparable to those of banks. It would also be necessary to extend to building societies the protection given to bankers by the Bills of Exchange Act and Cheques Act. Appropriate cheque clearing etc arrangements would also have to be made, although this would not be a matter for legislation.

3.14 The second question is whether the societies should be able to offer unsecured personal loans. This would in many ways be a logical extension of their business. For example, the typical housebuyer will also need to incur expenditure on furniture, fittings and repairs, and may wish to approach his building society for finance, something that building societies may already be providing in certain cases, but secured on first mortgage. And

unsecured loan finance may be a more sensible way of paying for some small home improvement and repairs than a full mortgage.

3.15 Consumer credit is a different sort of business from mortgage lending, with higher risks whose assessment is qualitatively different. The societies would accept that they do not at present have the necessary expertise to undertake it prudently on a large scale. Any society that began to lend unsecured would have to build up the business at a gradual rate, within its management and reserves capacity, and in consultation with the Chief Registrar.

3.16 Nevertheless, the Government considers that there is a legitimate role for building societies here, both in enhancing their housing function and in enabling them to provide a broader range of financial services. It is therefore persuaded that building societies should be able to lend unsecured, but there would need to be a limit on the size of loans to any one individual. The Government suggests £5000 initially, although this figure could be amended later. This would be additional to any debts incurred in the course of using new money transmission facilities.

3.17 The Government has also concluded that the wider unsecured lending power should be open only to the larger societies with free reserves in excess of £3 million. Smaller societies would however have available to them the powers enabling them to offer new money transmission services.

b. Ownership of land and property

3.18 Over the last few years, building societies have come to seek a more active role in the provision of housing than that of simply lending money on the security of mortgage. The Government welcomes this in principle. More flexible use of a small fraction of the considerable financial resources at the command of building societies would be a potentially powerful contribution to the private sector's involvement in the improvement and development of the country's housing stock. Nevertheless, history has demonstrated a need for caution in this area. The present bar to building societies holding land followed the collapse of the Liberator Building Society, then the largest in the country, as a result of imprudent involvement in property deals towards the end of the last century. In 1959 the State Building Society collapsed after lending to property companies which failed. Most recently, the early 1970s saw the failure of several property companies. Owning land and property is a relatively high risk activity. While some involvement by building societies is to be welcomed, it needs to be kept within prudent bounds.

3.19 Societies have not so far been able to enter this field directly. Nevertheless a few have done so indirectly by sponsoring and lending support to related housing associations or companies. They have no legal relationship with them, other than as providers of funds

secured on first mortgage. This means that if the "associate" got into serious financial difficulty, the society might not legally be able to provide the necessary support. At present, therefore, such ventures have in practice to be monitored and controlled very closely indeed by the society. But in extreme circumstances there would be a limit to the extent to which it could intervene. This is unsatisfactory. The standards of conduct expected of a financial institution are such that any subsidiary venture to which it lent its good name would have to be backed in full. In the final analysis, the liabilities of the subsidiary must be on a par with those of the parent institution itself.

3.20 A power to own land for purposes of letting would enable the societies to act directly as landlords and to own the rented element of shared ownership schemes. These are both activities with which the existing building society associates are involved. The second, and complementary, approach would allow the societies to set up housing associates as properly constituted subsidiaries. This could be either a controlling equity stake in a housing trust company or formal powers of control over a housing association incorporated as an Industrial and Provident Society. Both forms of establishment would be permitted. The society would also need to be given the power to underwrite its subsidiary or associate.

3.21 Many societies may want to undertake such operations through subsidiaries, because of the management and accounting attractions, and because it would enable them to set up joint ventures with local authorities, building contractors or other financial institutions. Others may prefer to carry such activities directly on their own balance sheets to retain maximum control. It needs to be stressed however that the financial risks are the same whether the activities are carried out directly or through a wholly-owned subsidiary - see further paragraph [3.24] below - and for supervisory purposes the balance sheet of a housing subsidiary would be consolidated with that of the parent society.

3.22 A further area for consideration is the development of property for sale. Building societies already play a part in ventures with builders, local authorities and other institutions, but their role is limited essentially to lending on mortgage. In general they are unable to play a full part in the management and control of such projects and in some cases this inhibits their willingness to participate in and finance potentially profitable ventures. While the Government does not consider that building societies should become involved in speculative non-residential development, there is a legitimate role for them in primarily residential development, particularly in co-operation with local authorities. Some local authorities, particularly in inner city areas, have welcomed projects with a strong building society involvement when releasing land for development. The Government also therefore see scope for building societies to become involved in developments for sale as well as for rent. Indeed the two are likely to overlap in many areas, where individual developments may contain a mix of tenures.

3.23 As indicated earlier, however, there are potentially serious prudential concerns. All forms of business involving ownership of land or property would entail a different sort of risk from that attaching to conventional building society assets. Both sides of building society balance sheets are at present made up of interest-bearing financial instruments which are capital certain and well matched in terms of income. Substantial property assets would introduce an income mismatch between assets and liabilities potentially increasing the financial riskiness of building society operations. The scale of these activities would therefore have to be limited not only to stay within the bounds of the legal definition of a building society but also to ensure that any potential loss was well within the capacity of its free reserves to absorb. Land and property assets would therefore require considerably higher reserves cover than many other sorts of asset. As a result, it will not be possible for societies to engage in such business on a significant scale. It is unlikely that any society would be able to have more than about 2 per cent of its assets in property for several years to come. As with unsecured lending, the Government does not consider that such powers should be open to societies with free reserves less than £3 million. The one exception might be a power to enter into shared ownership schemes where the risks - and indeed the structure - is very similar to an equity mortgage. Eligible societies wishing to hold land would need to seek the Chief Registrar's approval before doing so, and to satisfy him that reserves and management expertise were appropriate for the task. As discussed in Chapter 2 and Appendix 2, the Chief Registrar will in due course be issuing detailed criteria for assessing reserves adequacy.

c. Equity investment in subsidiaries

3.24 Before considering particular proposals which would involve building societies setting up subsidiaries, or taking a minority stake in other organisations, a few general points should be made. There is no reason in principle why a mutual organisation such as a building society should not own the equity of a company. There are already examples - the Cooperative Bank, which is owned by the Cooperative Wholesale and Retail Societies, is one such. There are likely to be advantages of financial management and accountability for societies in transacting certain operations through subsidiaries. But the subsidiary route must not be regarded as a way of sidestepping prudential considerations. A financial institution of the standing of a building society would take on certain moral obligations towards a subsidiary to which it had lent its good name. It could not walk away if it got into trouble. Any losses made by the subsidiary - even if the possibility is remote - would potentially be those of the parent building society. Similar principles could apply where the building society was a minority shareholder in a company, although the exposure in any one case would depend on a range of factors, including the proportion of the equity owned by the society, the nature of the other shareholders, and the extent to which the building society had been responsible for setting up the company in the first place. In view of this, the scope for even the largest building societies to take on such commitments is not large relative to

their size. Although the largest societies have free reserves running into hundreds of millions of pounds, the liabilities of a significant subsidiary, particularly a financial institution, could quite rapidly come to require reserves cover on that scale.

3.25 For this reason, the Government is not disposed to allow building societies to set up subsidiaries with potentially heavy contingent liabilities. Thus, for example, it is proposed that building societies could engage in unsecured lending on their own balance sheets, but not that they should be able to gear up further through a consumer credit subsidiary. There would be considerable risk of disproportionate expansion in such a subsidiary operating through a building society branch network. Rather similar considerations apply to insurance underwriting. A building society insurance subsidiary - in practice the only way in which a society could undertake insurance consistently with the requirements of supervision of the industry - would be subject to the same control as any other insurance company. This includes the maintenance of a statutory solvency margin and satisfactory capitalisation. The parent building society would again be expected to stand behind its subsidiary if it got into difficulty. If the insurance business grew substantially aided by the extensive branch outlets of the parent society, this could become a major commitment. Substantial additional commitments of this nature would not be consistent with the Government's general objectives for the societies.

3.26 As already discussed, however, the Government would envisage building societies over a certain size being able to invest in housing subsidiaries. It is also right that the societies should be able to invest in financial services subsidiaries. Some such are already in existence, in the form of consortia examining the possibility of setting up electronic money transmission networks. Legislation will make it clear that such activities - including those in co-operation with other financial institutions - will be permitted. It is impossible at this stage to be more specific about the precise use that may be made of such powers, since the major changes expected in retail financial services markets are still in their infancy. But it is the intention to provide a power with enough to cover all likely eventualities. As with other subsidiaries, there would be a need for ample reserve cover against the risk of any loss, and including any additional exposure as a result of growth.

3.27 One further possibility would be to empower building societies to set up housing finance subsidiaries in other EC countries. It is a power that the BSA have sought, and the Commission of the European Communities have indicated an intention to raise the questions of freedom of establishment and services in this field. The housing finance markets in each European country are all quite distinctive and self-contained. They have grown up in response to particular needs in those countries, and do not translate across borders very easily. There are no evident gaps in the market across Europe. Moreover, establishment overseas would involve building societies in new sorts of risk, not least foreign currency

7
risks. The Government is sceptical of the benefits in building societies operating overseas but would welcome further comments on this question.

Building society assets - conclusions

3.28 The scheme outlined in this Chapter is intended to maintain the societies as predominantly lenders for house purchase while allowing them adequate scope for diversification. At least 90 per cent of base assets must be in loans to individual owner-occupiers secured on first mortgage. For Class 2 assets, the main control within the 10 per cent ceiling would be the prudential controls and reserve requirements exercised by the Chief Registrar, although in practice it is unlikely that many will come close to the limit for a good many years. Class 3 assets would generally involve higher risk and most would be open only to societies with free reserves of at least £3 million. The exceptions would be those transmission services and shared ownership. Unsecured lending to any individual would be limited to £5000. Class 3 assets would be subject to an overall limit of 5 per cent of base assets. All figures would be capable of amendment by order.

Building society liabilities

3.29 Building societies have traditionally raised virtually all their funds from retail savers. In recent years, however, they have raised more money from wholesale sources, including syndicated loans, negotiable bonds traded on the Stock Exchange and, following changes in the tax law allowing them to pay interest gross on such instruments, certificates of deposit and time deposits. Such liabilities at present amount to about £2 billion, rather less than 10 per cent of which consist of certificates of deposit held by other building societies (which may increase the liquidity of the issuing society but not of the building societies as a whole).

3.30 In general, the Government welcomes those developments. Access to wholesale sources of funds is likely to enhance the ability of societies to cope flexibly with fluctuations in the supply of and demand for their funds. But there can be risks for financial institutions relying too heavily on money market funds, so that the proposed restriction that 80 per cent of liabilities should be raised from the personal savings sector will serve a prudential purpose as well as ensuring that societies continue to concentrate on their traditional functions. The Chief Registrar has already issued prudential guidance to building societies on the use of certificates of deposit. Further guidance will be issued as necessary in due course.

Matching liabilities and assets

3.31 New forms of liability clearly have a role in reducing risks attendant on new assets. When the pattern of income from a new asset differs from that of traditional assets, there

are dangers of mismatch with a need for considerable reserve cover. It may be possible in some circumstances to reduce the risk somewhat by matching liabilities to those assets. One obvious example is index-linked mortgages, which need in general to be matched by indexed liabilities, whether wholesale or retail. This is however a complex question, and matching should not be seen as offering unlimited scope for diversification. For example indexed mortgages could be redeemed, leaving unmatched indexed liabilities; or liabilities matching particular assets may prove difficult to roll over unless their maturity is matched exactly. It is intended that the forthcoming paper by the Chief Registrar on capital adequacy should consider this general question more fully.

x 3.32 On the face of it, it might be though^t that if building societies were to issue bonds or other instruments, the return on which was related to that on property investments, that could enable them prudently to do rather more in the housing field than suggested earlier in this Chapter. But this may in practice be unlikely on any significant scale, for the reasons to which the previous paragraph alludes.]

3.33 An alternative way of allowing the societies to play a wider role in housing, therefore, might be to allow them to manage property investments on behalf of others, in addition to any limited investments of their own. Such investments would not be part of the societies' assets, and all the profits and losses arising on them would accrue solely to those for whom the investments were being managed. The financial involvement of the society would be limited to its fees for providing a management service. The investments in question might indeed have formerly been held by the society in some cases. Such arrangements would be possible only if it could be clear that the investor for whom the society acted as agent was in no sense a subsidiary of the society or otherwise had the society standing behind it. [It might be appropriate to give the Chief Registrar powers to limit the scale of such management activities.]

CHAPTER 4 - BUILDING SOCIETY POWERS - NEW FUNCTIONS

4.1 This Chapter considers the possible extension of building society powers in ways which would not entail taking new assets onto their balance sheets. As such they do not in general involve exposure to the risk of financial loss. They need rather to be considered in terms of the primary role of building societies in the financial services and housing markets, and of the possible conflicts of interest to which they might give rise.

"One stop shopping" for house buying services

4.2 The BSA have put forward proposals to enable building societies to offer a package of services to house buyers, including estate agency, conveyancing and structural surveys. At present, the legislation does not enable a building society to offer these services, although arrangements have developed between the societies and the professional groups concerned which allow consumers to obtain an integrated service without duplication of work. For example, many estate agents act as agents for a building society. A building society will also frequently allow the borrower's solicitor to act on its behalf in the conveyancing transaction. And building society panel surveyors frequently carry out surveys for prospective borrowers as well as valuations for the society. The Government in principle welcomes any moves which increase competition and the range of choice open to consumers. But the issues need to be examined on their own merits, particularly in the light of possible conflict^s of interest.

4.3 On 17 February 1984, the Government announced its intention of legislating to enable solicitors employed by building societies, among others, to undertake conveyancing. A consultative document on the avoidance of possible conflicts was issued in April, and the issues therefore need not be discussed further here. Amendment of the Building Societies Act 1962 would be required to bring conveyancing within the statutory powers of building societies. While it would obviously be preferable to deal with this in general building society legislation, this is not essential and the Government will be prepared therefore to legislate in advance on conveyancing if necessary.

4.4 At the same time, the Government announced the establishment of a committee now chaired by Professor Farrand to consider the issues raised if non-solicitors were allowed to undertake conveyancing, conveyancing practice and any other matters concerning the simplification of house purchase which might be referred to it. There was also announced a wide-ranging interdepartmental review of the house transfer system with a view to identifying means of simplifying and speeding up the process. To a considerable extent, therefore, decisions on the widening of building society powers must await the outcome of that work. But some general comments may be offered at this stage.

4.5 So far as structural surveys by building societies are concerned, the risks of conflict of interest appear relatively slight. In general, the building society and the borrower have a common interest in ensuring that the property is sound and not over-valued. There could be risks of charges of neglect if a survey was shown subsequently to have been at fault, and this possible liability would therefore have to be covered by professional indemnity insurance. A building society would also need to consider carefully the risk of poor publicity in such circumstances affecting its public image of integrity and security. It would be a relatively small development of present practice to allow a building society to offer this service directly.

4.6 A more difficult question - and one on which the Government would particularly welcome wider comments - is that of building societies engaging in estate agency. In general, and subject to the conclusions of the Farrand Committee and the interdepartmental review, there is a powerful presumption that greater competition would benefit the market in house buying services. The entry of building societies into estate agency would be a major extension of competition, from which benefits to consumers might be expected to flow. Moreover, this would enable the societies to offer a "one stop shopping" facility for house buying, with all the relevant services available from the same place. There is evidence to suggest that this would be welcome to many potential house buyers.

4.7 But this very unification of services does raise new and potentially serious problems of conflict of interest. Building societies would almost certainly wish to run estate agency businesses directly from their branch offices, if only to improve the utilisation of their branch networks, rather than through separately housed subsidiaries. This would then mean that branch managers could be responsible both for arranging sales on behalf of the vendors of property and for financing the purchasers. This would pose a direct and immediate conflict of interest. As agent for the vendor, his duty would be to get as good a price as possible. But his duty to the purchaser (and his duties to value his security adequately) would point in precisely the opposite direction. His position would be complicated still further if the society also undertook the valuation of the property.

4.8 Such conflicts on their own would be unacceptable, and safeguards would need to be provided for customers if building societies are to be permitted to undertake estate agency. Some might require no more than strengthening or modification of existing powers. But considerably more thought needs to be given to the resolution of the fundamental conflict between the roles of mortgagee and estate agent. Full disclosure of interests to the different parties involved might be one possible route; alternatively some statutory separation of capacity might be imposed. The Government would welcome further views from all concerned as to whether and how the potential conflicts could be resolved and what safeguards would be necessary.

71
4.9 It would however be important that any society offering any new services of this sort should not make their use a precondition of granting a loan. The Director General of Fair Trading has powers under the competition legislation to investigate any such anti-competitive practices, and if appropriate refer them to the Monopolies and Mergers Commission. If the Commission find a practice to be against the public interest, the Secretary of State has powers to remedy the adverse effects. But it is for consideration whether further specific provision should be made in building society legislation.

Agency services

4.10 The BSA have proposed that societies should have a power to act at least as paying and collecting agents for other organisations. One attraction of this proposal for the societies is that it would enable them to make fuller use of their branch offices, which are in some cases somewhat under-utilised. One might envisage them taking on a function like that of Post Offices, collecting local authority rent and rates and paying bills to public utilities, for example. To the extent that the service was open to non-members, it might also help them to attract more custom. The public, for their part, would have a convenient new service available to them. The sums of money, if any, likely to be at risk as a result of such activities would be very small in relation to building societies' total assets.

4.11 There might also be scope for building societies offering agency services in the housing field. As suggested in Chapter 3, they might retain estate management functions in respect of residential developments whose ownership had passed from the society to another institution. Another possibility would be the provision of advice services on home ownership and home improvements, possibly in conjunction with local authorities. A further possible function would be to provide a mortgage management service on behalf of other mortgagees. This could be particularly useful to local authorities which wish to sub-contract the management of their mortgage business to the private sector. Societies would act as the agents of the local authorities, but might also be able to give the borrowers a convenient way of replacing their local authority mortgages with those of the society.

4.12 Attractive though some of these possibilities may be, they do need to be considered in the light of some possible difficulties. First, building societies have traditionally existed to provide services to their members. Some of the suggestions here would involve services to non-members also, and hence a fundamental change in the nature of their operations. Quite apart from this, there might be a significant effect on the public perception of building societies. Their present image perhaps rests less on the structure and content of their balance sheets than on the impression formed by customers at their branches. A general extension of agency powers could have a more profound effect on the way that building societies are generally perceived than many of the other possible changes discussed so far, even though their effect in commercial and accounting terms might be fairly small.

The Government regards this issue as finely balanced. While there are some attractions in allowing agency powers, it would welcome further views on this question.

Insurance broking

4.13 The BSA have also suggested that the societies should be permitted to undertake the full range of insurance broking services, including life assurance, motor insurance, etc. In practice building societies already act as intermediaries in respect of insurance related to their main business, such as mortgage protection policies, house insurance and endowment mortgages, receiving commission from insurance companies for introducing the business. Any further extension of building society activities in this way would need to be subject to proper standards of prudence and investor protection, and ^tso the standards of behaviour expected of the insurance services industry. The Government would welcome further comments on this.

Financial services

4.14 Many of the proposals in this paper are directed to enabling the societies to compete more effectively in a rapidly changing market in the provision of financial services. With competition for the provision of financial services now beginning to extend to retail operations, it can be argued that building societies should not be prevented from offering a similar range of services and expanding their role in relation to personal savings and investment, subject to the general legislation on investor protection. This might include arranging for the purchase or sale of stocks and shares and, more generally, the provision of savings and investment advice.

4.15 The Government would welcome comments on more radical ideas of this sort. For organisations with extensive branch networks like building societies to offer share buying and selling services could have a potentially important role in reversing the trend over recent decades towards institutional rather than individual investment in securities. While it is unlikely that building societies should deal in shares with the public as principals, they might do so as agents for a securities firm - in which perhaps they had some equity stake - or by allowing a stockbroker to make use of their premises for offering a "discount broking" service to the public, for example. This would be an example of the sort of development that might take place over a longer timescale than some other possibilities discussed in this paper. It would, for example, be necessary for a building society to consider very carefully the implications for its staffing and the risks to which it might be exposed before arranging to provide such a service. As already suggested, the Government would welcome further comments on this prospect.

CHAPTER 5 - THE CONSTITUTION AND ACCOUNTABILITY OF BUILDING SOCIETIES

5.1 Building societies have a member-based or "mutual" constitutional structure. They have traditionally existed to lend money to members on first mortgage, most of that money being raised from other members. Investing members' shares have financial terms which are very like those of bank deposits and markedly different from those of shares in a company. They generally give voting rights on a one member one vote basis. Profits are normally retained to build up the society's reserves and are rarely distributed, though on some mergers (achieved by a 'transfer of engagements') a bonus is paid to members out of reserves. The reserves are distributed in full to the shareholders only if the society is wound up.

Accountability of Boards

5.2 There are considerable difficulties in applying the concept of a member-based society to organisations of the size to which the larger societies have now become. There is a very clear distinction between the roles of the board to give overall direction to the society, of the senior executives to carry out the day to day management under the board, and of the members who elect the directors and to whom the directors are accountable for their stewardship. It is a particular problem how to give substance to that accountability when the largest societies have 10 to 20 times as many members as the number of shareholders in ICI, and there are no institutions with large shareholdings which can intervene on behalf of the generality of members. Even more than with companies, it is likely that the majority of building society boards will not be called to account effectively by their shareholders. In these circumstances they will tend to set their own standards of performance and select their successors.

5.3 The boards of societies must recognise their accountability to members and act accordingly at all times. In the case of the largest societies which are national institutions of considerable economic power that accountability extends in a generalised sense to the public at large. Boards of societies must be ready to give a good account of themselves and to respond to questions from the members, from the press and others, accepting that such questions are natural, healthy and proper. Similarly boards must be seen to be conducting any contested elections fairly. For their part, members must recognise that the day to day management of a major organisation has to be vested in the executives under the board, and that it is unrealistic to expect membership control over day to day management decisions.

5.4 Much of this is a matter of attitudes. As such it can be better dealt with by the leaders in the movement setting a good example, rather than by rules or legislation. The Government nevertheless considers that in the light of recent experience some changes

are necessary to the various statutory minimum requirements most of which date from 1960.

5.5 The changes are intended:-

- (i) to improve the quality of the information available to interested members;
 - (ii) to reduce the present burden on societies of circulating to members reports and accounts which are often unwanted;
 - (iii) to give groups of members with legitimate concern about how the society is being run a greater opportunity to raise points at an annual general meeting, while at the same time making it harder to abuse the system;
- and (iv) to tell members more about who is proposed for election to the board, even if that election is unopposed, and to make more even-handed elections in which candidates other than those put forward by the board are standing.

The following paragraphs deal in turn with the information provided to members; the ability of members to circulate resolutions for consideration at the annual general meeting; and the election of directors. The question of what should be the minimum qualifying shareholding for a member to exercise these rights is common to all three. This is discussed separately at the end.

(a) Information

5.6 In order that existing and potential investors can assess a society's financial position, and to help them in taking an interest in its affairs, building societies must now:

- (i) circulate the audited annual accounts and directors' report to all members, save investors with less than £25;
- and (ii) make available to members on demand the Annual Return which the society has to make to the Registry of Friendly Societies.

5.7 The first requirement has defeated its object. The heavy cost of printing and mailing has made the societies reluctant to achieve voluntarily the standards of the better company reports to shareholders. And both the full accounts and the Annual Return are technical documents which may not be readily understood by many members. The Government therefore agree with the Building Societies Association [and others] that the document to be circulated generally to members should be a simple statement of the financial affairs of the society - not unlike that which at present has to be sent

out to members when a merger is proposed. It would present the information in a readily understandable way, and alert members to the availability of the full accounts and directors' report. The financial statement would not be audited and might well be circulated before audited accounts are available. The auditors would owever be asked to confirm on the annual return that the statement was a fair summary of the annual accounts. The directors' report would be extended to include some material at present available only in the annual return. The report and accounts would be filed at the Registry on the public record.

5.8 There would be a separate annual return to the Registry. Like the present monthly and quarterly returns which the societies provide voluntarily, it would not be on public record, since it would include commercially sensitive information which the Registry needs in order to exercise its prudential supervision.

(b) Resolutions

5.9 At present, there is only one provision in the Building Societies Act enabling a member to bring an issue before the membership at large. This is the requirement for a society to circulate special resolutions - mainly those which propose a change in the rules - proposed by any member. (The rules of many societies also provide for members to table ordinary resolutions or to stand for election as directors.) The notice of the meeting, and of the resolution to be moved, then has to be circulated to all members, except those with a shareholding of less than £1.

5.10 This structure of members' rights has had some perverse results. A member wishing to raise an issue at an AGM has often found that the only way in which he could do so was to turn the issue into a proposed rule amendment, however inappropriate. Members have also sought to add long preambles setting out their arguments, although the High Court has recently ruled that these need not be circulated.

5.11 The Government accordingly suggest that a member should have a statutory right to table an ordinary resolution as well as a special resolution for consideration at an annual general meeting, and that a society should give notice of it on the agenda circulated to members. It is however reasonable that the member should be one of some standing, namely holding a qualifying shareholding at the two most recent balance sheet dates of the society, and [special resolutions only?] have his motion seconded by at least ten members of similar standing. To avoid abuse - for example by the circulation of advertising material - the board of a society would have power to refuse circulation if the resolution was not directly related to the affairs of the society, or if it was defamatory. Disputes over refusal to circulate a resolution would be referred to the Chief Registrar for arbitration.

(c) Election of Directors

5.12 There have been complaints about the way in which building society boards effectively choose their own successors, and the difficulties for any member wishing to stand for election to the board in opposition to the candidates put forward by the board. There has also been criticism of the fairly widespread practice of new members being co-opted to the board during the course of the year, and then standing for election as outgoing directors at the next annual general meeting.

5.13 It is essential to the proper functioning of a building society, and to the protection of its members' interests, that it should have an effective board. It needs non-executive directors with a range of skills and experience who can give guidance and support to the executives who run the society. The increased competition which societies face, and the accelerating pace of innovation, have put a heavier load on boards. The wider powers now proposed for societies will increase it further. The chairman and senior members of the board have a duty to ensure that the capability of the board grows to match these increased responsibilities, and that there is a sufficient spread of ages of board members to maintain continuity. It is proposed in Chapter 2 that there should be specific statutory duty on the boards of societies to make adequate arrangements for effective direction and management. In these circumstances, it must be right for the board to form its own views on its future composition and to tell the membership its reasons for preferring its own candidates for election.

5.14 It would nevertheless negate the member-based concept of societies if there were no effective opportunity for candidates to stand in opposition to those advanced by the board. It is reasonable to expect a member who puts himself forward for election to demonstrate a commitment to the society. The rules of the society might require a minimum shareholding on, say, the last two balance sheet dates, provided that the minimum was not too high - the legislation would impose an upper limit of £500. The candidate should also be able to demonstrate support from at least 10 members who had the qualifying shareholding (see below) on the last two balance sheet dates. Provided these requirements are met, the society should be obliged to circulate with the notice of the annual general meeting a short biographical note and election address; together they might be limited to, say, 250 words. This would ensure fairer elections than present arrangements, under which a candidate not put forward by the board can generally approach other members only if he obtains access to the register of members by securing a direction from the Chief Registrar, and then pays for the costs of any circulation of material himself. It would, as now, be left to a society's rules whether it in addition required a deposit from a candidate standing for election in this way: there would however, be an upper limit £100 imposed by statute, to avoid the imposition of penal deposits to deter candidates.

5.15 In some societies all new vacancies to the board are filled in the first instance by co-option. This means that no director stands for election before he or she joins the board and clearly undermines the principle that the directors are appointed by members. The Government nevertheless thinks it would be wrong to ban co-option. There will inevitably be instances in which mid-year co-option is justified. This should be left to the good sense of societies. But legislation will make universal the present general practice that any director co-opted during the year must stand for confirmation of his election at the next general meeting of the society. Such elections would be additional to the normal number of elections of directors who have retired by rotation.

(d) Qualifying Shareholdings

5.16 At present:-

- (i) any member may table a special resolution;
- (ii) any member with a shareholding of £1 or more may vote on a special resolution;
- (iii) any member with a shareholding of £25 or more is sent the annual accounts and directors' report together with notice of the annual general meeting.

5.17 It is unnecessary and confusing to have these different thresholds. It would be more logical to have a single level of shareholding at which members are entitled to receive a financial statement and notices of annual general meetings; to vote on resolutions; and, provided the shareholding has been held for two years, to move or second resolutions at the annual general meeting or to propose or second a member for election to the board. The choice of figure is a matter of balance. If it is too low, societies would be obliged to circulate material to many members whose interest in the society may be completely dormant. If it is too high, there is a risk of disenfranchising members with a genuine interest in the society. The Building Societies Association suggested that it should be £250. In the Government's view this is too high, and a figure of £100 would be more appropriate.

Composition of Boards

5.18 Reference has already been made to the importance of effective building society boards. One factor that is inhibiting the reinforcement of the boards now required is the age of many directors. The Government consider that the Building Societies Association is right in recommending that there should be a retirement age of 70 for building society directors.

5.19 There is such a provision already in the Companies Act. Company directors may stay on beyond the age of 70, provided that a resolution to that effect is passed annually at the annual general meeting. The Government do not consider that such a procedure would be effective for building societies, largely because of the absence of large institutional shareholders who may be prepared to intervene behind the scenes in a company if a director was seen to be outliving his usefulness. The Government therefore propose that there should be an absolute requirement that a director retire not later than the annual general meeting following his or her seventieth birthday. To allow time for adjustment, this provision would not come into effect until the annual general meeting of the society following the second anniversary of new legislation coming into effect.

5.20 It is also clearly desirable to carry over in the Building Societies Bill, suitably modified, the provisions of the Companies Act 1980 in respect of loans to directors and their families, in much the same form as they apply to banks.

5.21 But there is a wider problem in the case of building societies. Many societies originated with a professional practice, whether solicitors, accountants or estate agency, founding a building society to bring together clients who had money to invest and clients who wished to borrow to purchase a house. The practice often provided the administration for such a society. The majority of societies which started in this way have outgrown their origins and are now effectively, if not completely, independent of the professional practice which originally sponsored them. But there remain some societies which are still dependent on firms or partnerships in this way. This can give rise to problems. The interests of the firm or partnership and those of the members can clearly conflict, particularly when considering whether the society should continue independently or merge. Societies today nearly always require full time executive management, not just management support from such a firm. In extreme cases, such a close relationship can lead to the directors concerned abusing their position and running the society for the benefit of themselves and their firm, rather than for that of the members.

5.22 Conflicts of interest are not confined to societies sponsored by one firm in this way. There can also be problems where a society places a considerable volume of its business with a firm in which a director is a partner, or with company in which a director has a significant interest. The impression is too often given that a society is being run for the benefit of a firm or a caucus of the directors, and that directorships in the society are handed on from one member of the firm to another, to perpetuate the arrangement.

5.23 It is essential that societies should be seen to be run in the interest of their members. Legislation should accordingly provide that:-

- (i) societies should put at most a limited volume of business with any partnership, firm or company of which a director is a member or in which he has a significant interest directly or indirectly through his family;
 - (ii) any existing arrangements of this type should be run down to the minimum levels permitted in the long term within 5 years of the new legislation coming into effect;
- and (iii) in the meantime the directors' report should disclose the existence of such arrangements and the scale of business transacted under them.

Mergers

5.24 Proposals for mergers with other societies, unlike many other issues, often arouse considerable interest amongst members. Votes on such proposals often attract a relatively high poll. Some 20 per cent of the members entitled to vote have done so in large societies, and much higher percentages in some small ones.

5.25 The present procedures for a merger essentially provide for:-

- (i) a statement to members setting out the respective financial positions of the two societies and the terms of the proposed merger;
- (ii) a special resolution to be passed by a three quarters majority of those voting in person or by proxy at a general meeting of the society; and
- (iii) the written consent of the holders of two thirds of the shares (the one major exception to the 'one man one vote' rule), or confirmation from the Chief Registrar without such consents. In practice the latter course is almost universally adopted.

If the two societies are very different in size, the Chief Registrar can authorise the large society to approve the merger by a board resolution rather than by putting it to its members.

5.26 This procedure has worked reasonably well, subject only to three points. The first is that the members who often have the greatest interest in a merger are the borrowers. They will be very interested in the mortgage rate structure of the receiving society and, unlike the investors, cannot switch readily to another society if they do not like it. But at present borrowing members do not have a vote in most societies. It would appear right that their interests should be recognised by their having a vote on a merger,

irrespective of whether the rules of a society provide that they should have a vote generally.

5.27 Secondly, there can be difficulties if, as has happened several times in recent years a merger is approved by a majority, but not a three quarters majority. The insufficient majority may mean that the society has to continue in a situation where it lacks, and cannot afford, sufficient management resources for modern conditions. It might even be unable to give adequate protection to funds placed with it by investors. It may be right to require a board to establish why more than a quarter of those voting have been unconvinced, and to modify its proposals accordingly. But there may be a case instead for reducing the requisite majority to 60 per cent, say. Alternatively, there might in such circumstances be an opportunity for a further debate and vote, at which a 60 per cent majority would be sufficient to approve the merger. The Government would welcome comments on this question.

5.28 The third problem is that under the present procedure mergers can only take place by agreement between the two boards. The timing and choice of partners therefore tends to be influenced by personalities, by which individuals are due to retire and by the terms of compensation or transfer for the board and senior members of staff, rather than by the best interests of the members. This may result in some mergers taking place later than would be in the best interests of members. And, because it is often far easier for the board of a small society to accept a merger with a national society than with another local society, it may have contributed to the decline in the number of strong local societies.

5.29 It has been suggested that one way of overcoming these limitations would be to allow the board of one society to require another to circulate a merger proposal to its members, even if the latter's board did not recommend it. The difficulty is that a large society would be able to offer a substantial distribution of the reserves of the society to members as a bonus, as an inducement to vote for the proposal, without prejudicing its financial position. This might accelerate the absorption of small societies by the larger national ones, and militate still further against mergers between local societies into stronger local or regional units. The Government are not satisfied that the advantages of this proposal outweigh its disadvantages. But further comments would be welcome before a decision is reached.

Status of societies

5.30 The particular constitutional form of the societies means that they are not exposed to takeover by other societies or by companies. Mergers with other societies can take place only if the two boards agree to put the proposal to the members. Societies do not

face the financial discipline imposed on a company by the stock market, where present and prospective performance affects the price at which it can raise capital (although it is conceivable that money market credit ratings may come to impose an element of such discipline in the future). Members of a society can rarely, if every, exercise the degree of influence on a board which a major institutional shareholder can on that of a company. Finally, and particularly important for a financial institution, the board cannot quickly raise additional capital if it has inadequate capital for the present and immediately prospective scale and nature of its business.

5.31 In view of this, a compulsory change of societies to company status has been advocated in the past by those who have argued that the present constitutional structure insulates societies from the effects of competition, leaving too much scope for inefficiency and extravagance in their management. The Government does not accept that such radical change is needed. Since 1980, societies have been exposed to greater competition for both their savings and loan business. Their reaction has led to much greater competition between societies, and with other institutions, through various types of premium shares. The pace of innovation in the services provided to members has accelerated considerably. Some societies now seem to be recognising the importance of control over management expenses and seeking ways of reducing costs while maintaining services to members. The ratio of management expenses to capital, which had doubled over the past decade now shows signs of falling, albeit helped by the real growth of societies in the last two years. Those societies which have not yet begun to tackle the problem of management expenses will find themselves exposed in the more competitive environment and forced to adjust their policies until they have contained them.

SPACE
 X 5.32 While the Government accepts, however, that the societies generally should remain as mutuals, there seems to be no justification for the present position in which a society cannot legally turn itself into a company if its members so wish^s. The Government therefore propose that there should be provision for such conversion. Although there are at present no signs that many societies will wish to take advantage of such a power, it should facilitate greater flexibility in the future structure of the financial system by enabling building societies to convert into companies as a basis for linking with other institutions interested in extending into the retail financial services field.

5.33 Any proposal for conversion into a company would need to be approved by the members in a similar procedure to that required for mergers, although there might need to be greater protection for the interests of particular groups, notably the borrowers. The conversion itself would generally involve:-

- (i) the issue of a scrip issue of company shares to existing shareholders with holdings above a certain threshold, with the conversion of their existing shares into deposits;

- (ii) the issue of further shares, by a rights issue or otherwise, to secure additional capital.

5.34 A society which followed this procedure would become a company like any other. It would have to stop using the words 'building society' in its name. Perhaps most important, if it wished to continue to take deposits, as it presumably would, it would require a licence from the Bank of England under the Banking Act. A society considering such a conversion would need at an early stage to seek assurance from the Bank of England that it would receive such a licence when it converted into a company. The Bank would be particularly concerned to ensure that the new company would have the additional capital and management skills appropriate to the wider range of activities which it was contemplating.

CHAPTER 6 - THE FINANCIAL ENVIRONMENT AND INTEREST RATE ARRANGEMENTS

6.1 Building society interest rates are a matter of considerable economic and financial importance. The mortgage rate settles an important factor in many households' costs, with important effects on the retail prices index, and, as the price of borrowing, affects demand for mortgage finance. The rate paid to investors - which bears a broadly constant relationship to the mortgage rate - has a very direct effect on supply through its effect on building society inflows. The general level of building society rates - more particularly in relation to the interest rates used by other institutions in the same markets - has a pronounced effect on the volume of lending and on matching supply to demand for mortgage credit.

6.2 For a considerable time up to 1980, there was relatively little competition other than between building societies for the supply of mortgage finance, except for a period of increased lending activity by local authorities during 1974 and 1975. As a result, building societies acting together were able to set interest rates at levels which did not necessarily reflect a market rate of interest. In general, the societies were able to maintain the mortgage rate at a level lower than that necessary to clear the market, hence rationing the supply of mortgage finance. At the same time, the difference between the share rate and the mortgage rate was set at a level acceptable to all societies. In principle, this could be expected to have had the effect of enabling inefficient societies to continue in operation with no spur to improve their efficiency while the more efficient societies would have the resources to indulge in non-price competition, for example through a proliferation of branches. Certainly during the 1970s, there are strong indications that this was happening at least to some extent.

6.3 More recently, however, the competitive environment has changed quite fundamentally. Two developments are particularly noteworthy. The most important was the entry of the banks into the mortgage market in 1981. Before that time, the corset controls had inhibited their willingness and ability to enter this market, but their abolition in 1980 led to a new period of competition in mortgage lending. For a time the banks took over 40 per cent of new mortgage business, and, while they have subsequently cut back, they retain a market share of about 25 per cent. The result has been that the potential borrower has had access to more sources of funds and has no longer had to tolerate mortgage queues. On the lending side of their business, therefore, there is no longer the traditional presumption that building societies should seek primarily to keep mortgage rates down.

6.4 The second development has been increase in competition between building societies and other institutions, and among building societies, on both mortgages and savings. This was becoming apparent by the end of the 1970s, but it has accelerated

particularly since the entry of the banks into the mortgage market. The societies have come to place an increasing emphasis on premium accounts, and over half of the money in building societies shares and deposits is now in accounts which attract interest rates above the ordinary share rate.

6.5 Partly as a result of these developments, building society interest rate behaviour appears to have changed. The societies have effectively set their rates for the last year or more at levels intended to raise sufficient funds to meet demand. Mortgage queues have now shortened considerably and in many areas disappeared altogether.

6.6 Inherent however in a policy of meeting all mortgage demand is the risk that rates may settle above the level necessary to attract sufficient funds to finance house purchase needs. If they did not reduce their rates quickly, they might seek to diversify their lending. This could lead in turn to more lending on mortgage for non-housing purposes, whether directly (with or without tax relief) or indirectly by withdrawal of equity now held in property. It is true that most equity withdrawal is simply the natural counterpart of mortgage lending: every housing "chain" begins with a new owner-occupier and ends either with the purchase of a new property or with somebody leaving the owner-occupied sector, he or his estate retaining the proceeds of the sale. But, as indicated in the introductory chapter, the Government cannot ignore the scale of mortgage lending, given its concern with monetary aggregates containing at least some building society inflows, and their effect on short term interest rates.

6.7 A final observation on interest rates generally is that most societies currently charge a premium for larger mortgages. This policy reflects primarily the need to cover the cost of premium share accounts, and a reluctance to do this by charging more to smaller borrowers. Unless there is no competition, however, this is likely to cost them market share among larger borrowers, and it is arguable that the banks have been able to take advantage of this. It is also perhaps surprising that more societies have not adopted at least a neutral policy, given that many larger borrowers will be good credit risks, and given the scope that may exist for administrative economies of scale in a smaller number of larger loans.

The interest rate cartel

6.8 Since 1939, the BSA has run arrangements for recommending interest rates to building societies. Until October 1983 these arrangements consisted of two different agreements.

- (a) The recommendation of basic rates of interest to be paid on building society investments and charged on mortgages.

- (b) An undertaking by participating societies to give 28 days' notice of variations in interest rates from the recommended rates.

While most BSA member societies followed the recommended rates in practice, their observance was not a condition of BSA membership. A significant number of smaller societies followed policies of maintaining a fixed differential over the BSA recommended mortgage and share rates, so that the recommended rates in practice determined their rates. More recently, however, divergence from the centrally promulgated rates has taken a rather different form, with virtually all societies offering various forms of premium share accounts. This is in itself a more fundamental form of divergence than the previous, fixed differential form. It has resulted in undermining of the previously highly cartelised behaviour of societies.

6.9 On 21 October 1983, the BSA announced the introduction of revised arrangements, as follows.

- (a) The replacement of the recommended rates by advised rates for ordinary shares and mortgage loans.
- (b) No requirement to give notice of changes, but the largest societies have indicated a willingness to discuss changes in their basic rates with other BSA members and hence to give adequate notice of their intentions.
- (c) An information agreement under which societies may be notified of each other's rates.

6.10 When the restrictive trade practices legislation was extended to services in 1976, agreements between building societies relating to interest rates were specifically exempted. This means that neither the old system based on recommended rates nor the new arrangements have needed to be registered with the Director General of Fair Trading as restrictive practices, and are not therefore open to legal challenge on those grounds. The reason for the 1976 exemption was the existence of the system operated through the Joint Advisory Committee (JAC) of BSA and Government representatives for setting "guidelines" for building society lending. The interest rate agreements were an essential pre-requisite for the successful operation of such a system, since it provided a mechanism through which guidelines agreed in the JAC could be translated into practice. But the ending of the guideline system in 1980 has removed the original rationale for exempting the building societies from the legislation.

6.11 Time has eroded both the operation of the interest rate arrangements and the reasons which led to their exemption. In principle, the Government considers that arrangements of this sort are anti-competitive and undesirable in their own right. They

mean that the building societies operate a cartel. As long ago as 1967, the National Board for Prices and Incomes recommended its abolition, as more recently have the Committee to Review the Functioning of Financial Institutions (the Wilson Committee) and the National Consumer Council. The cartel itself is not unlawful. But, by withdrawing its exemption from the restrictive trade practices legislation, the Government could open it to legal challenge by the Director General of Fair Trading as being contrary to the public interest. If such an action were mounted and were successful, building societies would have to settle their own rates independently in the light of market conditions without central guidance from the BSA. This should in principle encourage competition between building societies and hence a greater range of choice and ultimately a better service to building society members.

6.12 Recently, the societies have been pursuing a more competitive policy which has resulted in mortgage queues largely disappearing, indicating perhaps that supply and demand for mortgage funds are in reasonably good balance. Therefore, the immediate effect in practice on interest rates might be negligible. Nevertheless, the transition to fully competitive rates would need to be handled carefully. Too abrupt a change might give rise to problems in the short term in managing interest rate changes, particularly when market conditions indicated a fall in rates. Without a collective arrangement, a general fall in rates would need to be triggered by one society stepping out of line and placing itself at a temporary competitive disadvantage in relation to others. While, in the long run, rates could be expected to adjust to market conditions, there might be problems in the short term, at least until the societies got accustomed to the new system. This problem was experienced in Australia after collective arrangements for determining mortgage interest rates were abandoned there. A further possible worry would be the position of borrowers if some societies decided to go for a new high interest rate policy following a sudden change. The difficulty and, frequently, expense of switching a mortgage from one lender to another also suggests a need for the transition period to be carefully handled to avoid the risk of people being placed in this situation without adequate notice. Finally, all changes are riskier in prudential terms if they are uncontrolled. Greater competition implies a need for a closer prudential supervision. Similarly, gradual change is better in prudential terms than a step change.

6.13 Nevertheless, the present collective interest rate arrangements inhibit the free play of competitive forces which would ensure the best deal for savers and borrowers. It is true that there is a long history of collective agreement on building society interest rates, that the societies are used to operating within such a framework and that too abrupt a change might have adverse consequences. The Government would therefore prefer to see a phased, orderly transition to a more competitive regime. The change in October 1983 was the first step in this process. The withdrawal of the exemption from the Restrictive Trade Practices

Act would be a logical development. This would expose the building societies' interest rate arrangements to the scrutiny described in paragraph 6.11 above, although the procedures under the Act allow ample time within which the societies could consider the future of the agreement themselves before any statutory action was set in train. This should ensure the orderly transition the Government seeks. It is therefore proposed that the exemption from the restriction trade practices legislation should be withdrawn at the same time as new legislation comes into effect.

Taxation of building societies

6.14 Tax is a further important aspect of the financial environment within which building societies operate. Although this paper does not offer any new proposals, there have been several recent changes, which are recorded here.

6.15 As part of the Chancellor's strategy of removing distortions in saving and investment, the 1984 Budget included several measures promoting a more even-handed treatment of the institutions competing in these markets. Before that time, there had been two major differences in the taxation of building societies as compared with that of banks. The first was that building society interest was paid net of a composite rate of tax, slightly lower than the basic rate, whereas banks paid interest on deposits gross. This was frequently held to confer a competitive advantage on building societies, because taxpaying investors were marginally better off as a result of the composite rate's being less than the basic rate, and because they were likely to find it a convenience not to have building society interest taken into account for tax purposes, so long as they paid only at the basic rate. By extending the composite rate arrangements to bank deposits, this anomaly will be removed from April 1985. There remain some differences of treatment between the two types of institution, but these are now the subject of discussions between the BSA and the Inland Revenue.

6.16 The second main difference was in the rate of corporation tax. Banks paid at the full rate of 52 per cent while building societies paid at a special rate of 40 per cent, a concession which had been granted to them and to some other mutual organisations to prevent their being disadvantaged on the change to the new imputation system of corporation tax. Their inability to pay dividends meant that they could not benefit from that system's partial relief for distributions. On the other hand, the banks were able to reduce their corporation tax liability through their leasing operations. The balance between these two factors was complex and contentious. Changes in the 1984 Budget - the phasing out of the first year allowances which will reduce the tax advantages of leasing, and the progressive reduction to 35 per cent in the rate of corporation tax, so that the special rate will no longer be relevant after 1985 - will introduce a regime that is clearly better balanced.

6.17 A further recent change was the announcement by the Inland Revenue on 23 February 1984 that the profits which building societies realised on disposal of gilt-edged and certain other stock would henceforth be treated as trading income rather than capital gains. This change, made following legal advice the Revenue had received, had the effect of bringing the societies into line with what had been the treatment of banks for many years.

6.18 Taken together, these changes in taxation reflect the Government's general policy of promoting fair competition between the two sets of institutions which, as noted earlier, have come to compete more directly with each other in many fields.