



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

PRIME MINISTER

BUILDING SOCIETIES GREEN PAPER

... As you know, the Treasury has been preparing a Green Paper setting out proposals for new building society legislation in the 1985/86 Session of Parliament. I attach a draft, which, subject to your views, I intend to circulate to members of ES for clearance in correspondence and hope to publish on Monday 23 July.

2. The Green Paper's fundamental premise is that we should retain the successful formula by which societies are regarded primarily as a secure home for people's savings and as financiers of home ownership. But there is considerable scope for relaxing the present statutory constraints on the societies without prejudicing that objective. The Green Paper therefore proposes that the societies should, within prudent limits, be able to own land and property so that they can play a fuller part in development, improvement and letting. They would also be permitted to compete much more widely in personal banking and money transmission services, offering such services as cheque books, electronic point of sale systems and unsecured personal loans. However, traditional first mortgages would have to account for at least 90 per cent of business with no more than 5 per cent in higher risk assets, like property and unsecured loans.

3. Other issues discussed in the Green Paper include the prospect of building societies offering "one stop" house buying services, including structural surveys and estate agency, as well as conveyancing (although the potential conflicts of interest would have to be resolved) and the possibility that



they might offer other financial services on an agency basis for others - for example, payments to public utilities - or as intermediaries, such as insurance broking.

4. The paper proposes a series of constitutional reforms, dealing with the controversy over "members' rights" in the societies. It also suggests new supervisory powers for the Chief Registrar of Friendly Societies and the rationalisation of his existing powers, reflecting partly our experience in the New Cross case. Finally, there is a discussion of the building societies' interest rate cartel, which concludes that its exemption from the Restrictive Trade Practices Act should be withdrawn at the same time as new legislation is enacted.

5. We have kept both the Department of the Environment and the Department of Trade and Industry in close touch with this work. Patrick Jenkin has told me that he agrees with the general approach of the Green Paper and you will have seen Norman Tebbit's letter of 21 June in which he says he supports the paper's objectives, but expresses certain reservations. However, while I fully share his concern that our general message on competition must come through loud and clear, I believe that, of the whole financial sector, it is in the area of building societies that we should exercise most caution, and ^{that} this is what the public will expect of us. But I trust that Norman will find that his justified criticisms of the tone of the earlier draft have now been very largely, if not completely, met.

6. Although I regard the substance as broadly settled, some editorial points still need to be incorporated and I shall show you as soon as possible the Appendix on the Chief Registrar's prudential powers. Subject to these points, however, I should be grateful for your agreement now to wider circulation of the draft among colleagues, with the objective of publication on 23 July.

CONFIDENTIAL



7. I am copying this minute and enclosure to the Secretaries of State for Trade and Industry and the Environment, and to Sir Robert Armstrong.

A handwritten signature in black ink, consisting of a stylized 'M' followed by a few dots.

N.L.
29 June 1984



10 DOWNING STREET

Prime Minister

Building Societies Green Paper.

You might like to concentrate on:

Paras 1.7 - 1.11

Para 2.9

Paras 3.14 - 3.16

Chapter 6.

Area B of the Policy Unit note
provides a commentary.

Agree Chancellor circulates to
colleagues?

(You are lunching with Building Societies
Association on 1 August)

AT

29/6

71/7

BUILDING SOCIETIES GREEN PAPER (Draft III - June 1984)

CHAPTER 1 - INTRODUCTION

Foreword

1.1 In its Manifesto for the 1983 General Election the Government said it would:

".. 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 largely consists of provisions which are well over a hundred years old. It is widely accepted that the time is now ripe for a comprehensive review. Comments are invited on the proposals in this document by 15 October 1984. They should be sent to HM Treasury, HF1 Division, room 37/G, Parliament Street, London SW1P 3AG.

1.2 Building societies have come to assume considerable importance in both the housing market and the financial system. Their governing legislation was never designed for institutions of their present scale. In recent years, they have come closer to the limits imposed on their activities by law, and many of these constraints seem neither logical nor coherent. As the pattern of housing needs and provision has changed, so the societies have faced new demands and begun to explore new avenues. At the same time, building societies have faced growing competition in both the savings and the mortgage markets, which has made them consider how to broaden and improve their services in the new competitive climate.

1.3 A Building Societies Association discussion document was published in January 1983, which examined 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.

History

1.4 Building societies began in the late 18th Century, as people 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 they had saved enough to buy land and start building. Members would draw lots to decide who was

housed first; payments continued until all members were housed and the society then terminated. In the early 19th Century, societies emerged which 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 but its basic structure has been left intact. The law was consolidated in the 1962 Act.

1.6 At the turn of the century, there were over 3,000 societies, almost all locally-based. As terminating societies have wound up and permanent societies merged, their number has steadily fallen, to about 200 today. Some are still very locally based, but others have strong presences throughout particular regions or - in the case of the 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 £87 million in 1920 to £[87] billion at the end of 1983, 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 societies have been very successful both in offering a safe home for investors' money and in financing the growth of home ownership. Nothing should be done to prejudice their success. Their primary role as specialists in the housing finance and personal savings markets, and their mutual constitution, should remain. There is however considerable scope for them to offer new services, and to further competition in the financial services industry, without prejudicing those objectives. The environment within which the societies operate is changing fast. The Government intends to let them play their full part in those changes.

1.8 The societies' main role will continue to be in the housing field, in particular housing finance. They have made a vital contribution to the extension of home ownership, which the Government is determined to bring within reach of as many people as possible. 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 even 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 new, low cost housing and to initiatives for shared ownership. The Government also believes that building societies could help the private rented sector by owning and developing land and property. They might also participate through the management of other financial institutions' housing investments.

1.10 It is important that building societies should be competitive in attracting savings. Major structural changes are now taking place in the financial services sector. Although these have not directly involved building societies, they will have a significant impact on the commercial environment in which they operate. Building societies will probably need to respond too to the trend towards "one stop" centres for financial and investment services. This paper therefore considers how far the societies might expand their services while safeguarding their main role as providers of housing finance. The Government welcomes competition in this market, for competition ensures the best service to investors. But the Government is also determined to ensure fair competition. 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.

1.11 There is however a potential conflict between diversification into new business and the importance of maintaining their safety as homes for investors' money. For example, diversification into property rather than loans secured by mortgage would be inherently more risky. The free play of competition between financial institutions must always be tempered by the need to ensure the protection of investors. Any move by societies into the provision of new services should not detract from their main role. The scope for diversification should therefore be limited and subject to proper prudential control. This is discussed in Chapter 2.

Building societies and monetary policy

1.12 As the societies have grown, so they have become more relevant to the formulation of the Government's monetary policy. Two monetary aggregates which include the majority of the liabilities of the societies are now published, namely M2 and PSL2. As noted in the Financial Statement and Budget Report 1984-85, 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 M0 and £M3, the measures of narrow and broad money used for target purposes. Too rapid a

growth of building society liabilities and lending could be a cause for concern. The Government seeks to influence monetary growth by fiscal policy, funding and operations in the money markets to affect short term interest rates. These policies have an impact on the growth of building society liabilities as well as those of the banking system.

1.13 From time to time successive Governments have also sought the co-operation of building societies in the execution of monetary policy. In 1982, the present Government became concerned that lending for house purchase might be unduly inflated by borrowers realising housing equity to finance other expenditure. Guidance was therefore issued to the banks, insurance companies and building societies which is designed to ensure as far as possible that borrowers who increase their mortgage on moving house do not reduce their own equity stake in housing.

CHAPTER 2 - THE PRUDENTIAL FRAMEWORK

The present financial structure of building societies

2.1 Building society balance sheets are quite simple. The main assets are loans to members secured on mortgage (typically about 80 per cent); liquid assets (usually in the range 17-20 per cent); and fixed assets, such as land, buildings and equipment, which average about 1½ per cent of the total. The other side of the balance sheet consists largely of shares and deposits from members of the public, although recently 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 excess of assets over liabilities is the general reserve, representing accumulated surpluses over the years.

2.2 There are some important points to make about this structure:-

- (a) The security of the assets. Normally a building society's assets very safe. Fraud and inadequate valuations apart, the main risk might 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 assets which then recorded a capital loss.
- (b) The societies have, despite large fluctuations in market rates, been able to match their interest rates by lending on terms under which they can vary rates at short notice. This is unlike, for example, the Savings and Loan Associations in the USA (the nearest equivalent there to UK building societies) many of whom have encountered serious problems in recent years through being unable to increase their lending rates to match increased costs of raising money.
- (c) The relatively low risk of capital loss, and the absence of any need normally to provide for unforeseen losses on the revenue account, means that a building society can maintain lower reserves as a percentage of assets than 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 ½ per cent of assets per year would be typical.
- (e) 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.

2.3 All these factors enable building societies to run on narrow interest rate margins. It is the very limited range of activities in 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.

2.4 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.

2.5 New building society assets would tend to imply greater risks than at present. Any institution needs a capital base which is adequate to cover any conceivable losses, particularly if it is receiving deposits from members of the public who have contracted to get their investments back a pound in the pound. A building society's capital base is its reserves, but for most purposes, 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.

2.6 These concepts are not new, but they are not reflected comprehensively in existing legislation or in the current general guidance from the Registry of Friendly Societies. The Chief Registrar will be producing discussion papers on the criteria for assessing the adequacy of reserves and liquidity, similar in character to those which the Bank of England has produced for banks and licensed deposit takers.

General limits on building societies

2.7 The existing statement of building society objects - effectively the statutory definition of a society - is 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."

A society has at present powers to do only what is necessary for this purpose (like owning offices, employing staff and advertising) or reasonably incidental to it, such as arranging insurance on properties mortgaged to it.

2.8 This definition has served well over the 110 years since it was first enacted. But societies are now seeking to widen their activities in ways not foreseen then. Considerable time has to be spent on establishing whether particular proposals for diversification are legal, sometimes with recourse to the courts. The definition of their purpose needs refinement and expansion to reflect the way building society business has developed and to allow the sort of diversification now proposed.

2.9 The Government therefore proposes that section 1(1) should be amended to provide that the primary purpose of a building society is to raise funds from individual members for lending on security of mortgage on owner-occupied residential property. A society could then do not only what was necessary or incidental to that primary purpose, but also engage in a range of related activities, subject to quantified limits on those involving either the acquisition of assets or the incurring of liabilities. These permitted activities would be set out in a list, the contents of which would be variable by order, subject to Parliamentary approval, as would the quantified limits.

2.10 These broad limits would take the following forms:-

- (a) At least 90 per cent of total assets, other than liquid assets and office premises and equipment, should be advances to individual members secured by first mortgage on residential property.
- (b) A society should be required to hold sufficient liquid assets for its business, but not more than one-third of total assets. The maximum would ensure that the money was applied to housing, the primary purpose of societies, rather than investment in gilt-edged stocks and other money market instruments.
- (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 a home for personal savings. It would also limit their exposure to the more volatile money markets. Some exception to this rule would be needed in particular cases, notably loans from other building societies under Section 44 of the 1962 Act, to a society facing 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, restricting loans exceeding £60,000, or of any amount to corporate borrowers, to 10 per cent of total lending, would be repealed, as it would be replaced by the first of these limits.

Supervisory controls of the Chief Registrar

2.11 Building societies are subject to prudential supervision by the Chief Registrar of Friendly Societies who carries out various statutory functions to protect investors. If the societies are to have wider powers, it follows that his functions will need to be extended. The statutory powers of the Chief Registrar, both present and proposed, are discussed in detail in Appendix 2.

2.12 Building societies have been restricted by law to a narrower range of significantly lower risk activities than those undertaken by other deposit takers. Their prudential supervision has therefore differed from that applied by the Bank of England 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 in response to the increased competition over the last few years among societies and with other financial institutions. Although the system of supervision will become more akin to that applied to the banking system, it will continue to be less labour-intensive and place less burden on the management of societies, because general constraints will remain on building society powers.

2.13 Building societies will have to keep their activities predominantly to their mainstream business. A society would be acting ultra vires if it did what it was not permitted to do. If a society appeared to be likely to breach any of the prescribed limits on permitted business, the Chief Registrar could direct it to put to its members plans for conversion to a company. If it failed to do so, if the members rejected the plan, or if the Bank did not give any assurance about granting a licence, he could apply to the Court for an order winding up the society, imposing a reconstruction upon it, or limiting the amounts of certain types of business which it could do.

2.14. A building society would also have a duty to do certain things in order to protect investors' money, some of which are already specific requirements:-

- (a) to maintain adequate reserves, and more specifically free reserves for its business;
- (b) to maintain adequate liquidity for its business;

- (c) to observe the limits on building society assets;
 - (d) to have adequate management for its business, including effective direction by at least two people of adequate repute and experience;
 - (e) to maintain adequate systems of internal control and inspection;
- and (f) to have adequate arrangements for independent valuation of mortgaged property.

2.15 Failure by a building society to observe these requirements, or otherwise to protect the interests of its investors, would be grounds for the Chief Registrar to use his statutory powers. 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.]

2.16 The Government announced in January 1983 that more staff would be recruited to the Registry of Friendly Societies in order to strengthen the prudential supervision of building societies. The new powers discussed in this Paper may require some further strengthening. The additional cost would be modest and 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 - NEW ASSETS AND LIABILITIES

3.1 This Chapter considers new building society powers which would involve new forms of assets or liabilities. Assets are discussed in three groups, described as Classes 1, 2 and 3 respectively, which categorise them by the nature of the business involved. Class 1 would be the principal business of the societies: mortgage loans to individual owner-occupiers. Class 2 would consist of other forms of secured lending, while Class 3 would be new types of asset, in particular unsecured loans and equity. Taken together, these are termed in this paper the "commercial assets" of societies, as distinct from their liquid assets and their fixed assets, such as office premises. A building society's spread between the asset classes would be subject to limits: at least 90 per cent of commercial assets would have to be in the form of Class 1 assets, and no more than 5 per cent Class 3, although these limits, and other features, could be amended later by order subject to Parliamentary approval.

Class 1 Assets

3.2 These would be advances secured on first mortgage of residential property to individuals who are owner occupiers of that property. They would include both traditional repayment mortgages and index-linked mortgages where the advance outstanding and the charge securing it is related to some general price index. At least 90 per cent of commercial assets would have to be Class 1. This is in theory somewhat narrower than existing powers since it excludes lending to bodies corporate or lending on non-residential property, which are included in Class 2. But in practice about 99½ per cent of building society advances are currently secured on domestic property, and lending to bodies corporate, already constrained legally by the special advances limit also accounts for a very small proportion of lending. So a limit of 10 per cent of base assets in Classes 2 and 3 would give societies considerable scope for the exercise of their new powers.

3.3 The BSA have suggested that building societies should be able to take into account, when considering advances of a high percentage of valuation, any additional security offered by the borrower. (At present, only certain specified types are permitted.) The Government accepts this. So long as the advance is within the valuation, there is no point in restricting the types of additional security which the society can take. A society's practice in respect of the percentage advance and the types of additional security may however need to be taken into account in assessing the adequacy of its reserves.

3.4 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 new loan is clearly well within the value of the security. There

will clearly be many circumstances in which a further valuation is not necessary. The Government will consider whether the present law is deficient in this respect and what change may be required to make the position clear.

Class 2 Assets

3.5 Class 2 assets would consist of other forms of wholly secured lending. They could in theory account for up to 10 per cent of commercial assets. Although a less traditional form of lending than Class 1, they would not necessarily be higher risk. Some-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 secured mortgage loan to a small business proprietor under its existing powers, for example, this would be likely in future to be within Class 2. Class 2 would also include certain new powers.

3.6 The first would be a power to lend on the security of second mortgage on a property where there already exists a first mortgage in favour of another lender, as suggested by the BSA and others. This would give greater choice to those wishing to borrow money for home improvements, etc, and would help those whose first mortgage lender - for example, a local authority - was unable or unwilling to make a further advance. Unlike further advances on existing mortgages, where the building society already has full control of the security, second mortgages are much less realisable security than first mortgages. The sum advanced on a second mortgage should allow a prudent margin within valuation and there may well be a case for providing that such a loan by a building society should not take a mortgagor's total debt above a specified percentage of a recent independent valuation of his property.

3.7 The Government also agrees that building societies should be given clear powers to make loans secured on equity mortgages, that is, where the borrower pays a lower rate of interest in return for the lender acquiring the value of a fixed share in the property, which will generally be expected to appreciate. While fully secured, such a loan relies on the appreciation of the value of the property and might be likely to involve an income mismatch. The extent of equity mortgage lending will need to be taken into account in the assessment by the board, and if necessary the Chief Registrar, of the adequacy of reserves.

3.8 Finally, societies might 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 cities, where the valuation of an unimproved property would be below its cost, but where a local authority is prepared to issue a guarantee under Section 111 of the Housing Act 1980. Such loans would be included in Class 2.

Class 3 Assets

3.9 There are three main sorts of business in this Class: unsecured lending, housing and other equity investment. Much of it would involve more risk and would therefore need to be covered by proportionately higher free reserves than has been necessary up to now. Many small societies would not have the necessary management expertise or reserves for this business. Nor would they wish to take it on. The power to hold most Class 3 assets should therefore be restricted to societies with free reserves of more than £3 million. This would mean that the widest powers would be available to some [] societies, whose total assets form [] percent of the movement as a whole.

3.10 There would be a statutory upper limit of 5 per cent of commercial assets for Class 3, within the 10 per cent for non-Class 1 assets. Societies would be unlikely to approach this limit - which, if applied uniformly across the movement, would be nearly £4 billion at today's prices - for many years to come. But it could be amended by order later if experience suggested that it constrained societies unreasonably. The £3 million free reserves threshold could also be amended by order.

i. **Unsecured lending**

3.11 Unsecured personal loans would be a logical extension of building society business. For example, many housebuyers will also need to spend money on furniture, fittings and repairs, and may wish to approach their building society for finance. This is something that building societies may already in effect be providing in certain cases, but within the amount of the loan secured on first mortgage. And unsecured loan finance may be a more sensible way of paying for some small home improvements and repairs than a full mortgage.

3.12 Consumer credit is a different sort of business from mortgage lending, with higher risks whose assessment is qualitatively different. It requires particular expertise, which the societies would need to develop. Any society that began to lend unsecured would therefore have to build up the business at a gradual rate, within its management and reserves capacity, and in consultation with the Chief Registrar.

3.13 There is a legitimate role for building societies in unsecured lending, both in enhancing their housing function and in enabling them to provide a broader range of financial services. Building societies should be able to lend unsecured, but with a limit on the amount of loans to any one individual. The Government suggests £5000 initially, although this figure could be amended later. But, for the reasons discussed above, unsecured lending should be open only to the larger societies with free reserves over £3 million.

ii. **Ownership of land and property**

3.14 Building societies are seeking a more active role in housing and the Government welcomes this. More flexible use of some building society resources would be a powerful private sector contribution to the development of the country's housing stock. Nevertheless, history has demonstrated a need for caution. 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 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 high risk activity. Some involvement by building societies is welcome but it needs to be kept within prudent bounds.

3.15 Societies have not so far been able to enter this field directly. 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.

3.16 The Government proposes a new power for societies to own land for purposes of letting. This would enable them to act directly as landlords of residential property and to own the rented element of shared ownership schemes. The societies should also be allowed to develop property for sale. They already play a part in ventures with builders, local authorities and other institutions, but their role is limited to lending on mortgage. While they should not become involved in speculative non-residential development, there is a clearly^a role for them in some types of 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.

3.17 Many societies may want to undertake such operations through subsidiaries. This could be done either through a controlling equity stake in a housing trust company or through formal powers of control over a housing association incorporated as an Industrial and Provident Society. The Government's proposal would permit both forms of establishment. The society would also need to be given the power to underwrite its subsidiary or associate. The financial exposure is however the same whether the activities are carried out directly or through a wholly-owned subsidiary, and so for supervisory purposes the balance sheet of a housing subsidiary would be consolidated with that of the parent society.

3.18 Ownership of land or property would entail new and different sorts of risk. 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 and new risks of capital loss should property values fall. Land and property assets would therefore require considerably higher reserves cover than many other sorts of asset, so that it would not be appropriate for societies to engage in such business on a substantial scale relative to their size and assets. 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. Chapter 4 discusses however how other possibilities, such as estate management, could be opened to the societies without incurring risks on the same scale.

3.19 As with unsecured lending, such powers would not be open to societies with free reserves less than £3 million. The one exception might be a specific power to enter into shared ownership schemes where the risks are comparable to those of equity mortgages. Eligible societies wishing to hold land would need to obtain the Chief Registrar's approval before doing so, and to satisfy him that reserves and management were adequate for the task.

iii. Equity investment in subsidiaries

3.20 The BSA have suggested more generally that societies should be able to transact certain types of business through subsidiaries. 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 such as the Cooperative Bank, which is owned by the Cooperative Wholesale and Retail Societies. There are likely to be advantages of financial management and accountability for societies in this. But the subsidiary route must not be regarded as a way of sidestepping prudential considerations or limitations upon the powers of societies themselves. A financial institution of the standing of a building society would take on certain moral obligations towards a subsidiary, over and above those required by the law of limited liability, 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 its exposure in particular cases would depend on how much equity it owned, the nature of the other shareholders, and how far the society had been responsible for setting up the company and for its management. These points are particularly important for a building society which cannot raise additional capital quickly. The scope for even the largest building societies to take on such commitments is therefore not large relative to their size.

3.21 For this reason, building societies should not set up subsidiaries with potentially heavy contingent liabilities. The Government proposes 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. Similar considerations apply to insurance underwriting. A building society insurance subsidiary - 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, which could represent too great a risk for the society's investors.

3.22 As already discussed, however, building societies over a certain size should be able to invest in housing subsidiaries. They should also be able to invest in financial services subsidiaries or consortia. Some consortia are already being formed to examine 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, so that the legislation would need to provide building societies with the freedom to respond flexibly. 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. But subject to that point, all societies, irrespective of size, would be able to participate in financial services groupings.

The European Community

3.23 Building societies already comply with certain general obligations under European banking legislation, notably the First Credit Institutions Directive of 1977. But there is as yet no specific legislation in the building society field. And the restriction to lending on security of freehold or leasehold estate effectively confines the societies to the United Kingdom.

3.24 The BSA have sought the power to operate in other European countries, whether through a branch, an agency, or a separately constituted subsidiary. The Commission of the European Communities have also indicated their intention of raising the questions of freedom of establishment and services in this field. It has always been recognised by all concerned that the area of housing credit is one of particular difficulty. The markets in the

different countries, and the relevant national laws, have grown up in distinctive and self-contained ways, reflecting their own evolution over very long periods. For this reason, a common market in the field is not possible at the present time.

3.25 A society operating abroad would have both to lend and raise money in foreign currencies, since it could not afford substantial exposure to foreign currency risks. There would also have to be no significant diversion of resources that could otherwise have been devoted to financing housing in this country. The Government favours freedom in financial services in the Community but is uncertain of the likely benefits in this particular case. It would welcome comments on the general prospect of building societies operating in other European countries in the future.

Building society liabilities

3.26 Building societies have traditionally raised virtually all their funds from individual 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 an individual society but not of societies as a whole).

3.27 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 supply and demand. 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 be a valuable safeguard. 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.

3.28 Building societies might also develop new fund raising instruments with characteristics, notably the incidence of income, resembling some of the new forms of asset. One obvious example might be the development of index-linked liabilities, whether wholesale or retail, which would be needed generally to match indexed mortgage lending on any scale. Taken with prudent limits on the amount of new business taken on, otherwise unacceptable risks from mismatch may in some cases be scaled down to a level which can be accommodated by given reserves, although matching does not offer unlimited scope for diversification into new forms of riskier assets. Matching is a complex subject, the role of which in assessing sufficiency of reserves will be considered more fully in the forthcoming discussion papers on capital adequacy by the Chief Registrar.

CHAPTER 4 - BUILDING SOCIETY POWERS - NEW FUNCTIONS

4.1 This Chapter considers the extension of building society powers in ways which would not affect their balance sheets directly. They do not in general involve financial risk, but need to be considered in the light of the primary role of building societies in the financial services and housing markets, and of possible conflicts of interest.

Money transmission services

4.2 Building societies should be able to offer a fuller range of personal banking and money transmission services to their members, if they so wish. Several societies have already taken some steps in this direction, but certain problems have arisen. For example, it has not been possible for building societies to issue cheque guarantee cards because this would mean that a society promised to meet a payment to a third party whether or not sufficient funds were present in the individual account. The same point could arise with new electronic money transmission systems, for example certain types of "point of sale" or automated teller machine networks.

4.3 Financial institutions must be able to compete on equal terms, and any unjustified impediment in the building societies legislation should be removed. Those societies taking advantage of the new unsecured lending power might be able to make use of it for money transmission purposes. But the legislation might also provide an explicit power to guarantee payments in certain circumstances, with a power to require a member to make good any debt within a specified period. As a minimum, ^{this} 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, insofar as they are undertaking banking business, the protection given to bankers by legislation like the Bills of Exchange Act and Cheques Act. Other legislation may also need amendment. Appropriate cheque clearing etc arrangements would also have to be made, although this would not be a matter for legislation.

"One stop shopping" for house buying services

4.4 The BSA have proposed that building societies should be able to offer a package of services to house buyers, including estate agency, conveyancing and structural surveys. While they cannot now offer these services, arrangements have developed between the societies and the professions which allow consumers to obtain services without duplication of work. For example, a building society will frequently allow the borrower's solicitor to act on its behalf. And building society panel surveyors frequently carry out surveys for prospective borrowers as well as valuations for the society. The Government welcomes

moves which increase competition and the range of choice open to consumers. The question is how to avoid possible conflicts of interest.

xx 4.5 On 17 February 1984, the Government announced proposal^s for legislati^{on}g 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. 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 legislate in advance on conveyancing if necessary.

x 4.6 At the same time, the Government set up a committee now chaired by Professor Farrand to consider the issues raised in England and Wales if non-solicitors were allowed to offer conveyancing ser^vices, and other matters. It also set up a wide-ranging review to identify means of simplifying and speeding up house transfers in England and Wales. Final decisions on the widening of building society powers must be taken in the light of that work, but some general comments may be offered at this stage.

4.7 So far as structural surveys by building societies are concerned, the risks of conflict of interest are slight. The building society and the borrower have a common interest in ensuring that the property is sound and not over-valued. The risks of charges of neglect if a survey was shown subsequently to have been at fault would therefore have to be covered by professional indemnity insurance. It would be a relatively small development of present practice to allow a building society to offer this service directly.

4.8 A more difficult question - and one on which the Government would particularly welcome comments - is that of building societies engaging in estate agency. Subject to the conclusions of the Farrand Committee and the interdepartmental review, greater competition should benefit the market in house buying services. The entry of building societies into estate agency would greatly increase competition. It would enable the societies to offer an integrated service for house buying. This would be welcome to many house buyers.

x 4.9 The potential conflicts of interest are obvious. Building societies would almost certainly wish to run estate agencies from their branch offices, rather than through separately housed subsidiaries. Branch managers could then be responsible both for arranging sales on behalf of the vendors and for financing the purchasers. As agents for the vendor, their duty would be to get as good a price as possible. Indeed, the society would have a direct financial interest in achieving a high selling price. But its duty to a purchaser to whom it was also making a loan, and its duty to value its security adequately, would point

in precisely the opposite direction. The position would be complicated still further if the society also valued the property.

4.10 Such conflicts would be unacceptable, and safeguards must be provided for customers if building societies are to be permitted to undertake estate agency; it would also be in the long term interest of societies to avoid conflicts of interest. Some might require no more than strengthening or modification of existing provisions. 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 on whether and how the conflicts could be resolved and on what safeguards would be necessary.

4.11 Any society offering new services of this sort should not of course be able to make their use a precondition of granting a loan. The Director General of Fair Trading has powers under the competition legislation to investigate 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 for Trade and Industry has powers to act. It is however for consideration whether further specific provision should be made in building society legislation.

Agency services

4.12 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. For example, they might collect local authority rent and rates and pay bills to public utilities. 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.

4.13 Building societies might also offer agency services in the housing field. This might include the provision of advice services on home ownership and home improvements, possibly in conjunction with local authorities. Or they might provide a mortgage management service on behalf of other lenders. This could be particularly useful to local authorities which might 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.

4.14 A further possibility, which would allow the societies to play a wider role in housing, 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' own 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 might have formerly been held by the society in some cases. Such arrangements would be possible only if it were 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.

4.15 The main difficulty with these possibilities is one of principle. 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. The Government is inclined to the view that the societies should be able to undertake financial services on an agency basis for a defined list of bodies, but would welcome further views before reaching a final decision.

Insurance broking

4.16 The BSA have also suggested that the societies should be permitted to undertake the full range of insurance broking or agency 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 to the standards of behaviour expected of the insurance services industry. The Government would welcome further comments on this.

Financial services

4.17 Many of the proposals in this paper are intended to foster more effective competition in a rapidly changing market for financial services. It can be argued that building societies should not be prevented from offering the maximum range of services, subject to the general legislation on investor protection. This might include arranging for the purchase or sale of stocks and shares and providing more general financial and investment advice.

4.18 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 help to reverse the trend towards institutional rather than

individual investment in securities. Building societies might develop arrangements with securities firms - in which perhaps they had some equity stake - or allow a stockbroker to use their premises for offering broking services to the public. This sort of development might take place over a longer timescale than some of the 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 services.

Supervision

4.19 It is not envisaged that the new powers discussed in this chapter would be subject to the same degree of prudential control as those in Chapter 3. They would in theory be open to all societies who could prudently undertake them. They would however be subject to the regulatory regime of the particular service. For example, wider financial services would in many cases be subject to whatever legislation may follow Professor Gower's Review of Investor Protection. In all cases, new services should not prejudice a society's main business. If necessary, a society would have to satisfy the Chief Registrar that these services were being provided without prejudice to the position of investors, whether by diversion of management resources, or otherwise.

CHAPTER 5 - THE CONSTITUTION AND ACCOUNTABILITY OF BUILDING SOCIETIES

5.1 Building societies are member-based or "mutual" institutions. Most of their money is raised from members to lend to others. Investing members' shares are financially very like bank deposits and markedly different from 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 a bonus is paid to members out of reserves.

5.2 The concept of a member-based society is however difficult to apply to organisations as big as the larger societies. The largest societies have 10 to 20 times as many members as the number of shareholders in ICI, the company with the largest share register.

5.3 While it is the board which gives overall direction to a society, and the senior executives who carry out the day-to-day management, it is the members who elect the directors and to whom the directors must account for their stewardship. Boards must recognise that accountability, which for the largest societies extends to the public at large. Boards must give a good account of themselves and respond to questions from the members, from the press and others, accepting their right to ask such questions. Similarly boards must be seen to be conducting contested elections fairly. For their part, members must recognise that the 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 and is better dealt with by the leaders in the movement setting a good example than by legislation. But some changes are necessary to the statutory minimum requirements, with the following objectives:-

- (a) to improve the information available to interested members but to reduce the present burden on societies of circulating to members often unwanted reports and accounts;
 - (b) 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 (c) to tell members more about candidates 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.

Information

5.5 To allow investors to assess a society's financial position, and to help them take an interest in its affairs, building societies must now circulate the audited annual accounts and directors' report to all members, except investors with less than £25. They must also make available to members on demand the Annual Return which the society has to make to the Registry of Friendly Societies. 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.

5.6 The Government therefore proposes, as recommended by the BSA and others, that the document for members should be a simple financial statement similar to that sent to members when a merger is proposed. It would present the information in a readily understandable way, and alert members to their entitlement to receive the full accounts and directors' report on request. The financial statement would not be audited but the auditors would be asked to confirm on the annual return that it was a fair summary of the annual accounts. The directors' report would be extended to include some material at present published only in the annual return.

5.7 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 for prudential supervision.

Resolutions

5.8 The only statutory right that building society members have to bring an issue before the membership is that of proposing special resolutions, mainly those which propose a change in the rules. 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.

5.9 The rules of many societies provide for members to table ordinary resolutions for consideration at annual general meetings. The Government suggests that this should be a statutory right. It is however reasonable that the member should have held a qualifying shareholding at the two most recent balance sheet dates of the society, and have his motion seconded by at least ten members of similar standing. To avoid abuse - for

example 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.

Qualifying Shareholdings

5.10 At present:-

- (a) any member may table a special resolution;
- (b) any member with a shareholding of £1 or more may vote on a special resolution;
- (c) 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.

5.11 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 to propose or second resolutions or candidates 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.

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 members wishing to stand against candidates nominated by the board. There has also been criticism of the fairly widespread practice of new members being co-opted to the board during the year and then standing for election as outgoing directors at the next annual general meeting.

5.13 Societies need effective boards, including non-executive directors with the skills and experience to guide and support the executives who manage 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 boards should have a specific statutory duty to make adequate arrangements for effective direction and management. In these circumstances, it must be able to form its own views on its future composition and tell the membership its reasons for preferring its own candidates for election.

5.14 But there must be a fair chance for candidates to stand against those of the board. 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 circulation himself. But such members should be able to demonstrate a commitment to the society. It would be reasonable for the rules of the society to 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 on the last two balance sheet dates. At present, some building societies' rules contain requirements for deposits from candidates for election. It is for consideration whether this practice should continue.

5.15 In some societies all vacancies to the board are filled 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. But mid-year co-option is sometimes justified. This should be left to the good sense of societies. But the present general practice that any director co-opted during the year must stand for election at the next general meeting should be made mandatory. Such elections would be additional to those of directors who have retired by normal rotation.

Composition of Boards

5.16 One factor that is inhibiting the reinforcement of boards is the absence from the rules of many societies of an age limit on directors. The Government consider that the BSA is right in recommending that there should be a retirement age of 70 for building society directors.

5.17 Under the Companies Act, company directors may stay on beyond the age of 70, provided that a resolution to that effect is passed at each annual general meeting. Such a procedure would not however be effective for building societies, largely because of the absence of large institutional shareholders who may be prepared to intervene behind the scenes if a director was seen to be outliving his usefulness. The Government therefore proposes that a director should have to 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 1 January 1987, so long as new legislation had received Royal Assent by then.

5.18 New legislation will also have to deal with conflicts that might arise between the role of board members in the society and their outside interests. It is clearly desirable to carry over, 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.

5.19 But there is a wider problem with building societies. Many were founded by a professional practice, whether solicitors, accountants or estate agency, to bring together clients with money to invest and those wishing to buy a house, the practice often providing the administration. The majority of these societies have outgrown their origins and are now independent. But some 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.

5.20 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.

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

- (a) the volume of business a society could put with any partnership, firm or company of which a director is a member or in which he or his family has a significant interest, would be limited both in absolute terms and as a proportion of the society's total business;
 - (b) any existing arrangements of this type should be run down to the new limits within 5 years of the legislation coming into effect;
- and (c) in the meantime the directors' report should disclose the existence of such arrangements and the scale of business transacted under them.

Mergers

5.22 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.

5.23 Under the present procedures a statement must be sent to members setting out the financial positions of the two societies and the terms of the proposed merger. For the merger to be effective, a special resolution must be passed by a three quarters majority of those voting in person or by proxy at a general meeting of the society, and the written consent of the holders of two thirds of the shares must be obtained. Confirmation may be sought from the Chief Registrar instead of the second, a course which 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.

5.24 This procedure has worked reasonably well, subject only to three points. The first is that borrowing members do not have a vote in most societies, but they often have the greatest interest in a merger, because of the mortgage rate structure of the receiving society and the greater difficulty for them in switching elsewhere. They should have a statutory right to vote on a merger, irrespective of whether the rules of a society provide that they should have a vote generally.

5.25 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. This may mean that the society has to continue with insufficient 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 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.

5.26 The third problem is that mergers can take place only by agreement between the two boards. The timing and choice of partners therefore tends to be influenced mainly by personalities, by the incidence of retirements, and by the terms of compensation or transfer for the board and senior executives. 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 accelerated the decline in the number of strong local societies.

5.27 One suggestion has been that the board of one society might be able to require another to circulate a merger proposal to its members, even if the latter's board did not recommend it. But a large society could offer an inducement to vote for the proposal, in the form of a substantial distribution of the reserves to members, 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 is not satisfied that the advantages of this proposal outweigh its disadvantages. But further comments would be welcome.

Status of societies

5.28 A compulsory change by societies to company status has been advocated by some in the past on the grounds that the present constitution insulates societies from the effects of competition, leaving too much scope for inefficiency and extravagance in their management. The societies are not exposed to takeover in the same way as companies. They do not face the financial discipline imposed on a company by the stock market, where performance affects the price at which it can raise capital (although money market credit ratings may conceivably impose such discipline in the future). Members of a society can rarely, if ever, exercise the degree of influence on a board which a major 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 reserves for its business.

5.29 The Government has no wish to insulate the societies from competition but does not accept that such a 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 are 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 assets, 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 their management expenses will find themselves exposed in the more competitive environment and forced to adjust their policies.

5.30 It is however wrong that a society cannot turn itself into a company if its members so wish. The Government therefore intends to provide for this in new legislation.

Although there are no signs that many societies will wish to become companies in the near future, this will provide greater flexibility, for example for a society considering linking with another institution. It would also provide a means by which a society which wished to diversify radically could acquire the necessary increase in its capital base reasonably quickly.

5.31 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 particular groups, notably borrowers. The conversion itself would generally involve:-

- (a) a scrip issue of company shares to existing shareholders with holdings above a certain threshold, with the conversion of their existing shares into deposits;
- (b) the issue of further shares, by a rights issue or otherwise, to secure additional capital.

5.32 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. It would need at an early stage to seek an assurance that the Bank would be minded to grant a licence when it converted into a company. The Bank would be particularly concerned to ensure that the new company would have the requisite capital liquidity and management skills for the business it was contemplating.

CHAPTER 6 - THE FINANCIAL ENVIRONMENT AND INTEREST RATE ARRANGEMENTS

6.1 Building society interest rates are of considerable economic and financial importance. Mortgage interest is an important element in many households' costs. Mortgage rates affect both the retail prices index and demand for mortgage finance. The general level of building society rates relative to other interest rates has a pronounced effect on the volume of lending and on matching supply to demand for mortgage credit.

6.2 For several years up to 1980, there was relatively little competition 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 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 have enabled 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. During the 1970s, there are strong indications that this was happening.

6.3 More recently, however, the competitive environment has changed quite fundamentally. The abolition of corset controls in 1980 led to the entry of the banks into the mortgage market in 1981 and 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. Potential borrowers have had access to more sources of funds and have no longer had to tolerate mortgage queues. On the lending side of their business, therefore, there is no longer the traditional presumption that a prime objective of building societies should be to keep mortgage rates down. There has also been increased competition among building societies and with other institutions on savings as well as mortgages. The societies have put more emphasis on premium accounts, and over half of the money in building societies shares and deposits is now in accounts which pay interest above the ordinary share rate. There is also considerable diversity now on the structure of mortgage interest rates, although most societies currently charge a premium for larger mortgages. This has however tended to cost them market share among larger borrowers, as the banks have been able to take advantage of the administrative economies of scale in a smaller number of larger loans and of the good credit standing of many larger borrowers./

6.4 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. This policy however runs

risk that rates may settle above that level. This might encourage the societies to diversify into 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.

The interest rate cartel

6.5 Since 1939, the BSA has recommended interest rates to building societies generally. 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 from the recommended rates.

6.6 While most BSA member societies followed the recommended rates in practice, their observance was not a condition of BSA membership. A good many smaller societies kept a fixed differential over the BSA recommended rates, so that the recommended rates in practice determined theirs. More recently, however, virtually all societies have offered various forms of premium share accounts, undermining the previous highly cartelised behaviour.

6.7 On 21 October 1983, the BSA announced new 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, implying they will give some notice of their intentions.
- (c) An information agreement under which societies may be notified of each other's rates.

6.8 When the restrictive trade practices legislation was extended to services in 1976, agreements between building societies relating to interest rates were specifically exempted. Neither the old recommended rate system nor the new arrangements have therefore had to be registered by the Director General of Fair Trading as restrictive practices, so they are

not 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 essential to the successful operation of such a system, since they provided a mechanism for putting the agreed guidelines into practice. But the ending of the guideline system in 1980 has removed the original rationale for exempting the building societies from the legislation.

6.9 Time has eroded both the operation of the interest rate arrangements and the reasons for their exemption. In principle, arrangements of this sort are anti-competitive and undesirable. They mean that the building societies in practice 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. 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 encourage competition between building societies, a greater range of choice and a better service to building society members.

6.10 The transition to a fully competitive system 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 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, in view of the difficulty and, frequently, expense of switching a mortgage from one lender to another. Finally, all changes are riskier if they are uncontrolled, so that gradual change is better in prudential terms than a step change.

6.11 Nevertheless, the present collective interest rate arrangements inhibit the free play of market forces which would ensure the best deal for savers and borrowers. There needs to be 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 the logical next one. The procedures under the Act would

allow ample time within which the societies could consider the future of the agreement themselves before any statutory action was set in train, thus ensuring an orderly transition. It is therefore proposed that the exemption from the restrictive trade practices legislation should be withdrawn at the same time as new legislation comes into effect.

Taxation of building societies

6.12 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.

6.13 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 relevant institutions. There were two major differences in the taxation of building societies and 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 being less than the basic rate, and also 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 were liable to income tax 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.

6.14 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 exist after 1985 - will introduce a better balanced regime.

6.15 A further recent change was the decision by Ministers (announced 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.