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CABINET

MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

BANK TAKEOVERS AND MERGERS

Note by the Chancellor of the Exchequer

The bid for the Royal Bank of Scotland (RBS) by the Hong Kong and Shanghai Banking Corporation (HSBC) now under examination by the Monopolies and Mergers Commission (MMC) raises the general question of our ability to control takeovers of UK banks, and in particular overseas bids for clearing banks.

2. I am reluctantly forced to the conclusion that it is essential to legislate in the 1981-82 Session to ensure that there is no doubt about our power to control such developments in future. I propose legislation chiefly for general political reasons. Given the special responsibilities of banks, their pervasive role throughout the economy and their importance for economic policy, we would be open to strong political criticism if, for example, several of the clearing banks fell into American hands and we were powerless to prevent it. The annex sets out in more detail the reasons for regarding banks as a special sector of the economy

and for having special control over takeovers in that sector.

Background

3. Banking takeovers have long been subject to special control in addition to the general control on mergers, now exercised under the Fair Trading Act (FTA). This special control has been exercised informally by the Bank of England through an understanding with the banking system that takeover proposals were not to be pursued without the Bank's consent. The understanding was later codified in an announcement by the Bank in 1972. Although it has no statutory basis, it was until recently accepted by both and overseas banks interested in acquiring banks in the UK. Since it had not been challenged, it was not then thought necessary to include statutory controls on takeovers in the Banking Act 1979. This does leave a gap in the statutory framework, since it can be argued that supervision cannot be exercised properly without powers over changes of control. Such a power exists in the case of insurance, where a change in control can be prevented if there are "prudential" objections to it as harmful to policy holders (i.e. on grounds of competence, probity, or financial standing of the new controller).

The problem

4. The loophole was revealed by HSBC's decision to proceed with their bid for RBS without the Bank's approval. The bid has been referred to the MMC, together with a parallel bid by the Standard Chartered Bank. The deadline for the MMC's report is the end of January, although it is hoped to complete it by the end of the year. Whatever their finding, however, HSBC's action makes the Bank's informal non-statutory procedure an unreliable weapon for future cases.

5. Admittedly others might still be willing to submit to the Bank's informal authority despite HSBC's known failure to do so. An adverse MMC finding in the HSBC case might also deter other bidders. And any further bids for clearing banks could also be referred to the MMC, as has been done in the HSBC case. But the MMC is an independent body, which is primarily (although not

exclusively) concerned with competition policy. Its findings cannot be predicted with confidence, and there is no power to prevent a merger unless the MMC finds it against the public interest. So none of these possibilities offer any guarantee that we could prevent unwanted takeovers. We are vulnerable where we see objections, whether for reasons of prudential control, sound long term development of UK banking or national control, and the MMC takes a different view.

6. For the political and other reasons mentioned above, I believe that we must legislate to restore on a statutory basis the degree of control that was available to us informally before HSBC's bid. It is worth noting that powers to prevent foreign takeovers in the parallel case of important manufacturing industries already exist in the Industry Act 1975. While we criticised that legislation and have repealed parts of the Act, we consciously chose not to repeal the powers in question. Further overseas bids for UK clearing banks are a distinct possibility in the coming months. There have been press reports of American banks' interest in bidding for the Midland and Lloyds. The low stock market valuation of clearing bank shares, which stand at a substantial discount on net asset value, would make them attractive to an overseas buyer. And the high degree of concentration in UK deposit banking means that even one takeover could bring a substantial share of UK banking under overseas control. This is not at all to say that all proposals for overseas takeovers, even of major banks, should be resisted. Each case should be considered on its merits, which might include improved competition in UK banking. But I believe that our powers of control should be as comprehensive and reliable as we can make them to ensure that we are not caught unprepared.

7. Earlier exchanges with colleagues most closely concerned showed that there was a substantial measure of agreement on the need for additional powers. The main issue for us to consider is their precise scope.

Form of proposed controls

8. If we are to provide an adequate replacement for the existing informal arrangements, I consider that the legislation must give me power to veto changes in control of banks not only on prudential grounds (as in the case of the Insurance Companies Act) but also for reasons of the public interest moere generally, including questions of overseas control. To avoid highlighting the foreigner aspect, I propose that the public interest should be defined in a sufficiently general manner in the legislation, although there should certainly be an obligation to give full reasons for the exercise of the veto.

9. The Secretary of State for Trade considers that a wide power of this kind would be open to criticism, and that it might be enough to legislate for prudential purposes only. He suggests that we could rely on the MMC to consider questions of the wider public interest, which they have a duty to consider as a whole in addition to the competition issues with which they are normally concerned. He has mentioned in particular the recent Davy-Inco case in which the MMC found against a proposed takeover by a US company on what amounts to national interest grounds.

10. In my view this would not be sufficient. The MMC's findings in each case are sui generis. While they have made adverse recommendations on national interest grounds in a limited number of non-banking cases, this provides no certainty about their view in a major banking case. Significantly, we cannot now make a reliable forecast of their likely findings in the Royal Bank of Scotland case. More generally, I do not think that we can or ought to look to the Commission for protection from political opposition to foreign control of a major part of our banking system. Yet this might be the overriding difficulty we might face if there were American bids for, say, two of the London clearing banks.

11. Recognising the difficulty for the legislative programme in the 1981-82 session, I intend to keep the proposed legislation as simple as possible. I would introduce an amendment to the

Banking Act 1979 to require prospective shareholders to notify me and verify that I have no objection to their becoming controllers of a recognised bank or licensed institution incorporated in the UK. My decision would be taken after receiving advice from the Bank of England. If I objected to any takeover under these powers the legislation would oblige me to give reasons and to inform Parliament by means of a Statutory Instrument subject to negative resolution.

12. My proposals would formally mean that the same question - whether a banking takeover was in the public interest - could be considered under two pieces of legislation: by me under the new power and by the MMC under the Fair Trading Act. In practice, however, the two sets of powers are likely to be exercisedfor somewhat different purposes: the new powers for reasons of banking prudence and national control; the Fair Trading Act primarily for questions of competition and the interest of the consumer. Discussions at official level suggest that there should be no real difficulty in practice in co-ordinating the use of the proposed powers with those in the FTA. If no objection was raised under the banking powers, cases which raised issues of competition, for example, could of course still be referred to the MMC. Departments should have no difficulty in ensuring that the two questions were considered alongside each other. The possibility of examination under two separate procedures exists already with the informal Bank of England arrangements, so there is really nothing new in it.

Presentation

13. The presentation of the legislation would need to be handled carefully. I appreciate that the introduction of special powers to control bank takeovers could be regarded as contrary to our general approach of encouraging both foreign investment and greater competition. I would not accept that any such criticism was well founded. For the reasons already mentioned, banks are a special category and are so considered in most other countries. The controls I propose would only replace the existing informal

arrangements and put the UK on a par with most other western countries in having statutory powers specifically related to banking takeovers. We have no intention of changing our present liberal approach to foreign entry in general - evidenced by the fact that London has more foreign banks than any other major financial centre. And I would stress that while foreign takeovers are the main reason for proposing legislation, I also see a need for power to control all takeovers of UK banks and propose that the powers should apply even-handedly to both domestic and overseas bidders, without any special reference to the latter on the face of the legislation. We would of course assure the Commission that we would use these powers in conformity with our Treaty obligations and I am advised that this should provide a satisfactory defence against any EC criticism. We would have to accept that this would mean that we could not use the powers to discriminate against an EC bidder on grounds of nationality and it might also be difficult to use them against an EC subsidiary of a non EC bank. As regards criticism from the Americans, we could draw attention to the powers of control available to the federal and state authorities in the United States, explain that we were simply putting previous informal arrangements on a statutory basis, and assure them that our generally liberal approach remains unchanged.

The Royal Bank of Scotland case

14. Although the legislation will apply formally to the bids for RBS which are now before the MMC, I think that existing cases must in practice continue to be dealt with under the existing powers in the Fair Trading Act. I would propose, therefore, to make it clear that the new powers would not be used to object to either of the present bids for RBS if the MMC did not find them against the public interest. I sympathise with the Secretary of State for Scotland's concern about this, since his anxiety about the uncertainty of the MMC's findings on RBS illustrates precisely why I am not content to rely on the MMC alone for the future. But I am afraid I cannot see how existing cases could be objected to in conflict with the MMC's findings without retrospection of an indefensible kind.

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Timing and Procedure

15. If we are to be in a position to control further bids following the MMC's decision on the RBS case, it will be essential for the legislation to take effect from the date of the announcement of our intention to legislate. The latest date for such an announcement would be at the time the MMC's decision became known, which is likely to be not later than the third week of February. But I think there would be advantage in announcing our intention as soon as possible, before the MMC's report is made. There could be pre-emptive bids in the expectation of a favourable MMC recommendation in the HSBC case, or following leaks about their views. An early announcement would forestall these difficulties if, as I propose, the legislation takes effect from the date of the announcement.

Conclusion

16. I invite colleagues to agree:-

(i) That I should announce as soon as convenient our intention to introduce legislation, to take effect from the date of my announcement, to place the previous informal controls over takeovers in the banking sector on a statutory basis;

(ii) that these controls should give power to object to proposals on wide public interest grounds, not merely for narrower prudential reasons; and

(iii) that legislation should be introduced to secure these powers in the 1981-82 Session.

(G.H.)

H.M. TREASURY
23 October 1981

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ARGUMENTS FOR SPECIAL CONTROLS OVER BANKING MERGERS

ANNEX

Besides the risk of political criticism if major banks came under foreign control, the reasons for maintaining special controls over banking mergers, and giving them statutory form, include the following points:-

(a) The importance of banks to the economy.

Banks play a central role in the economy as recipients of savings and managers of money for the public, and as a channel for allocating funds to industry and commerce.

(b) Banks' importance to economic policy

Banks' central role and their importance for monetary policy in particular has led successive governments to seek voluntary co-operation from banks over a wide field. Practical examples include the corset, directional guidance and consumer credit controls. Such co-operation could be threatened by undesirable takeovers.

(c) Public confidence in the banking system

Public confidence in the banking system is important for both economic and social reasons, and effective prudential supervision has a significant role to play in maintaining it. Supervision should include oversight of the ownership and control of banks to ensure that they are in reliable hands, but the Banking Act includes no power over changes of control because of the existence of the informal arrangements to deal with mergers. It is unsatisfactory for the supervisory authority to be responsible for supervising an institution without power over changes in its control. And now that the informal arrangements cannot be relied on, it is desirable for prudential reasons to have power on this point - as already exists in the case of insurance companies. This argument, on which the Bank lays great stress, applies to domestic as well as foreign takeovers.

(d) Possible support operations

If, despite thorough supervision, a crisis of confidence occurred which created the need for immediate support, as in the lifeboat operation in 1973-74, foreign ownership of major banks could present difficulties. There could be major objections to the use of UK public money to support a foreign-owned institution in such circumstances, since the long term benefits of such support could go to overseas shareholders. Indeed, foreign ownership might increase the risk to public funds since domestic banks might be reluctant to help as much as they did in the past.

(e) Practice in other countries

Most other countries regard banking as special and have specific powers to control mergers and takeovers. In France and Italy the major banks have long been in public ownership, so that no question of foreign takeover can arise.

(f) Bank share value

Clearing bank shares stand at a substantial discount on net asset value. While the reasons for this are complex, it is unacceptable that major UK banks should be picked up by foreign buyers on the cheap.