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Financial Mutuals Arrangements Bill

Bill 23 of 2006-07

This private member's bill is introduced by Sir John Butterfill MP. It seeks to loosen certain restrictions on the operating conditions of mutual societies and to provide the opportunity for government to change the manner in which future rule changes are made. The institutions most affected will be the building societies.

Timothy Edmonds

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Summary of main points

The *Financial Mutuals Arrangements Bill* is a short, four clause, Private Member's bill introduced by Sir John Butterfill. It has three objectives:

- To amend the building societies' legislation in order to enable the relaxation of the prescribed non-member funding limits on building societies;
- Establishing the interests of mostly, individual members to rank equally with non member funders, i.e. large corporate investors, in the unlikely event of a society becoming insolvent; and
- Transfer of Engagements – to widen the opportunities of societies to merge and to provide the Treasury with wider regulatory powers with respect to mergers and takeovers between societies and between societies and other mutual organisations.

It is therefore the latest in a line of statutory attempts, introduced over the last twenty years, to fit the legislative framework better to the commercial needs of the building society sector. It can trace its parentage to the Miles Report of 2004 into long term mortgage funding and the conclusions of the all-party Parliamentary Group on Building Societies and Financial Mutuals.

The Miles Report looked at the limited appeal of long-term, fixed-rate mortgage funding in the UK mortgage market and saw the current funding limits on building societies as contributing to this deficiency. Evidence to the all-party Parliamentary Group showed that many of the supposed cost advantages of mutual societies were cancelled-out by access to more wholesale (non high- street derived) sources of finance.

In the unlikely event of a society becoming insolvent, depositors (mainly institutions) would have priority over members (mainly individuals) in any distribution of funds. If, as a result of changes to the funding limits mentioned above, societies came to utilise wholesale city funds more than now, protection for the members needs to be increased to compensate.

The bill has general Treasury and industry support.

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I Introduction

This short, four clause, Private Member's bill introduced by Sir John Butterfill has three objectives:

- To amend building societies' legislation in order to enable the relaxation of the prescribed non-member funding limits on building societies;
- Establishing the interests of members (to rank *pari passu* with non member funders) in the event of the insolvency of a society; and
- Transfer of Engagements – to widen the opportunities of societies to merge and to provide the Treasury with wider regulatory powers with respect to mergers and takeovers between societies and between societies and other mutual organisations.

It is therefore the latest in a line of statutory attempts, introduced over the last twenty years, to fit the legislative framework better to the commercial needs of the building society sector. It can trace its parentage to the Miles Report of 2004 into long term mortgage funding and the conclusions of the all-party Parliamentary Group on Building Societies and Financial Mutuals. The bill has general Treasury and industry support.

II The development of building society legislation

The modern governing legislation of building societies is the *Building Societies Act 1986.* This Act was seen at the time as giving the societies greater market freedoms. It followed hard on the heels of a major wave of de-regulation of financial services regulation and the City's famous 'Big Bang'. The 1986 Act set out limits on the classes of assets that building societies could invest in from Class 1 assets – mortgages to Class 3 assets that included personal, unsecured, loans. The Act also provided the 'paving' legislation giving societies their ultimate freedom, namely to allow them to convert to companies. Of the six largest building societies at the time the Act was passed only one, the Nationwide, has retained its mutual status. The Act met the broad aspirations of the building societies at the time and allowed them to start the process of business diversification and demutualisation witnessed since then. A note prepared on the Bill by the Building Societies Association (BSA) chronicles the de-mutualisation process:

> Between 1989 and 2000 a number of building societies demutualised, becoming shareholder owned public limited companies. These institutions are no longer building societies. Abbey National was the first to demutualise in 1989. In 1995 Cheltenham & Gloucester demutualised, becoming part of the Lloyds TSB Group and in 1996 National and Provincial Building Society was acquired by Abbey National Plc. In 1997 Alliance and Leicester, Woolwich, Halifax, Bristol & West and Northern Rock became banks. They were followed in 1999 by Birmingham Midshires (acquired by Halifax) and 2000 by Bradford & Bingley. There have been no building society demutualisations since 2000. In 2006 the savings

> business of Bristol & West plc was remutualised, with the acquisition of the business by the Britannia Building Society. [1]

The 1986 Act was substantially amended by the *Building Societies Act 1997.* This Act was the culmination of a lengthy process of review and consultation on the reform of the 1986 Act. It replaced the prescriptive regulatory regime of the 1986 Act with a more permissive regime and made corresponding changes to the powers of the sector's regulator, the Building Societies Commission. Measures were introduced to improve the accountability of societies to their members, and provisions were introduced that were expected to help to protect the remaining mutual building societies from pressure to change status. Introducing the legislation the then Economic Secretary, Angela Knight, said:

> The Building Societies Bill will give societies and their members a new framework for the future. The Bill aims to give societies the freedom they need so they can offer better and wider services to their customers and compete more effectively in the financial high street.
>
> I believe the financial high street is better off for having building societies. Even after the current round of much publicised conversions the remaining building societies will still have around £130 billion in assets and more than a fifth of the mortgage market. More importantly, they will have some 13 million members.
>
> I want to ensure building societies continue to thrive. That is why I have brought forward this new Bill. It has been a long time coming but it is worth the wait.[2]

Despite the much-publicised decline in the number of societies, figures more recent than those quoted by the minister above, display some greater resilience in the sector over the last decade.

Building societies service activity

Year	Number Authorised Societies	Branches	Estate Agency Offices	Staff Full time	Staff Part time	Shareholders 000s	Depositors 000s	Borrowers 000s	Advances during year Number 000s	Advances during year Amount £m
1995	80	5,141	1,113	75,701	23,434	38,998	6,307	7,178	1,047	39,200
2000	67	2,361	607	32,334	10,823	22,237	740	3,107	548	31,514
2001	65	2,126	241	28,200	9,150	20,310	568	2,750	509	31,845
2002	65	2,103	229	28,982	9,257	20,724	511	2,688	558	37,303
2003	63	2,081	556	32,502	11,440	20,897	520	2,679	736	49,628
2004	63	2,074	559	34,335	11,571	20,734	525	2,749	811	59,283
2005	63	2,148	224	35,615	12,203	22,090	449	2,822	697	59,011

Source: Building Societies Association

[1] BSA Bill briefing available at: http://hcl1.hclibrary.parliament.uk/Other_orgs/Building_Societies_Association/FMAB_Briefing_March2007.pdf

[2] *Building on Success - Benefiting the Future: Building Societies Bill Gets the Go-Ahead*', HM Treasury press release 22/97, 28 February 1997

It is likely that the number of societies will continue to decline, albeit slowly. Consolidation is continuing although the recent trend has been for smaller societies to merge with larger societies rather than to demutualise. For example, in 2006 the Lambeth BS was taken over by the Portman BS, which in turn is in the process of merging with the Nationwide. The only known example of a society regaining mutual status was when the savings business of Bristol & West Building Society, which had been bought entire by the Bank of Ireland in 1997, was subsequently sold to Britannia Building Society in 2005: the UK's first case of 're-mutualisation'.

Subsequent to the 1997 Act the major legislative change has been the introduction of the *Financial Services and Markets Act* 2000. This has a particular impact with respect to the governance of the sector and provisions concerning the protection of investors. Building societies now are also subject to the provisions of the Financial Services Authority (FSA) rulebook in addition to primary legislation.

Legislative changes have been considered by the Treasury for some time. In November 2006 the Treasury issued a consultation document *Legislative changes to the Building Societies Act 1986.* This document focused on the treatment of building societies 'offshore deposits and the content of societies' annual reports.[3]

III The Bill

The main focus of the bill is the societies' funding limit. Section 7 of the 1986 Act provides that at least 50% of the funds of a building society (or of the society's group) must be raised in the form of shares held by individual members of the society. This single funding limit was introduced by the 1997 Act, replacing two previous limits on funding. Thus, no more than half of a society's funds can be raised on the wholesale markets. At times it is cheaper to borrow on the wholesale markets than rely on retail funds such as share accounts. This point was made briefly by an ex building society – Northern Rock- who gave evidence to the all-party Group on Building Societies and Financial Mutuals in its report on demutualisation.[4]

> The case for demutualisation was given strongly by Northern Rock, which had converted to plc status in 1997. The company told the Inquiry that its subsequent high growth and continually falling cost ratios had enabled it to price its products more competitively. The most important metric, it said, was its net interest margin – the difference between the average rate paid by savers and the average rate charged to borrowers. This, Northern Rock said, had been cut from 1.86% to 0.82% during 1997-2004. It insisted that its success over the past eight years would not have been possible under the old mutual model. By being able to access external capital (75% of which is now raised abroad) it could grow quickly and therefore keep unit costs down.
>
> Northern Rock said its cost income ratio was now 30.4% compared to an average of over 53% for building societies and argued that this proved it was "clear that

[3] HM Treasury consultation Paper: *Legislative changes to the Building Societies Act 1986* available at http://www.hm-treasury.gov.uk/media/CDA/B4/consult_buildingsociety091106.pdf retrieved 15March 2007

[4] *Windfalls or Shortfalls: the true cost of demutualisation.* All-party Group on Building Societies and Financial Mutuals, March 2006

> mutual status does not encourage efficiency. We gained our cost efficiency by rapid growth and ensuring our costs increased below the rate of income growth and half the rate of asset growth" it told the Inquiry.

The issues surrounding funding limits had already been examined in a report published in 2004 - *The UK Mortgage Market: Taking a Longer Term View*[5] written by Professor David Miles. This report was commissioned by the Treasury in order to examine why fixed rate mortgages are not more common in the UK mortgage market. The Report looked at the consequences and challenges that the current funding limits might have for the societies:

> […] 50 per cent of the funds raised by a building society must be in the form of members' funds. If there were a significant increase in long-term, fixed-rate lending, this requirement could place building societies at a disadvantage to other mortgage lenders if tapping wholesale markets turned out to be the most effective way of funding fixed-rate lending.
>
> Funding limits constraints
> 7.79 About 24 per cent of outstanding funds invested with building societies were from non members at the end of 2002. Among the ten biggest building societies, the lowest ratio of non member funds was just over 9 per cent, and the highest was 39 per cent. Overall, five building societies reported non-member funding ratios above 30 per cent. By 2003, 30 per cent of all outstanding funds were from non-members. This rapid change in the stock figure reflected a sharp decrease in the flow of new funds into building societies accounted for by members.
>
> 7.80 If this decline continues, some building societies may be close to the 50 per cent limit of funding by non-members in the near future. A potential shift in the UK mortgage market towards substantial longer-term fixed-rate lending could intensify this trend. The current funding limits do not generate significant constraints on building societies. It is possible that even in the event of very much more long-term fixed-rate lending in the UK, building societies would find that continuing to be funded largely by variable-rate deposits and using swaps and swaptions markets to get rid of interest and pre-payment risk would turn out to be the most efficient route. But, in the case that the use of wholesale funding turned out to be the most effective funding source, building societies could struggle to compete.
>
> 7.81 The possible relaxation of the funding limits of building societies raises two important issues: the nature of building societies, and the protection of their members' deposits in case of insolvency.
>
> 7.82 The aim of the funding – and lending – limits placed on building societies is to ensure that they retain their specific purpose. If how the building societies' assets are funded is what defines a building society, then any change to the funding limits is potentially problematic. But the essential characteristic of building societies is that they are mutuals that take funds from members and that make

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[5] See Treasury website for related information on the Report at http://www.hm-treasury.gov.uk/consultations_and_legislation/miles_review/consult_miles_index.cfm - retrieved 19 March 2007

mortgage lending on residential properties their primary business. Building societies are set up and owned by members with the aim of providing lending to finance house purchases. To fulfil their aims they need to raise funds in the most efficient way. If the key characteristic of building societies is that they are run in the interest of members and a 50 per cent funding limit prevents them from offering their members competitive mortgages, then there is a prima facie case for reviewing the funding limit. In principle, building societies can continue to fulfil one of their roles of accepting funds from members even if a majority of funds do not come from members.

[…]

7.86 With regard to the funding limits there are three options; (i) to do nothing; (ii) to use primary legislation to change the limits affecting building societies; or (iii) to change the funding limits with secondary legislation.

7.87 *Option (i):* Building societies could continue to operate within the current limits. If a large proportion of UK mortgage lending were fixed for a longer period, they could use the swaps and swaptions markets. New legislation could be passed in the future if the limits proved to be a constraint.

7.88 *Option (ii):* The second alternative is to change the Building Societies Act 1986 through primary legislation. Section 5 (1) of the Act states that the "purpose or principal purpose is that of making loans which are secured on residential property and are funded substantially by its members". The requirement of "substantially funded by members" can be modified with primary legislation. Primary legislation is a very costly option since there is a premium on parliamentary time.

7.89 *Option (iii):* The final option is to use secondary legislation to modify the funding limit. The Building Societies Act 1986 provides a secondary legislation route for altering the lending limit[6] which is at Section 6 of the Act, not for altering the funding limit at Section 7 of the Act. However, there is the option of using a Regulatory Reform Order to amend the funding limit. This is a type of secondary legislation which enables the government to amend legislation by Order made under the Regulatory Reform Act 2001. This route can be used where an amendment is to reform legislation which has the effect of imposing burdens affecting persons in the carrying out of any activity. The funding limit may be a burden of the type meant by the Regulatory Reform Act. The funding limit imposed by Section 7 of the Building Societies Act could be amended by Regulatory Reform Order (RRO). An RRO takes longer than other types of secondary legislation – between nine months and a year.[7] This route would not modify the requirement that building societies be substantially funded by members.

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[6] Section 6 of the Building Societies Act 1986 states that no more than 25 per cent of business assets (total assets minus liquidity, fixed assets and long-term insurance funds) can comprise assets other than loans fully secured on residential property.

[7] The reason it takes so much longer is that the order has to be cleared by Cabinet Office Legal Advisers, the Regulatory Impact Unit and Parliamentary Counsel. The order has to be made available for consultation for at least 12 weeks. Then there is first stage scrutiny by a Commons Committee and a report on the draft RRO from a committee of each house. 60 days after that stage the RRO can be laid for second stage scrutiny and if both Houses of Parliament approve the Order then the Minister can make the RRO

> *7.90 Recommendation: that Government consider lowering the minimum funding limit by members from the current 50 per cent. 25 or 30 per cent of building societies' funds coming from members would still represent a substantial source of funding.*

As it currently stands clause 1 of the bill would abolish all funding limits.[8] Apparently, however, this is not the long-term aim of the bill's sponsors which is rather to prompt further legislative change and action. The aim of the bill is, according to the explanatory notes provided, to effect a change in the way that the limits might be changed, rather than to make changes to them now. The explanatory notes state:

> Having this limit in primary legislation, given the difficulties involved in amending primary legislation, is unnecessarily inflexible.
>
> Under the proposed Bill the non-member funding restraint in the current primary legislation would be retained. However, if the Bill was enacted, HM Treasury would be able to lay down a Statutory Instrument, which would have the effect of amending the current limit. Such a proposal would be consulted upon.
>
> Accordingly, the Bill itself would have no immediate impact on the existing 50% limit. It would merely make it easier to change that limit in the future. The FSA's prudential supervisory powers in relation to any individual society's proposal to take advantage of any new general limit would remain unchanged.

The BSA briefing talks to both the bill as it stands and to likely developments:

> The removal of the constraint means that building societies would be in a position to meet whatever changes emerge in the market place over the next few years, rather than having their response to market changes constrained by legislation that might, in the future, appear out of date and unnecessarily restrictive. The removal of the limit does not in any way **force** building societies to move in the direction of non-retail funding, but merely gives them the **opportunity** to do this in the event that this is the most cost-effective way of funding the cheapest possible mortgages for their borrowing members. If building societies are not able to meet the demand for mortgages in the this way there is no doubt that other institutions will take the opportunity created by building societies' absence from this market.
>
> 13. It is understood that, at the committee stage of the Bill, an amendment may be moved that would provide an Order–making power to the Treasury to move the non-member funding limit into secondary legislation (rather than removing it entirely as is envisaged by the Bill as it stands) and for the non-member funding ratio to be increased to a maximum of 75% (from the current 50%). Building societies would be content with such an amendment. A 75% non-member (i.e. wholesale) funding limit would be very unlikely to be a significant constraint on societies in the future. The granting of an Order making power to HM Treasury would mean that if the current 50% limit did become a constraint this could be amended relatively rapidly compared to the time that would be taken to amend primary legislation.[9]

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[8] Clause 1 (3) Section 7 of the 1986 Act (the funding limit) shall cease to have effect.

[9] Op cit.

It should be noted that if there is such an intention, exercising it will give power to the Treasury, not the Financial Services Authority, to determine funding limits.

Clause 2 of the bill establishes parity of treatment between savers and depositors in a building society in the event of an insolvent wind up of a society. Typically, societies offer share and deposit accounts. The technical difference is that whereas depositors merely have a deposit account with the institution, share accounts convey ownership rights (hence the windfalls on conversions). In the past, there was often a minute difference in interest rates offered on these accounts – the deposit rates were fractionally lower to reflect the fact that if a society was made insolvent depositors would get their money back before the shareholders. The bill would give parity to these two classes in the event of a winding up – something that is very hard to imagine in real life. The BSA states that "No investor in any building society since at least 1945 – and probably for a considerable period before this date – has lost any of their investment in their society. "[10] The explanatory notes state that:

> Currently, if a building society were to become insolvent members' funds would be protected by the Financial Services Compensation Scheme. Savers would be entitled to 100% compensation for the first £2,000 invested. Above that they could claim 90% of the next £33,000. The scheme has never been put into practice in the building society sector. Separately, in theoretical terms depositors (mostly wholesale funders) enjoy a greater level of security than shareholders (mostly individual investors). In the extremely unlikely event of a building society becoming insolvent, depositors would receive all their money back before any distribution is made to shareholders (although the credit rating agency Moody's have expressed the view that this order of priority would not be enforced).
>
> The Treasury and FSA appear to be forming the view that this order of priorities is inappropriate and that depositors and shareholders should rank equally, or *pari passu,* in this unlikely event. The Bill, if enacted, would achieve that.

Apart from a number of exceptions, individual investors may only have share accounts with societies. The exceptions - where customers may still open deposit accounts – include: current accounts; client or trustee accounts; qualifying time deposits; deposits at overseas branches; and where the society has announced publicly that it intends to transfer its business to a company. Currently, most depositors are the big wholesale investors; hence, the bill would shift the balance of advantage, in the unlikely event of insolvency, marginally towards the 'man in the street' and away from wholesale funders. The extent to which this might deter wholesale depositors from using the societies is not explored in the bill's literature.

The Miles Report also discussed the connection between changing the funding limit and the protection of members.

> 7.83 A second important implication of any change to the funding limits is the protection awarded to depositors in the event of a building society's insolvency. Members' funds rank behind wholesale funds in the event of liquidation. Holders of the debt of a building society have priority over members with regard to its

[10] Op cit

> assets. In some ways members would find themselves in a similar position to that of shareholders if a society is liquidated. If the limit on retail funds from members came down from the current 50 per cent to a lower level such as 30 per cent or 20 per cent, then in some sense the gearing of members' funds would increase. If a society being liquidated had 70 per cent of its funding from non-members, its assets would need to cover a higher volume of claims by creditors than if only 50 per cent of its funding were from non-members. A smaller number of members' funds would have to make up for the shortage of assets, increasing the risk to members' deposits.
>
> 7.84 Protecting members' deposit is important. Funding limits may in fact weaken building societies' positions by not allowing them to compete for efficient funding if long-term fixed-rate lending becomes more prevalent in the UK. Members' interests are not protected if the societies cannot lend efficiently.
>
> 7.85 The risk to members' funds is monitored by the regulator and affected by the capital adequacy regime to which building societies are subject. An additional – and substantial – line of protection for members who have provided funds is afforded by the Financial Services Compensation Scheme. The scheme is triggered when an authorised firm goes out of business. The Scheme may also be triggered when the FSA considers that an authorised firm is unable to repay its depositors, or is likely to be unable to do so. The maximum level of compensation that a depositor can receive from the Scheme for a deposit claim is £31,700 (100 per cent of £2,000 and 90 per cent of the next £33,000). The compensation limit applies to each depositor and covers the total of all their deposits held with that firm.15 The five biggest building societies have the following distribution of member funds: 62 per cent of members have less than £2,000, 33 per cent of members have between £2,000 and £35,000 and five per cent have more than £35,000.16

Clause 3 of the bill aims to make the process of two mutual societies merging simpler, as the BSA paper explains:

> The third section of the Bill would enable the Treasury to make regulations that would have the objective of enabling any financial mutual organisation to merge with another financial mutual of a different type using the same procedures as if the "other" mutual was of the same type. In other words, if the necessary regulations were made by the Treasury a friendly society, for example, would be able to transfer its engagements to a building society, using the same approach as if the building society were another friendly society. Similarly, the rules governing a building society transfer to another mutual institution would be those relating to the transfer of engagements to another building society, rather than those relating to the transfer to another type of corporate body.[11]

[11] Op cit