Building Societies Bill

Bill 124 of 1996/97

Research Paper 97/34

7 March 1997

The *Building Societies Bill* amends the *Building Societies Act 1986* to create a permissive regulatory regime for building societies to replace the current prescriptive regime. Other changes will make societies more accountable to their members. The Second Reading is down for 10 March 1997, with the Committee and Remaining Stages on 17 March. The Bill is introduced as several of the largest building societies are in the process of converting into banks instead. Research Paper 97/20, *Building Societies*, provides more information about the building society sector, the conversion process and the reviews which led to this Bill.

Christopher Blair
Business and Transport Section
House of Commons Library

CONTENTS

I Introduction and Summary

This Bill is the culmination of a lengthy process of review and consultation on the reform of the main building society statute, the *Building Societies Act 1986*. It replaces the prescriptive regulatory regime of the 1986 Act with a more permissive regime and makes corresponding changes to the powers of the sectoral regulator, the Building Societies Commission. Some measures are introduced to improve the accountability of societies to their members, and there are clauses which may help protect the remaining mutual building societies from the pressure to become public companies. The Bill has been issued twice in draft for consultation, and the Labour Party has agreed to facilitate its parliamentary passage.

This paper provides a brief summary of the background to the Bill, and includes notes on the main clauses. Additional background is contained in a recent Research Paper, *Building Societies*.[1] That paper, which should be read in conjunction with the present one, describes in more detail the process of planned legislative reform in the building society sector which has led to the Government's Bill. It also discusses wider issues which are relevant to the Bill, including the historical development of building societies and the present series of conversions and mergers amongst societies. Reference information is given about all societies which have completed or proposed mergers and conversions.

Several of the largest societies have not waited for the reforms of this Bill and are instead committed to converting into public companies which will be regulated under the banking legislation. The building society sector's assets will fall by about 60 per cent as a result of recent and ongoing conversions and takeovers, and it is against this background that the Bill is introduced.

Part of the conversion process involves substantial payments being made to some members and customers. The expectation of windfall distributions has disrupted normal business at many societies as speculators try to make quick gains. Meanwhile the logic and fairness of some of these schemes has been called into question. This Bill removes the distinction between shareholders and depositors which has been one source of confusion, and alters the balance of protection between newly converted societies and societies which remain in the sector in the favour of the mutuals.

There is another building societies Bill before the House this session. A Private Members' Bill, the *Building Societies (Distributions) Bill 1996/97* [HC 77], was introduced by Douglas French MP under the Ten Minute Rule, and seeks to address an effect of the law which

---

[1] RP 97/20

means that mentally impaired society members may not receive the full value of a distribution made by a converting society. This perceived injustice affects those who, perhaps for practical or administrative reasons, are named second on accounts established for their benefit. The Bill's sponsor in the Lords, Lord Hayhoe, described the remedy of his Bill as follows:[2]

> This Bill will require building societies to make more than one distribution, of cash or bonus shares, to members who have more than one account where the other account is held by the member on trust for another person where it can be shown that it is not reasonably practical for that other person to hold the account.

Mr French's Bill has secured Government support. It passed its Commons stages without debate, and completed its Second Reading in the Lords on 28 February 1997. Although it is expected to reach the statute book, it would only benefit the members of societies which announce conversion plans after 22 January 1997.

---

[2] HL Deb 28 February 1997 c1248

II Recent background

A review into the working of the *Building Societies Act 1986* was initiated by Anthony Nelson on 20 January 1994.[3] The results of the first stage were announced in a written answer on 6 July 1994, including proposals to increase the proportion of funds which societies could raise on the wholesale markets, and to allow them to own an insurance company which writes buildings, contents and mortgage protection policies.[4]

A second stage review was then announced with the wider aims of investigating how to encourage evolutionary change in the sector; improving the accountability of directors to members; considering whether the current prescriptive style of the legislation could be altered into a permissive regime; and other specific changes. As part of the review a consultation document was issued by the Treasury in September 1994.[5]

The results of the second stage review were announced in a written answer on 24 February 1995. Among the proposed changes was the abolition of the distinction between investors and depositors and a number of other proposals to:

> enable societies to expand the range of services they offer, while retaining their primary focus as providers of housing finance;
>
> improve societies' accountability to their members; and
>
> maintain a sound prudential framework.[6]

Following the review, a draft Building Societies Bill was published with a consultation document on 18 March 1996. The draft opened the way to a permissive regime which would allow societies to pursue a much wider range of activities subject to two main constraints: 75 per cent of their loans must be secured on residential property, and at least half of their funds must be raised from their members in the form of shares. At the time, the Treasury also sought opinions on several measures which it was considering adding to the draft Bill. These included extending some corporate rescue procedures to the building society sector and allowing societies more flexibility in the use of names. Both of these measures are included in the present Bill.

---

3 A more detailed discussion of the review process and the recent development of building societies is given in the companion Research Paper, *Building Societies* (RP 97/20, 10 February 1997)

4 HC Deb 6 July 1994, cc.213 - 5w

5 *Review of the Building Societies Act 1986*, HM Treasury, September 1994

6 HC Deb 24 February 1995, c342w

Following the consultation in March 1996, a Bill had been expected to appear in the Queen's Speech in October 1996. When it did not, the Economic Secretary to the Treasury announced that another revised version would be published 'later this year' and introduced 'when a suitable opportunity arises'.[7] A written answer of 6 November 1996 outlined in detail the content of the proposed Bill. The draft Bill itself was published on 18 December 1996.

There was a widespread understanding that despite the shortage of parliamentary time left in this Parliament, a Bill might be introduced and speeded through the House if broad cross-party support existed for the measure. On 27 February 1997, in answer to the week's Business Statement, Jeff Rooker MP asked the Leader of the House:[8]

> Another point, which has been raised repeatedly in the past few months, relates to the mystical building societies Bill. Where is it? Are we going to see it? The Leader of the House is well aware that the Opposition are prepared to facilitate the agreed legislation, for which the industry is desperate. There is clearly a hole in the Government's programme and we would like to know whether that Bill will be put into it.

In reply, the Leader of the House said:[9]

> I am not quite sure whether the hon. Gentleman will be aware--although I imagine that he has been told--that a good deal of discussion has taken place in the usual channels on the building societies Bill. I can tell him that we do intend to introduce the Bill--on the basis that the Opposition will deliver on the assurance which he has now publicly given on the Floor of the House that they will fully co-operate in passing it speedily, which clearly is the only way in which it can be passed at this time in the Session. I am grateful to him for giving that assurance, and I hope that he will make every endeavour to ensure that they--I was about to say "deliver", but the implication of that word would be offensive, and I certainly do not mean to be offensive in any way. I am grateful for his comments.

The Bill was introduced on 28 February 1997. Its Second Reading is down for Monday 10 March 1997, after 7 pm, with the Committee and Remaining Stages scheduled for Monday 17 March.

Commenting on the present Bill on 28 February 1997, the Economic Secretary, Angela Knight MP, remarked:[10]

---

7 HC Deb 28 November 1996 c390w

8 HC Deb 27 February 1997 c444

9 HC Deb 27 February 1997 c446

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

> 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.

The Labour Party has agreed to support the Bill but it has some reservations. According to press reports, it will introduce an amendment designed to enforce the so-called two year rule which had been thought to limit distributions, in the event of a takeover or merger, to society members with a two year membership history. Mike O'Brien MP is quoted:[11]

> We want to stop mere speculators from benefiting from conversions and that is why we think only members of two or more years' standing should receive bonuses.

With the limited time available for the Bill's stages, if it is to reach the statute book in this Parliament, there must be some doubt whether there will be scope for significant amendment during the parliamentary process. The Minister, in her welcome for the Bill, drew attention to the size of the residual building society sector. The expected decline to £130 billion in assets when the present takeovers and mergers are completed, from assets in excess of £300 billion in 1994, has nonetheless caused some to question whether this Bill has come too late to protect this distinctive form of financial institution.

---

[11] 'Societies Bill set to be law before election', *The Times*, 28 February 1997. The rules which govern distributions are a complex mixture of statute law, judicial rulings and the discretionary decisions of the society in question. See RP 97/20, especially pp. 26-38, for more information on this topic

III Notes on clauses

Formally, the *Building Societies Bill* will amend the 1986 Act in fundamental respects. The Bill adopts five Part headings: Constitution and Powers; Powers of Control of Commission; Accountability to Members; Protection of Investors and Complaints; and Miscellaneous and Supplemental. Some comments on the major clauses are given below. They take account of information in the Explanatory Memorandum and in the consultation document of March 1996. Some simplification has nevertheless been necessary.

A. Part 1 Constitution and Powers

Clause 1 revises the **principal purpose** clause: a society can be established under the Act if its 'purpose or principal purpose is that of making loans which are secured on residential property'. The 1986 Act refers to 'advances secured on land for [their members'] residential use' (s.5(1)). The new wording brings loans secured on rented housing within the definition of a building society's principal purpose for the first time. This clause also provides for a building society to have those powers which are conferred on it by the society's memorandum, subject to the Act. Previously the Act was the main source of a society's powers, and the change reflects the shift towards a permissive regulatory regime where a society is broadly free to engage in any type of business. The present regime is prescriptive: a society can only engage in activities specifically permitted under the Act. This change is expected to allow societies to be more strategic in response to market developments, although there will have to be an increase in regulatory oversight by the Building Societies Commission (BSC). That work will be offset by lesser legislative responsibilities at the BSC.

Clause 4 provides that **loans secured on residential property** must form at least 75 per cent of a society's total or group assets (the 'lending limit'). This is one of the key 'nature limits'. Societies will be assessed on this lending limit quarterly. Certain assets (including liquid assets and long term insurance funds) are deducted from the calculation of total assets for this calculation. The Treasury is given the power to reduce the lending limit by order to a minimum of 60 per cent, whilst the Commission can modify the calculation of assets in relation to subsidiaries by order. **Clauses 5 and 6** define a loan secured on land, and a loan fully secured on land. These definitions are necessary to determine who is a borrowing member of the society (to be a member the loan must be fully secured), and to identify the lending which counts towards the lending limit.

Clause 8 establishes a **funding limit**: at least half a society's funds must be raised from its members in the form of shares (that is, funds placed in investment accounts by members of

the society). This is another 'nature limit' and ensures that societies obtain the majority of their funds from their traditional source.

Clause 9 in effect abolishes the **distinction between 'members' and 'depositors'** at a society. All money invested by individuals in the society will go into share accounts which confer membership rights, subject to a few exceptions. Transitional arrangements apply to existing deposit account holders and societies will be able to accept deposits if they have announced their intention to convert or be taken over by a company. Since depositors are not members of the society, the ability to set up deposits after the announcement of conversion allows a converting society to go on accepting new business without obliging it to include post-conversion accounts in any planned distribution to members. Current accounts and certain other accounts will not confer membership rights.

Clause 10 applies the few **restrictions on activities** which will remain if this Bill is enacted. Societies will not be able to act as a market maker in securities, trade in commodities or currencies, or enter into derivatives transactions for profit. Societies will not be allowed to have a stake or more than 5 per cent in any company which is engaged in these restricted activities. Societies will, however, be able to hedge their own exposures in the market, and may carry out some otherwise restricted activities if they are for less than £100,000 and are on behalf of customers. The restrictions do not apply to such activities as insurance or fund management.

Clause 11 prohibits a building society from creating a floating charge.

B. Part II Powers of Control of Commission

Under **clause 13**, if a society breaches the three crucial obligations of the Act, the Building Societies Commission can issue a **direction to the society** which requires it to submit a plan ('a restructuring plan') to regain compliance with the statutory requirements and remain in compliance with them, or to put forward proposals to its members to convert into a public company. The three requirements are the principal purpose (clause 1), the lending limit (clause 4) and the funding limit (clause 8). The Commission can also require the society to alter aspects of its business or remove officers or directors. Clause 13 provides for various permutations where a direction is issued; more detailed procedures for issuing directions are contained in **Schedule 3**. If a restructuring plan is not carried out, the Commission can issue (see **clause 14**) a prohibition order (after giving notice of its intention to do so) which forbids the society from conducting certain activities or which requires the disposal of certain assets. A breach of a prohibition order can be treated by the High Court as a contempt of court.

Clause 15 allows the Commission to petition the High Court that a society be wound up if it no longer complies with the principal purpose, or has contravened a direction or prohibition order (see clauses 13 and 14).

Clause 16. Where there is need for **urgent action**, such as to safeguard investors' funds, the Commission has stronger powers. Under clause 16 it can vary the conditions of authorisation for a society without giving prior notice. Under **clause 17**, the Commission can direct a society to transfer its engagements to another society or to a public company, if necessary on the basis of a resolution of the directors rather than a vote of the membership. **Clause 19** allows the Commission to control activities at societies to which it has given notice of its intention to revoke their authorisation. These again are emergency powers designed to protect the interests of the society's members.

Clause 21. Some of the Commission's powers of intervention are triggered by an identified threat to investors' money. The Act contains a set of **criteria of prudent management**, and where these criteria are breached, the Commission is entitled to assume that money is at risk. This clause inserts revised criteria into the Act. Criterion 1 is new and requires compliance with the principal purpose, and the lending and funding limits. Criterion 4 is also new, and requires societies to have a system in place to manage balance sheet risk and threats to net income. Criterion 5 addresses the systems for assessing the adequacy of securities for loans. A new requirement is that societies must assess the willingness and ability of borrowers to repay their loans. This change is an additional safeguard against imprudent lending and may indirectly protect borrowers themselves.

Under **clause 22**, the Commission must **publish a statement of principles** on how it will interpret the criteria for prudent management and exercise its powers generally. The requirement to publish a statement formalises the current procedure. It is similar to an obligation which applies to the banking supervisor and should make for greater transparency. Significant changes to the principles will be given in the Commission's annual reports to Parliament.

C. Part III Accountability to Members

Clause 25 puts on a statutory footing the right of building society members to **requisition** a **special meeting** of the society: this right is currently provided for in the rules of societies rather than in statute. The right is triggered by a requisition backed by at least a specified number of members, and includes a right to circulate a statement of not more than 500 words. The society can set the threshold for the number of backers, but that threshold must not require more than 100 backers. A society may restrict this right in its rules if the same

proposed resolution has been defeated at the one of the previous three annual general meetings, or if the meeting is requisitioned soon after the end of the financial year. Statements do not have to be circulated if they are likely to damage confidence in the society or are defamatory, frivolous or vexatious.

Clauses 27 and **28** relate to the **election of directors**. Nominations of directors will be allowed during a much longer period than at present. If the directors are to be appointed at the AGM (rather than by postal ballot) all members must be sent a proxy vote. Even if the number of candidates is no more than the number of vacancies, a vote must still be taken and each director must be positively endorsed by a majority of those voting. The number of members needed to support a nomination will be reduced for smaller societies, and a sliding scale of between ten and fifty members is introduced which relates the number required to the size of the society.

Clause 29 requires a society to seek the membership's approval for **substantial non-core acquisitions**. If this is not done, the acquisition does not become invalid, but the directors must explain in the next directors' report why they did not seek approval. Approval is by an ordinary resolution; it is required where the acquisition would cost more than 15 per cent of the society's own funds, and where the majority of the business in question is not connected with making loans secured on residential property.

Clause 30 allows a **summary transfer document** to be sent to members where the society proposes to transfer business to a company. The full transfer document must be provided on request to any member who asks for one.

Clause 31 requires a separate resolution at a meeting called to approve the transfer of the society's business (as part of a conversion or takeover) if the transfer terms provide for an increase in the **remuneration of directors**. Previously, remuneration proposals would have been included in the main resolutions on whether the transfer should go ahead. A resolution on salary increases would not, however, be binding on the successor.

D. Part IV Protection of Investors and Complaints

Clause 32 would allow the Treasury to merge by order the **deposit protection regime** of the building society sector with that of the banking sector. The Building Societies Investor Protection Board would be merged with the Deposit Protection Board, and the Building Societies Investor Protection Fund would be merged with the Deposit Protection Fund. Both are statutory schemes and now offer the same level of protection to investors (90 per cent of

the first £20,000 of an investor's deposit). Consultation would be required with the relevant boards, the Bank of England and the Building Societies Commission, and an order, if brought forward, would need to be approved by both Houses.

Clause 34 extends the jurisdiction of the **Building Societies Ombudsman** to cover all services which societies offer customers in the normal course of business: at the moment the matters which fall within the scope of the scheme are prescribed. The scheme will cover subsidiaries of societies as well, if the service falls within the remit of the Ombudsman. **Clause 35** defines the classes who are entitled to have complaints investigated: as well as individuals, companies and unincorporated businesses with turnovers of £1 million or less, partnerships and clubs may use the scheme. Note that the Act does not directly establish the present Scheme: it sets conditions which any Scheme which wants to be recognised must meet. There is, however, only one Scheme in operation.

E. Part V Miscellaneous and Supplemental

Clause 36 allows building societies to use **business names**, that is names other than their registered name. The clause creates a similar regime to the one which applies to companies, where the use of business names is widespread. Societies which use business names must ensure that their registered name and an address at which documents can be served are included on documentation and at premises. These proposals may assist societies in developing additional brand names, and in retaining goodwill associated with the names of former societies with whom they have merged.

Clause 37 provides that members who wish to **obtain the names and addresses** of other members of their society from the register must be of sufficient standing to vote on a special resolution or to nominate directors under the society's rules. This may impose a two year membership requirement, and an account balance of at least £100. This clause may prevent recent members from gaining access to the register simply in order to lobby for the conversion of the society. The clause also contains provisions to restrict and punish the further disclosure of information obtained in this way.

Clause 39 and **Schedule 6** extends aspects of the **insolvency regime** which apply already to companies and banks to building societies. This will allow a wider range of options to a society which is in financial trouble and may result in a more advantageous result for the members of the society too. In particular, modified versions of the company voluntary arrangement procedure and the administration procedure are extended to societies. Although these procedures are unlikely to be invoked, a brief explanation follows.

Administration is a procedure which aims to make it easier to rescue companies which have become insolvent. An administration order allows proposals to be formulated for the reorganisation of a company or the orderly realisation of its assets. While the administration order is in force, the company has protection against winding up and other legal processes, and its assets and business are managed by an administrator. A company voluntary arrangement (CVA) is an alternative to formal reorganisation through the insolvency legislation. It takes the form of a settlement between a company and its creditors. Its object is normally to secure either a moratorium (a delay of payment) or to negotiate an agreed partial repayment to creditors in full settlement.

Clause 40 abolishes the present Right to a **Priority Liquidation Distribution (PLDR)** for members of a society which has converted into a public company. The PLDR offers some protection to the balances of members as at the time of conversion in the unlikely event of the society being wound up once it has become a company. This clause would abolish that right. The PLDR can impose significant capital constraints on a converted society, and for that reason the Halifax has opted to structure its conversion in a way which allows it to avoid the PLDR under the present Act (by transferring to an existing company). It is also argued that the members' claims are to some extent realised by the distributions which have accompanied recent conversions so the PLDR is no longer necessary.

Schedule 8, para 9 of the Bill contains transitional rules applying the abolition of the PLDR to societies which are now in the process of converting. If the transfer document of the society mentioned the possible abolition of the PLDR, and, subject to abolition, made provision either that no PLDR would be conferred, or that if it had already been conferred it would be withdrawn, then the society can take advantage of the transitional rules. These allow the society to take advantage of the new rules if, either their transfer of business happens after clause 40 comes into force, or if their transfer took place after 6 November 1996 (and they are not already being wound up). The 6 November 1996 is the date of a written answer from the Economic Secretary to the Treasury which set out the Government's plans to amend the building societies legislation and described the application of the abolition of the PLDR to those societies which were in the process of converting.[12]

Clause 41 alters the existing **protections** which former building societies which have converted into public companies presently enjoy **against being taken over**. This has proved one of the most controversial proposals of the present Bill. Societies which are in the process of converting have protested strongly against this clause, whilst it has been endorsed by the remaining building societies. Currently, once a society has converted, no one may build up a stake of more than 15 per cent in the shares or debentures of the new company. It was argued that this allowed former building societies unfair protections, both in relation to mutual building societies which enjoy no similar protection and could therefore be acquired by former

---

[12] HC Deb 6 November 1996 cc539-41w

societies, and in relation to their competitors, the other public financial services companies who also have no protection against takeover. The rationale for the provision was to allow former societies to develop as public companies and not be swallowed up by a predator as soon as they had completed the expensive and time-consuming process of demutualisation.

This clause provides that takeover protection, which would otherwise last for five years after conversion, lapses if the former society or one of its subsidiaries acquires another financial institution during this period. The former society's shareholders can also vote to shed their takeover protection in a ballot endorsed by holders of at least 75 per cent of the shares (by value). Two points are worth noting. The shares of a company which has barriers to takeover are likely to be valued less highly than shares in a company where control can be acquired. If the protection remains in force, the shares will probably be worth less to their holders therefore. On the other hand, the revised rules will be valued by those who see them as protecting the building society sector from further diminishment. The background to this clause is discussed in more detail in Research Paper 97/20.[13]

Clause 43 and **Schedule 7** make extensive and mostly minor modifications to the Act. Perhaps the most significant of these is the extension to borrowers of equivalent voting rights to those enjoyed by the shareholders or investors (**Sch. 7 para. 56** following). In **Sch. 7 para. 18**, the Building Societies Commission is given the right of entry to obtain documents without notice if it believes that giving notice would lead to the destruction or removal of documents or that the notice would not be complied with.

[13] p.21

Economic Policy, Finance and Taxation

Recent House of Commons Library Research Papers:

97/20	Building Societies	10.02.97
97/21	The Police Bill [Bill 88 of 1996/97]: National Policing Structures	11.02.97
97/22	The Police Bill [Bill 88 of 1996-97]: Intrusive Surveillance	11.02.97
97/23	Police Bill [HL] [Bill 88 of 1996/97]: Access to Criminal Records	10.02.97
97/24	Unemployment by Constituency - January 1997	12.02.97
97/25	Late Payment of Commercial Debt	12.02.97
97/26	Voting Systems - The Alternatives	13.02.97
97/27	Update on BSE and CJD	14.02.97
97/28	House of Lords 'Reform': Recent Proposals	17.02.97
97/29	EMU: the convergence criteria	25.02.97
97/30	Economic Indicators	01.03.97
97/31	VAT Harmonisation	27.02.97
97/32	By-elections since the 1992 general election	03.03.97
97/33	The National Air Quality Strategy	28.02.97