EXPLANATORY MEMORANDUM TO

THE BUILDING SOCIETIES (ACCOUNTS AND RELATED PROVISIONS) (AMENDMENT) REGULATIONS 2007

2007 No. 859

1. This explanatory memorandum has been prepared by Her Majesty's Treasury ("HMT") and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 These Regulations amend the Building Societies (Accounts and Related Provisions) Regulations 1998 (S.I. 1998/504) ("the principal Regulations) to specify the format and contents of summary financial statements ("SFS") for societies that prepare their accounts according to international accounting standards ("IAS"). They also amend the required contents of the directors' report ("DR") and annual business statement ("ABS") for those societies.

2.2 These Regulations substitute a new definition of "EEA State" in the principal Regulations.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Legislative Background

4.1 The Building Societies Act 1986 ("BS Act 1986") is the primary legal framework for building societies in the United Kingdom. That Act was amended by the Building Societies Act 1997 and by and under the Financial Services and Markets Act 2000. The principal Regulations, made under the BS Act 1986, specify the required format and contents of the SFS, DR and ABS for all building societies.

4.2 In accordance with EC Regulation 1606/2002[1] from 1 January 2005 all listed companies in the UK have to prepare their consolidated accounts based on IAS rather than UK accounting standards (UK GAAP). This means that building societies that issue listed securities such as permanent interest bearing shares are therefore required to use IAS.

4.3 The format and contents of the SFS, DR and ABS specified in the principal Regulations are not suitable for societies that use IAS. These Regulations make appropriate amendments to the principal Regulations to cater for those societies.

4.4 The existing definition of "EEA State" in Schedule 11 to the principal Regulations (interpretation of Schedules) excludes Bulgaria and Romania, which became Community member States on 1st January 2007. The amendment ensures consistency

[1] Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards.

with the definition of "EEA State" in the Financial Services and Markets Act 2000 and other financial services legislation, which was substituted by the Financial Services (EEA State) Regulations 2007 (S.I. 2007/108).

5. Territorial Extent and Application

5.1 These Regulations apply to all of the United Kingdom.

6. European Convention on Human Rights

6.1 As the Regulations are subject to negative resolution procedure and do not amend primary legislation, no statement is required.

7. Policy background

7.1 Building societies are organisations**,** owned by their members, which pay interest on deposits and lend money on the security of property to enable members to buy their own homes. There are 60 building societies in the UK with total assets of over £305 billion. About 15 million adults have building society savings accounts and over 2¾ million adults are currently buying their own homes with the help of building society loans.

7.2 Building societies have diversified in recent years and a number now offer, among other services, current accounts, credit cards, cash machines, travel money, unsecured loans, various types of insurance and estate agency services. The Building Societies Association is the trade association for all the UK's building societies and they are registered and regulated by the Financial Services Authority ("FSA").

7.3 The changes will make all the summary financial statements of societies, which prepare accounts in accordance with IAS more transparent, harmonised and consistent with similar requirements for companies. They will also make it easier for consumers to make comparisons between societies.

7.4 The UK Accounting Standards Board intends to achieve convergence between IAS and UK GAAP in the near future. This means that making these changes now is useful to societies and will ensure consistency and comparability between societies' summary financial statements, directors' reports and annual business statements.

Consultation

7.5 HMT held a 12-week public consultation from 9 November 2006 to 1 February 2007. Over 300 copies of the consultation documents were issued to stakeholders in the UK and a copy posted on the HMT public website. There were 28 responses 27 of which supported this proposal for HMT to introduce legislation to facilitate the preparation of summary financial statements, directors' reports and annual business statements by building societies as described.

7.6 As part of the consultation HMT informed and discussed with other Government departments and agencies including the Department of Trade & Industry, Small Business Service, Companies House, and Office of Fair Trading. HMT also consulted with the FSA and informed the Scottish Executive, Welsh and Northern Ireland Assemblies.

7.7 A summary of the consultation responses is available on the HM Treasury public website at www.hm-treasury.gov.uk

8. Impact

8.1 A Regulatory Impact Assessment is attached to this explanatory memorandum and will be available on the HMT public website alongside a copy of the consultation document and summary of responses.

9. Contact

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FINAL RIA ON MINOR LEGISLATIVE CHANGES TO THE BUILDING SOCIETIES ACT 1986

1.PROPOSAL

a) This is a revised version of the partial regulatory impact assessment (RIA) that went out during the public consultation on building societies legislation held from 9 November 2006 to 1 February 2007.

2. PURPOSE AND INTENDED EFFECT OF MEASURES

Objective

b) Building societies in the United Kingdom (UK) are governed by the Building Societies Act 1986 ("BS Act 1986") and are regulated by the Financial Services Authority ("FSA"). The BS Act 1986 was substantively revised by the Building Societies Act 1997 and by and under the Financial Services and Markets Act 2000 ("FSMA 2000"). The purpose of the proposed measures is to ensure that the legislation remains relevant to the needs of societies.

c) Two key areas were identified as requiring attention. These were in relation to the treatment of building societies' offshore deposits, the content of building societies summary financial statements (SFS), directors' reports (DR), annual business statements (ABS) and certain financial amounts specified in the Building Societies Act 1986.

Devolution

d) HM Treasury (HMT) has the power to make statutory instruments (Orders, Regulations etc) which, subject to Parliamentary approval, amend or change the effect of aspects of the BS Act 1986 and legislation made under that Act. The BS Act 1986 extends to the whole of the UK so the proposed changes to that Act will have effect for the whole of the UK.

Background

e) There are 60 building societies in the UK with total assets of over £305 billion. About 15 million adults have building society savings accounts and over 2¾ million adults are currently buying their own homes with the help of building society loans. Building societies have diversified in recent years and a number now offer, among other services, current accounts, credit cards, cash machines, travel money, unsecured loans, various types of insurance and estate agency services.

f) The Building Societies Association (BSA) is the trade association for **all** the UK's building societies. Following discussions between the BSA and HMT it was decided that there was a case for consulting with stakeholders with a view to making certain changes to aspects of the BS Act 1986.

g) The changes sought to remove anomalies and update the existing legislation, and to better align it with companies legislation where appropriate. The proposed changes are consistent with the Government's better regulation agenda, cutting burdens on building societies and facilitating accurate communication between building societies and their members.

h) The two main inconsistencies in the legislation that the proposals focussed on were in relation to:

- offshore deposits; and

- the requirements concerning contents of summary financial statements, directors' reports and annual business statements; and certain financial amounts specified in the BS Act 1986.

OFFSHORE DEPOSITS

i) Building societies are constrained in their business operations by the statutory requirement that they:

- raise at least 50% of their funds in the form of shares held by individual members of their society; and
- have at least 75% of their lending secured on residential properties.

j) The funding limit is set out in section 7 of the BS Act 1986. The limit is designed to ensure that the amount and sources of funds raised by building societies is consistent with the principles that building societies' principal purpose is making loans, which are secured on residential property, and that building societies are funded substantially from their members.

k) Currently, deposits made by individuals with a building society's offshore subsidiaries are treated as wholesale funding[2] in measuring compliance with the funding limits. This is anomalous since such funding has more in common with retail funding[3]. It is proposed therefore that such deposits be excluded from the funding limit calculations, although the value of the excluded deposits must not exceed 10% of the value of individuals' shares in the building society in the UK.

l) Taking this step would relieve pressure on societies who are close to their funding limits. It would enable societies to raise a greater amount of generally cheaper wholesale funding and would facilitate the provision of cheaper and better products for the societies' members.

SUMMARY FINANCIAL STATEMENTS, DIRECTORS' REPORTS AND ANNUAL BUSINESS STATEMENTS

m) All UK building societies are currently required to provide summary financial statements (which include information derived from the directors' report and the annual business statement) to their members by the BS Act 1986. As from 1 January 2005 all listed companies in the UK and the rest of the EU are required to prepare their accounts based on international accounting standards ("IAS"). Building societies that issue listed securities such as permanent interest bearing shares (PIBS) are therefore r

n) All other UK building societies are allowed to continue using UK Generally Accepted Accounting Principles ("UK GAAP") but it is the UK Accounting Standards Board's intention to achieve convergence between IAS and UK GAAP. This will mean that any changes to the building societies legislation at this stage for building societies that prepare accounts in accordance with IAS will be useful in the future for all building societies. The proposed changes will make the summary financial statements of societies, which prepare accounts in accordance with IAS more transparent, harmonised and

[2] The FSA describes Wholesale funding as: credit institutions (as defined in Article 1 of Directive 2000/12/EC); supranational institutions, national governments and central administrative authorities; large corporates, defined for this purpose as: companies which have called up share capital of £10mn or which meet at least one of the following criteria; balance sheet, total above £100mn, net turnover above £15mn and more than 250 employees.

[3] For building societies retail funding means deposits received from their members, who are individuals.

consistent with similar requirements for companies. It will also make it easier for the consumer to make comparisons between societies.

The proposed changes will also update the definition of "EEA State" in building society accounts regulations. This is a technical change resulting from the accession of Bulgaria and Romania into the EU on 1st January 2007, and will bring the regulations into line with other financial services legislation. Although it was not included in the draft SI contained in the consultation document, it is expected to have little, if any practical effect on the sector.

FINANCIAL AMOUNTS SPECIFIED IN THE BUILDING SOCIETIES ACT 1986

o) A number of thresholds of the financial limits for building societies under the BS Act 1986 were last reviewed in 1999. Updating the limits will allow us to adjust them to reflect current commercial realities and to make them comparable with Companies Act equivalents.

p) Examples of the proposed changes are limits of director's shareholdings, restrictions on loans to directors and restrictions on certain transactions by societies. A full list of the proposed changes was included in the consultation document for stakeholders to review and comment upon.

Rationale for Government Intervention

q) The consultation is consistent with the government's aim to engage with industry and the public in order to modernise legislation affecting UK businesses. The consultation with stakeholders will ensure that the burdens on businesses are reduced. Although one of the changes suggested (namely the contents of the summary financial statements, directors' reports and annual business statements) could be introduced by the BSA offering guidance to its members the Government view was that it would be in the wider interest of consumers, the industry and the economy as a whole if this was introduced by legislation.

3. CONSULTATION

r) The consultation sought stakeholders' views and proposed changes to redefine how deposits from a building society's offshore subsidiaries should be treated in calculating a society's funding limits. It also sought views on changing the detail of the requirements for the contents of the summary financial statements, directors' reports and annual business statements for societies that prepare accounts in accordance with International Accounting Standards. Finally, it made certain proposals for updating certain financial limits and thresholds for societies in line with inflation to make them comparable with Companies Act equivalents.

Within Government

s) HMT has consulted with the FSA and informed the Scottish Executive, Welsh and Northern Ireland Assemblies. The Department of Trade and Industry (DTI), Small Business Service, Companies House, and Office of Fair Trading have similarly been advised.

Public Consultation

t) HMT has had regular bilateral meetings with the BSA. Consultation documents were sent to the BSA, all building societies in the UK, academicians as well as interested stakeholders in the financial services sector. The consultation document was also posted on the HMT public website and printed copies were made available upon request.

4. OPTIONS

u) We considered 3 options for the proposed policy. The first evaluated the implications of not doing anything. The second proposed a consultation with stakeholders in respect of offshore deposits, summary financial statements, directors' reports and annual business statements. The third involved a more detailed review of the legislation involving stakeholders and enquired as to what they considered to be their main priorities for legislative action with a view to a comprehensive overhaul of the BS Act 1986.

OPTION 1: Do Nothing

v) We did not consider this option helpful. It would only defer the issues for consideration at a future date. Societies who are near their funding limit would find it costly to raise funds if we failed to exclude offshore deposits from the funding limit calculations. With regards to summary financial statements, directors' reports and annual business statements we considered that doing nothing would confuse the public and sector alike. Consumers would not be able to make like-with-like comparisons between societies' summary financial statements. It was likely that some societies who prepared accounts in accordance with IAS could fail to disclose volatile transactions such as derivatives since that was not required within the current framework for their summary financial statements. Furthermore leaving the financial limits and thresholds for societies unchanged would mean that these would lag behind inflation and put societies at a disadvantage compared with companies.

OPTION 2: Updating the Building Societies Act and amending the secondary legislation

w) Option 2 appeared the most practical. These are issues suggested by the BSA as requiring urgent attention and generally representative of their members' views. It would also fit in with the legislative timetable and building societies financial year ends so that societies that prepare accounts in accordance with IAS could have the benefit of the revised format of the summary financial statements as soon as practicable.

x) The proposals will benefit the members of societies by ensuring that that they receive accurate and easily comparable information from the Summary Financial Statements. The amendment of the funding limit calculations, to take account of the retail nature of offshore deposits, will enable societies to have greater access to wholesale funding, which will assist in keeping mortgages at a competitive level. The adjustment of the financial limits maintains the specified limits at the levels provided for at the time the legislation was made, allowing for inflation, so the effect will be neutral.

OPTION 3: Review of the Entire Act

y) Option 3 would not be helpful and would not be an efficient use of resources. Asking stakeholders for a wish list would not in our opinion have been a pragmatic solution and would not resolve current problems.

5. COSTS AND BENEFITS

Sectors and groups affected

z) These proposals will potentially benefit the building societies sector as a whole. It will remove burdens and enable building societies to access cheaper sources of funding leading to cheaper mortgages for the consumers.

Analysis of costs and benefits

aa) We do not envisage that societies will incur any costs as a result of these proposals. The practical impact of the proposed change to the basis of calculating the funding limit will be to allow a greater proportion of wholesale funding to be raised by building societies with offshore deposit-taking subsidiaries. This will enable such societies, which account for around 75% of the sector in terms of total assets to offer cheaper mortgages to their members when wholesale funds are available at lower rates than retail funds.

bb) Building societies have different funding strategies and, at any time, individual societies will wish to raise different proportions of funds from the wholesale markets. Section 7 of the BS Act 1986 will continue to restrict the amount of wholesale funds raised by building societies, and the volume of deposits by individuals with offshore deposit-taking subsidiaries. However, based on recent interest rate differentials, individual societies may be able to raise funds from the wholesale markets that are 0.1%, 0.2% and up to 0.25% cheaper than raising funds from individuals.

cc) Because of their different funding strategies however it is still conceivable for some societies to be in situations where new wholesale funding may in fact be more expensive than both new member funding and offshore deposits. Bearing this in mind and the unlikelihood of all the societies that might benefit moving to increase their wholesale funding levels quickly, it would not be sensible to relate potential interest rate differentials explicitly to the total amount of current offshore subsidiary funds - of approx £6 billion - and describe the resulting amounts below as incontrovertible benefits.

dd) Based on conservative estimates however the annual interest saved at a 0.1% lower interest rate on £6 billion would be £6 million and the annual interest saved at a 0.2% lower interest rate on £6 billion would be £12 million etc. The consultation sought stakeholders' views on these anticipated benefits and any costs. We considered that this would give a more accurate picture since it would be based on information supplied directly by the various societies.

6. SMALL FIRMS IMPACT TEST

ee) We do not expect the proposed changes to have a major impact on small firms.

7. COMPETITION ASSESSMENT

ff) We performed a simple competition assessment of the building societies sector. There are at present 60 societies in the UK. The largest ten societies, ranked in order of group assets are Nationwide, Britannia, Portman, Yorkshire, Coventry, Chelsea, Skipton, West Bromwich, Leeds and Derbyshire. Of these 10 societies 6 of these have offshore subsidiaries. Excluding offshore deposits from the funding limit calculations is not expected to alter the sector dynamics, as it will offer a level playing field for all the others. This proposal should therefore not have any competition implications.

8. ENFORCEMENT, SANCTIONS AND MONITORING

gg) The FSA in its role as Regulator has extensive powers of enforcement, sanctions, monitoring and control to ensure that building societies comply with the principal purpose requirement, lending limit or the funding limit and to act where they fail.

hh) These powers include a direction by the FSA for the society to submit for approval a restructuring plan to bring it within the relevant statutory requirements, a prohibition

order where a society has failed to carry out a restructuring plan, a direction to the society to consider transferring their engagements to another building society or transferring its business to an existing company and to present a petition for the winding up of the society.

9. COMPENSATORY SIMPLIFICATION MEASURE

ii) As part of the drive to create a better balance between the creation of new measures and reducing existing requirements on businesses, Cabinet Office guidance requires departments to look for opportunities to simplify or remove existing requirements when introducing new legislation. The proposed changes have a cumulative effect in reducing the burdens on building societies and will help to make them more competitive.

10. IMPLEMENTATION AND DELIVERY PLAN

A. 36 A key success criteria for this legislative proposal is the timely laying of the legislation before Parliament and the absence of technical or legal drafting errors. HMT is aiming to lay the legislation before Parliament to ensure it comes into effect by 6 April 2007. The BSA will issue guidance on the legislative changes to its members and make this available on their corporate website.

11. POST-IMPLEMENTATION REVIEW

A.37 HMT will liaise with BSA to conduct a post implementation review in two year's time to assess how well the arrangements that were put in place meet the policy objectives as well as any unintended effects. We will also consider any required changes to te legislation in the light of emerging issues.

12. CONFIDENTIALITY DISCLOSURES

A.38 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily) the Freedom of Information Act 2000 (FOIA), the Data Protection Act (DPA) and the Environmental Information Regulations 2004. We cannot give an assurance that confidentiality will be maintained in all circumstances.

A.39 An automatic confidentiality disclaimer generated by respondents' IT system will not, of itself, be regarded as binding on the Department. The Department will process personal data contained in the consultation responses in accordance with the DPA, and in the majority of circumstances, this will mean that personal data will not be disclosed to third parties.

13. SUMMARY AND RECOMMENDATION

A.40 The summary of preliminary costs and benefits in paragraphs 27 to 30 are merely indicative. The only discernible costs would be the one-off administrative cost of setting up accounting systems to facilitate the preparation of SFS, DR and ABS by building

societies. However this will be offset by the greater transparency and comparability it will offer to members.

A.41 As explained earlier the expected benefits would differ from one society to another based on their funding strategies. However the overall view is that the proposed measures in relation to funding limits will result in greater access to cheaper wholesale funding and annual interest savings. It is expected that this will deliver cheaper mortgages and more competitive savings products for members. In addition raising the financial limit/ thresholds and updating the existing building societies legislation would make societies better aligned with companies.

A. 43 On the basis of the available evidence and the unanimous consultation responses the Government recommends Option 2- Updating the Building Societies Act and amending the secondary legislation. Neither the Government nor respondents considered the other two options viable. Option 1 (Doing nothing) would merely defer the issues for consideration at a future date as well as put a strain on societies that were near their funding limits whilst Option 3 (Review of the entire Act) would be unnecessary and costly.

A. 44. The proposed changes will strengthen the building societies sector. It will make them more competitive as well as deliver cheaper mortgages, better quality services and greater transparency to customers.

A. 45 I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Ed Balls, Economic Secretary

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