



# Interim Prudential sourcebook: Building Societies

Financial Services Authority

*Final Rules – Building Societies*  
*Volume 1 of 2*

**Part of:**

The Interim Prudential  
Sourcebook for  
Building Societies

June 2001

# **IPSB FOR BUILDING SOCIETIES**

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# Interim Prudential Sourcebook for Building Societies

## X. Introductory Chapter

### X.1 Introduction

X.1.1 G The rules in this sourcebook are made under section 138 of the Financial Services and Markets Act 2000 (“the Act”) and that section and sections 149 and 156 are specified for the purposes of section 153. The guidance in volume 2 of this sourcebook is given under section 157(1)(b) of the Act.

X.1.2 G From 31 December 2004 as part of the programme to implement the Integrated Prudential sourcebook (PRU), rules and guidance on elements of liquidity risk systems and controls located in PRU 1.2 and PRU 5.1, come into effect, and supersede some original material in this sourcebook.

### X.2 Application

**X.2.1 R The Interim Prudential Sourcebook for building societies applies to all firms with permission from the Financial Services Authority to take deposits which are also building societies as defined in the Building Societies Act 1986 and, in this sourcebook, “society” and “societies” are construed accordingly.**

### X.3 Content of this sourcebook

X.3.1 G This sourcebook is divided into two volumes. Volume 1 contains eleven prudential chapters which set out the Financial Services Authority’s prudential standards for societies. Three of the prudential chapters incorporate material drawn from the Interim Prudential Sourcebook for banks and guidance on the presentational style of the bank material can be found in section 4 of chapter GN of that sourcebook. Volume 2 contains five chapters of constitutional guidance: the Financial Services Authority (the “FSA”) inherits

from the Building Societies Commission (“the Commission”) a range of functions under the Building Societies Act 1986 (“the 1986 Act”) related to the constitutional aspects of building societies and these chapters give guidance on how the FSA will exercise certain of these functions. The constitutional chapters replace Guidance Notes previously issued by the Commission. In addition, the role of the competent authority for listing in the UK has been transferred to the FSA from the United Kingdom Listing Authority (“UKLA”). This change has been reflected in amendments to the Volume 2 guidance.

## **X.4 The Purpose of the Interim Prudential Sourcebook for Building Societies**

X.4.1 G The Interim Prudential Sourcebook for building societies sets out most of the FSA’s detailed prudential standards and related notification requirements (where these apply only to societies authorised under the Act) and covers the constitutional matters referred to above. Other prudential standards applying to societies are set out in the Act and elsewhere in the Handbook: see, for example, the Threshold Conditions (COND), the Principles for Businesses (PRIN), Senior Management Arrangements, Systems and Controls (SYSC) and the Integrated Prudential Sourcebook (PRU). Other notification requirements are set out in chapter 15 of the Supervision Manual (SUP).

X.4.2 G This sourcebook, together with the separate prudential sourcebook applying to banks, also implements EC directives setting out prudential standards as they apply to credit institutions.

X.4.3 G The rules and evidential provisions are distributed throughout the prudential chapters of this sourcebook: rules can be found in paragraphs X.2.1, X.8.2, 1.2.1, 1.2.2, 4.2.1, 4.2.5, 4.2.6, 5.2.7, 6.2.1, 6.2.2, 6.2.3, 7.6.2, 7.6.3, 7.7.1, 7.7.3, 8.2.1, 9.2.1, 9.2.7 and 9.2.8. Evidential provisions can be found in paragraphs 5.2.4, 9.2.3 and 9.2.5.

X.4.4 G The approach outlined in X.4.3 has been adopted, after consultation, as appropriate for material drawn from the previous standards of the Commission that will apply on an interim basis only. It is the FSA’s intention in developing its final prudential standards (in the Integrated Prudential Sourcebook) to make further use of its rule-making powers to express its detailed prudential standards.

X.4.5 G This sourcebook also sets out both rules and guidance on the information related to prudential standards which societies should notify to the FSA. The FSA needs to be provided with certain information by societies if it is to monitor compliance with its requirements. The rules and guidance in this sourcebook supplement, for societies, the FSA's general notification requirements set out in the Supervision Manual (see SUP 15). In addition to the rules, the following paragraphs contain guidance on matters about which the FSA expects to be notified: 1.5.2, 1.6.4(1), 1.11.1, 1A4.2, 2.9.1, 4.5.8, 7.6.4 and 7.6.5.

X.4.6 G In addition to the rules and guidance applying to societies under the Act, directors and certain staff of all firms are subject to obligations referred to as the Statements of Principle for Approved Persons. The FSA has issued a Code of Conduct to help determine whether an Approved Person's conduct has complied with a Statement of Principle. The Statements and the Code of Conduct are set out in APER. A society's failure to meet the prudential standards set out in this sourcebook may also be relevant to the FSA's assessment of whether a particular Approved Person has complied with a Statement of Principle.

## **X.5 Principal Purpose of a building society and funding and lending limits**

X.5.1 G Building societies are bound by sections of the 1986 Act which place limitations on certain aspects of their business (particularly sections 5, 6 and 7). The following paragraphs provide guidance on compliance with those sections and the FSA's powers in relation thereto, replacing guidance previously included in the Commission's Statement of Principles.

X.5.2 G A building society may only be, and continue to be, incorporated under the 1986 Act if its principal office is in the United Kingdom and if it complies with the purpose or principal purpose (section 5(1) of the 1986 Act) of all building societies, namely:

*“... that of making loans which are secured on residential property and are funded substantially by its members ...”*

This criterion lies at the heart of what it is to be a building society and sets down its defining characteristics. A failure, or projected failure, to comply with the criterion may therefore cast doubt on the society's longer-term commitment to remain as a building society.

X.5.3 G The lending (section 6) and funding (section 7) limits, commonly known as the "nature limits", are quantitative criteria which help to determine an individual society's compliance with the purpose or principal purpose.

X.5.4 G Compliance with the statutory purpose is not, however, limited to compliance with limits on the composition of the society's assets and liabilities. Societies are involved in activities or provide services which do not of themselves create significant balance sheet assets or liabilities. Such business may still have an impact on a society's compliance with the statutory purpose because of the actual or projected proportion of the society's business made up of those activities.

X.5.5 G In assessing whether a society is complying with the statutory purpose, the FSA will adopt a broadly-based judgement taking all relevant factors, both quantitative and qualitative, into account. As part of that overall assessment, there are two main quantitative indicators. First, the actual and projected proportion of the society's gross income that is, or is intended to be, derived from activities or services that have little or no connection with the making of loans secured on residential property (income from car insurance would, for example be considered unconnected business but income from mortgage and property related insurance and valuation services would, for example, be considered connected with core lending business). Second, it would take into account the actual and projected proportion of the society's resources (for example, financial assets, capital, senior management and staff) that are, or are intended to be, applied to those other activities or services.

X.5.6 G The FSA expects societies to draw up their corporate and other business plans so as to provide reasonable assurance that they will comply with the statutory purpose and the nature limits. The FSA inherits the Commission's enforcement powers (in sections 36, 36A and 37 of the 1986 Act) in relation to breach of statutory purpose or nature limits.

## **X.6 The continuing 1986 Act**



X.6.1 G Before N2, the main piece of legislation governing building societies and their activities has been the Building Societies Act 1986, as amended, in particular by the Building Societies Act 1997. The 1986 Act fulfilled a number of roles. It established the Commission as the prudential supervisor for societies and gave the Commission certain prudential powers of control, but it also, for example, set out the principal features of a building society and made provision for societies' internal constitutional arrangements and procedures for mergers and transfers of business. Although nearly all of those sections of the 1986 Act which related to prudential supervision have been repealed by or under the Act, a substantial part of the 1986 Act remains in force. For example, all references to the Commission have been removed and any remaining powers of control pass to the FSA (the Commission's powers to make secondary legislation under the remainder of the 1986 Act pass to the Treasury). The constitutional parts of the 1986 Act, however, remain, e.g. principal purpose and nature limits, the obligation to prepare annual accounts, provisions on societies' rules and general governance, membership, meeting and voting arrangements and procedures for mergers and transfers.

### **Modification of the 1986 Act by the Electronic Communications Order 2003**

X.6.2.1G The Building Societies Act 1986 (Electronic Communications) Order 2003 (SI 2003 No: 404) came into force on 20 March 2003. This Order modifies the 1986 Act and enables building societies, if they wish, to communicate electronically with their members on constitutional matters, including those of the type covered in volume 2 of this sourcebook. The Order amends sections 60, 61, 66A, 68, 69, 76, 81, 92A, 115 and 119, together with schedules 2, 8A, 11, 16 and 17 to the 1986 Act.

X.6.2.2G The Order clarifies the conditions a society must satisfy if it uses electronic communications to comply with requirements to notify members and other persons in relation to constitutional matters. It covers regular communication concerning the business to be transacted at annual general meetings, such as the provision of financial statements, notices of meeting, and arrangements for proxy voting or ballots. The Order also covers communications on occasional matters, such as special meetings, mergers and transfers of

business. In all cases the consent of the member or other person to the means of communication must be obtained.

X.6.2.3G The Order does not amend the 1986 Act provisions under which societies submit certain returns that are placed on their public file. Nor does it affect those supervisory financial returns required under rules in SUP that are currently submitted electronically.

## X.7 Frequently Used terms

X.7.1 G The following terms are used frequently in the sourcebook and have the meaning described here:

PN	a Prudential Note issued by the Building Societies Commission
section 9A	section 9A of the Building Societies Act 1986, as amended
the Accounts Regulations	the Building Societies (Accounts & Related Provisions) Regulations 1998 (SI 1998/504) as amended
the Act	the Financial Services and Markets Act 2000
the BCD	Directive 2000/12/EC of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions (the “Banking Consolidation Directive”). This directive consolidated most of the EC directives relating to credit institutions into one text. The directives so consolidated include the Own Funds Directive (89/299/EEC), the Solvency Ratio Directive (89/647/EEC), the Large Exposures Directive (92/121/EEC), the 1 <sup>st</sup> and 2 <sup>nd</sup> Banking Co-ordination Directives (respectively 77/780/EEC and 89/646/EEC) and the 2 <sup>nd</sup> Consolidated Supervision Directive (92/30/EEC).
Credit institution	An undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account or an electronic money institution within the meaning

of article 1(3)(a) of Directive 2000/46/EC (the E-Money Directive) that has the right to benefit from the mutual recognition arrangements under the BCD.

the central office                      the department of the FSA carrying out the registration functions transferred from the central office of the Registry of Friendly Societies

the Commission                      the Building Societies Commission

the Electronic Communications Order 2003                      The Building Societies Act 1986 (Electronic Communications) Order 2003 (SI 2003 No. 404). The Electronic Communications Act 2000 generally permits electronic communications as an effective alternative to paper based methods, with the consent of the parties (except where any relevant legislation shows a clear contrary intention). This Act also permits other primary legislation to be amended so as to facilitate electronic communication, and this Order has been made by the Treasury in exercise of that power. The Order came into force on 20 March 2003. More details are given at paragraphs X 6.2 to X.6.2.3

the FSA                      the Financial Services Authority

the 1986 Act                      the Building Societies Act 1986, as amended in particular by the Building Societies Act 1997 and by and under the Financial Services and Markets Act 2000

the 1997 Act    the Building Societies Act 1997

X.7.2G              Expressions (in italics or not) which are defined in particular chapters of the sourcebook (e.g. Chapters 2 and 3 of Volume 2) have the meanings given there for those chapters (and see GEN 2.2.10G).

X.7.3G              Unless the context otherwise requires or GEN 2.2.11R applies, an expression which has not been defined in this sourcebook has its natural meaning.

## **X.8 Schedule of Transitional Provisions**

X.8.1 G A number of rules in this Sourcebook require societies to provide copies of policy statements covering various aspects of their business and their corporate plan to the FSA. These rules replace similar prudential requirements previously imposed by the Commission.

**X.8.2 R A society which, before the date of the coming into force of this rule, had provided to the Commission a copy of its current policy statement on each of financial risk management, liquidity, and lending and a copy of its current corporate plan is taken to be in compliance, at that date, with any obligation to submit to the FSA such document contained in, respectively, rules 4.2.5, 5.2.7, 6.2.2, and 9.2.7.**

X.8.3 G X.4.5 refers to particular paragraphs in this Sourcebook which contain guidance on matters about which the FSA expects to be notified or in respect of which it expects to receive certain documents. These matters were previously required to be communicated to the Commission and in some cases (where the communication related to a past event, a proposed change in a society's approach or a situation which is ongoing) notification or documents may already have been given to the Commission before the date on which the guidance set out in this Sourcebook comes into effect. The relevant guidance for these purposes is set out in paragraphs 1.5.2, 1.6.4(1), 1.11.1, 1A.4.2, 2.9.1, 4.5.8, 7.6.4 and 7.6.5. Any society which, before that date, had notified the Commission, or provided documents to the Commission, about a matter referred to in any of those paragraphs, in compliance with the Commission's guidance, is taken to be in compliance, at that date, with the relevant paragraph in this Sourcebook in so far as it relates to the matter in respect of which notification or documents had been received by the Commission.

X 8.4 G In addition , GEN contains some technical transitional provisions that apply throughout the Handbook and which are designed to ensure a smooth transition at commencement ( that is ,when section 19 of the Act ( the general prohibition ) comes in to force ) . The Supervision manual ( SUP ) contains transitional provisions which carry forward written concessions relating to pre-commencement provisions.

# Interim Prudential Sourcebook for Building Societies

## 1 SOLVENCY

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# Interim Prudential Sourcebook for Building Societies

## 1 Solvency

### 1.1 Introduction

1.1.1 G This chapter replaces PN 1998/1 issued by the Commission. It includes rules and guidance for societies on the Threshold Condition in Schedule 6 paragraph 4(1) of the Act (the resources of a firm must, in the opinion of the FSA , be adequate in relation to the regulated activities it seeks to carry on ) – see also COND 2.4 - and on Principle 4 ("a firm must maintain adequate financial resources " ). It describes the purpose of capital in a deposit-taking institution and the particular risks faced by building societies. It describes how societies should calculate their solvency ratio for capital adequacy purposes, what funds are eligible for inclusion in own funds and the FSA's methodology for setting Threshold Ratios. It should be read in conjunction with Chapter 2.

1.1.2 G This chapter further explains that the FSA will set each society a Threshold Ratio based on the FSA's assessment of a society's risk profile. Societies are expected to meet their Threshold Ratio at all times on both a consolidated and society only basis. The setting of a Threshold Ratio by the FSA does not absolve the society's board from maintaining such higher capital ratio as it considers prudent for the maintenance and management of the society's business and its future plans.

1.1.3 G Finally this chapter explains how the capital adequacy requirement should be calculated and sets out the FSA's methodology for setting threshold ratios.

### 1.2 Rules

**1.2.1 R A society must maintain adequate capital resources commensurate with the nature and scale of its business and the risks inherent in its business. Where a society has subsidiary undertakings it must also maintain capital resources commensurate with the scale and nature of the activities of the whole group.**

**1.2.2 R A society must maintain own funds of at least £1m.**

## **1.3 The Purpose of Capital**

1.3.1 G The capital of a body corporate is the amount by which the value of its assets exceed its non-capital liabilities. A deposit taking institution needs sufficient capital:

- (1) to maintain itself as a viable going concern, able to overcome either expected or unexpected difficulties (including both squeezes on margins and losses on assets), to exploit opportunities and to sustain its infrastructure;
- (2) to secure, in conjunction with liquidity, its ability to repay deposits (and in a building society, shares) whenever that may be required; and
- (3) to maintain public confidence that the institution will be able to repay such deposits (and shares) in full.

## **1.4 EU Directives**

1.4.1 G The EU has harmonised capital adequacy requirements for credit institutions in the EU by the following principal directives:

- (1) Council Directive of 17 April 1989 on the Own Funds of Credit Institutions (89/299/EEC);
- (2) Council Directive of 18 December 1989 on a Solvency Ratio for Credit Institutions (89/647/EEC).

1.4.2 G In March 2000, these directives, along with the Large Exposures Directive, the 1<sup>st</sup> and 2<sup>nd</sup> Banking Co-ordination Directives and the 2<sup>nd</sup> Consolidated Supervision Directive, were consolidated into a single Directive, known as the Banking Consolidation Directive (2000/12/EC). Elsewhere in this sourcebook, references will be to the consolidated directive (“BCD”).

1.4.3 G A further directive, 93/6/EEC on the capital adequacy of investment firms and credit institutions (the "CAD", not included in the BCD), sets out the capital requirements for credit institutions which have trading books and foreign exchange exposures. Building societies which are on the "Trading Book" approach to Treasury management may engage in those activities (see section 1.18).

1.4.4 G The BCD requires national authorities to ensure that all credit institutions maintain sufficient capital resources in relation to their business to ensure a minimum solvency ratio of 8%. The BCD specifies the types of capital resources whose inclusion is permitted in the calculation of the solvency ratio: those resources are known, collectively, as "own funds". It also sets out the calculation of the solvency ratio as follows:

$$\text{solvency ratio} = \frac{100 \times \Sigma \text{ own funds}}{\Sigma(\text{risk weighted assets} + \text{off balance sheet items})} \geq 8\%$$

i.e. the solvency ratio equals own funds divided by the sum of risk weighted assets and off balance sheet items, expressed as a percentage and should be 8% or more.

1.4.5 G The BCD specifies the minimum risk weights which should be applied to assets in the balance sheet and the "credit conversion factors" to be applied to off balance sheet items, in order to calculate the denominator of the solvency ratio.

1.4.6 G The BCD also requires the FSA to carry out consolidated supervision of building society groups. The EU provisions for consolidated supervision have been supplemented by the Financial Groups Directive (2002/87/EC). Where a building society group includes an entity active in the insurance sector, while the group's main business lies in the deposit-taking sector, it may possibly constitute a "financial conglomerate" ( though the FSA expects this will be rare, at least in the near future ). The exact definitions and criteria as to what constitutes a "financial conglomerate" and the additional rules and guidance that apply to them, are set out in the Integrated Prudential Sourcebook (PRU) at PRU 8.4. If (but only if) a building society is, or becomes , a financial conglomerate, it will be subject to these additional rules and guidance , as well as to the rules and guidance in this IPRU (BSOC). Moreover, all building societies that are part of a group are subject to the general provisions in PRU 8.1.



## **1.5 Threshold Ratios**

1.5.1 G Each society has been informed of the Threshold Ratio it is expected to maintain. This has been set by the FSA taking account of the nature and inherent risks of that society's business in areas which are not covered or not sufficiently covered by application of risk weighting. The Threshold Ratio should be maintained on both a society only basis and on a group basis reflecting the fact that the subsidiaries are separate legal entities and that the society cannot rely on having access to their capital at all times. In certain circumstances solo consolidation may be agreed; this is further explained in section 1.11. Paragraph 1.5.3 explains the FSA's approach to setting threshold ratios for societies. In every case the FSA has provided against a society inadvertently breaching the EC 8% minimum. The setting of a Threshold Ratio by the FSA does not absolve boards of societies from the responsibility of maintaining such higher ratios as they consider appropriate for their business and future plans.

1.5.2 G There is no prescribed amount by which the FSA expects a society's capital to exceed that required to meet the threshold but it is the responsibility of the society to plan so it has sufficient capital at all times to avoid breaching its Threshold Ratio. The Board should therefore set and monitor a capital margin above both the society only and the group threshold ratios which management will be expected to observe at all times; societies' systems should be able to demonstrate that this is the case. The FSA should be advised of the margin set and any changes thereto. Subject to the foregoing, the FSA does not object to societies reducing solvency ratios, for example, by repaying excess capital to their members, but it will want to be satisfied that any such reduction is planned and capable of being reversed without undue adverse affect should changes in the economic position of the society or in its risk profile so dictate. Any society that falls below its margin and/or is in danger of breaching its Threshold Ratio should advise the FSA immediately, stating how it proposes to remedy the situation. The projected solvency ratio should feature in all operational and strategic plans and any proposal for a new business venture should take into account any impact on the society's solvency ratio.

1.5.3 G A society's threshold ratio reflects the FSA's assessment of the society's risk profile. The seven factors which go into establishing the threshold ratio are board, management, systems, asset quality (insofar as not adequately covered by minimum risk weights and including MIG arrangements), treasury management (including hedging, funding and liquidity), planning (including the planning and control of new initiatives) and operating performance (including consistency in financial results and vulnerability to external shocks, for example, through geographic concentration). A blank appraisal form currently used to assess societies' risk profile can be found in Annex 1J.

1.5.4 G There are a number of points which have an important bearing on the appraisal process:

- (1) the seven broad factors, and the various criteria underlying those factors, do not carry equal weight amongst themselves or uniformly across societies. The system recognises that some factors and criteria are more important to some societies than others, consequently the threshold ratio is not based on an arithmetical average of criteria and factors but these are weighted by the FSA to the extent appropriate to each society;
- (2) the assessment system recognises that there are other criteria, which may be relevant only to particular societies, and these are also taken into account where they exist;
- (3) whilst some criteria focus on societies' competence in a particular area, others evaluate the risk of particular activities which are not reflected in the asset weighting formula but which exist even in the most competently managed operation;
- (4) societies are assessed in the context of both their past performance and of their current and planned business activities. The process recognises that some societies' business requires less sophisticated systems and less board and managerial expertise than others;

- (5) where societies merge, the merged institution will be the subject of a full new appraisal. The FSA recognises that the threshold ratio which is set on the basis of this appraisal might affect the merger terms and the FSA will be prepared to give an advance indicative ratio, if so requested by the societies involved.

1.5.5 G In setting the ratios the FSA has been careful to review each society's ratio against those of the rest of the building society sector to ensure that societies' ratios are consistent with one another. Both societies and the economic environment in which they operate are constantly evolving and the FSA reviews societies' ratios both individually and across the sector on a regular basis, but it is the FSA's expectation that threshold ratios will be reasonably stable with infrequent changes.

## **1.6 Own Funds**

1.6.1 G The BCD specifies which capital resources can count towards own funds and the extent to which they may do so. Its purpose is to ensure that credit institutions operating under supervisory regimes in different EU member states do not count towards own funds any items not falling within the BCD's list nor include any items to a greater extent than the BCD permits. But not all the items contained in the list are relevant to societies: moreover the BCD gives national authorities discretion whether or not to allow the use of the various constituents of capital listed.

1.6.2 G For building societies, own funds comprise reserves, all other capital resources listed in Annex 1A and minority interests in accordance with section 1.7.

1.6.3 G The BCD distinguishes between those components of own funds, such as reserves and PIBS, which may be included without limit and those to which a limit applies (see also chapter 2). These two categories closely correspond to the categories of core, or Tier 1 capital and supplementary, or Tier 2 capital used in the Basel Accord, and the same terminology is therefore used for convenience in this chapter although it does not feature in the BCD itself.

1.6.4 G Whenever a calculation of own funds is to be made other than at the balance sheet date, the amount of reserves included should be after deduction of any overall losses in the current year:

- (1) where a society does not seek to take credit in its solvency ratio calculation for profits earned in the current year, but simply reports on the basis of its previous year-end reserves, then as a minimum the society should have passed a board resolution, after the close of the second financial quarter, to the effect that the directors have satisfied themselves that no reduction in reserves has been sustained during the first six months of the financial year and a copy of this resolution should be forwarded to the FSA. Should the FSA be concerned about a society's ability to meet its capital requirements the society may be required to obtain a certificate or opinion from its external auditors that no reduction in reserves has been sustained;
- (2) interim current year profits may be included with reserves, i.e. in Tier 1, but only if they have been verified by the society's external auditors and a report from the auditors that the interim profits have been verified should be provided.

Where a society includes general or collective provisions in its solvency ratio calculation other than at balance sheet date then as a minimum it should have passed a board resolution, after the close of the second financial quarter, to the effect that the directors have satisfied themselves that those provisions meet the requirements set out in Annex 1A3.1.

1.6.5 G What constitutes verification by external auditors is summarised in Annex 1E. Societies may include interim profits on a quarterly basis, but are not required to do so: some societies whose capital is plentiful may prefer to choose the simpler minimum procedure outlined in paragraph 1.6.4(1). Moreover, the FSA recognises that it will not be practicable for societies or their auditors to complete the verification procedures prior to the deadline for submission of the quarterly returns. For the first, second and third financial quarters societies may include interim profits in their returns, if they so wish, on the understanding that the society will submit the required reports and, where necessary, board resolutions within two months of the quarter end. For the fourth quarter the FSA will rely on the forthcoming

audited accounts and accordingly the full year's profits should be included in own funds under Tier 1. The figure shown for reserves in the return for the first quarter should agree with that shown in the annual accounts.

## **1.7 Minority Interests**

1.7.1 G The BCD provides for the inclusion of minority interests when they are credit (negative) items in the capital of a subsidiary undertaking in the calculation of consolidated own funds of a society and these subsidiaries. The FSA believes that building societies should not regard minority shareholdings as having all the properties of their own capital because minority interests cannot absorb the losses of the building society or any other member of its group and they would not necessarily be available to the building society if the society or subsidiary undertaking were to be wound up.

1.7.2 G Accordingly, minority interests should only be included for the purpose of calculating consolidated own funds, and then only if:

- (1) the total amount of minority interests aggregated with Tier 1 or Tier 2 capital does not exceed 10% of the society's own funds in that category;
- (2) it is clear that the society has effective practical control over the subsidiary undertaking and can pass a special resolution;
- (3) the society owns at least 75% of the equity capital of the subsidiary undertaking.

In determining which elements of minority interests should be integrated into Tier 1 own funds societies should have regard to the characteristics of the subsidiary undertaking's capital. Only those items which are analogous to a society's Tier 1 own funds should be included in Tier 1. The remainder should be assigned to the appropriate category of Tier 2 funds. In this section, references to subsidiaries are to entities which are subsidiaries of the society.

## 1.8 Deductions

1.8.1 G Societies should make certain deductions from own funds and observe certain restrictions on the inclusion of Tier 2 items. The deductions comprise:

- (1) intangible fixed assets, including goodwill;
- (2) all holdings of capital instruments of other credit or financial institutions (see Annex 1D for definitions);
- (3) all holdings of capital instruments of regulated broker-dealers (subject to CAD or an analogous regime);
- (4)
  - (a) the amount of the capital deficit of any subsidiary undertaking which has such a deficit (only required for society only calculations). The entire deficit should be excluded even if the subsidiary is only partially owned;
  - (b) the proportion attributable to outside minority interests in the capital deficit of any subsidiary undertaking which has such a deficit (required for consolidated calculations).
- (5) the amount of any material insurance holding (see Annex 1 D for definitions), relating to an insurance undertaking, reinsurance undertaking, or insurance holding company.

1.8.2 G Societies may be expected to make a deduction from own funds to reflect the existence of a contingent liability which, if called, would create an asset that societies would be required to deduct from own funds.

N B: See section 1.13 for the treatment of insurance companies that are subsidiaries, section 1.14 for MIG captives, section 1.16 for holdings in other institutions, and for possible deductions arising out of securitisation, section 1.15.

1.8.3 G Societies may not include the following in own funds:

- (1) any unrealised gains or losses on cash flow hedges of financial instruments measured at cost or amortised cost;
- (2) any unrealised gains or losses on debt instruments held in the available-for-sale financial assets category;
- (3) any unrealised gains or losses, which are not attributable to changes in a benchmark interest rate, arising when a building society, upon initial recognition, designates its financial liabilities as at fair value through profit or loss;
- (4) any defined benefit asset.

1.8.4 G Societies may, for the purpose of calculating own funds, substitute for a defined benefit liability their deficit reduction amount. The election should be applied consistently in respect of any one financial year. Societies should keep a record of and be ready to explain to their supervisory contacts in the *FSA* the reasons for any difference between the deficit reduction amount and any commitment a society has made in any public document to provide funding in respect of a defined benefit occupational pension scheme. For these purposes, and for the purpose of 1.8.3G:

- (1) a "defined benefit occupational pension scheme" is an occupational pension scheme which is not a defined contribution occupational pension scheme.
- (2) a "defined contribution occupational pension scheme" is an occupational pension scheme into which the society, as employer, pays regular fixed contributions and will have no legal or constructive obligation to pay further contributions if the scheme does not have sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.
- (3) "occupational pension scheme" is defined in the main glossary of defined terms in the Handbook, and is derived from the Pension Schemes Act 1993.
- (4) a "defined benefit asset" is the excess of the value of the assets in a

defined benefit occupational pension scheme over the present value of the scheme liabilities, to the extent that a society, as employer, should recognise that excess as a liability in its balance sheet

- (5) a "defined benefit liability" is the shortfall of the value of the assets in
- a
- defined benefit occupational pension scheme below the present value of the scheme liabilities, to the extent that a society, as employer, recognise that shortfall as a liability in its balance sheet.
- (6) a society's "deficit reduction amount" is, in respect of a defined benefit occupational pension scheme, the sum, determined by the society in conjunction with the defined benefit occupational pension scheme's actuaries or trustees (or both), of the additional funding (net of tax) that will be required to be paid into that scheme by the society over the following five year period for the purpose of reducing the society's defined benefit liability.

## **1.9 Limits on Tier 2 Capital**

1.9.1 G The maximum amount of term subordinated debt which should be counted as own funds within Tier 2 is 50% of Tier 1 capital after deduction of intangible fixed assets. Total Tier 2 capital should not exceed 100% of Tier 1 capital after deduction of intangible fixed assets. Funds eligible for inclusion in Tier 2 capital are defined in Annex 1A.

## **1.10 Solvency Ratio**

1.10.1 G The solvency ratio of any society is determined by the formula set out in paragraph 1.4.4. Societies should calculate their own ratios using the definition of own funds contained in this Chapter and in Annex 1A and the risk weights and credit conversion factors in Annexes 1B and 1C. The relevant risk weight (a percentage) is applied to the balance sheet value of an asset, or in the case of off balance sheet items, to the nominal value multiplied by the appropriate credit conversion factor. Asset values and values attributed to off balance sheet items should also be determined on a basis consistent with the statutory accounts and should be net of any specific/individual provisions. Where a society has subsidiary undertakings, the solvency ratio should be calculated on a consolidated basis. For these purposes a subsidiary undertaking is defined by Article 1(13) of the BCD, which refers to Article 1(1) of the Seventh Company Law Directive (83/349/EEC); these provisions are



implemented in section 258 of the Companies Act 1985, to which section 119(1) of the 1986 Act refers. Where subsidiary undertakings, either singly or in aggregate, have either:

- (1) total gross assets equal to or greater than 1% of the society's assets; or
- (2) income which is equal to or greater than 1% of the society's total income; or
- (3) profits or losses which are equal to or greater than 1% of the society's profits;

the society should also calculate its solvency ratio on a society only basis and both calculations should meet the society's solvency ratio threshold (see Annex 1H for definitions of terms used in (1), (2) and (3)). Societies should report their solvency ratios quarterly in the QFS1 return.

1.10.2 G The percentage weights given in the BCD are minima: the directive explicitly recognises that national authorities may set higher weightings as they see fit. The FSA has decided to do so for securities issued by Zone A or Zone B countries. These are weighted at 10% or 20%, according to residual maturity, as a proxy for interest-rate risk, rather than at 0% as the BCD permits.

1.10.3 G The FSA uses the "mark-to-market" approach for the measurement of off balance sheet risks associated with interest-rate and foreign exchange contracts, and societies are expected to report on this basis. Treatment of off-balance sheet items is shown in Annex 1C.

## **1.11 Solo Consolidation**

1.11.1 G The FSA recognises that for structural reasons societies have historically conducted certain core business through subsidiaries which they might otherwise have preferred to conduct themselves. In such cases the FSA may agree or expect societies to consolidate such subsidiary undertakings when calculating their society only solvency ratio. However, in so doing the FSA may expect the society to deduct a percentage of the

subsidiary undertaking's capital from the society's own funds when making the society only solvency ratio calculation. This deduction will reflect the FSA's view of any enhanced risk in opting to conduct the business through a subsidiary rather than the society itself. At the minimum there is a risk that the environment which made the subsidiary route profitable may change leaving the society with a cost to unwind the structure. The FSA will discuss with societies where solo consolidation is considered appropriate or necessary, but see section 1.12, which sets out the FSA's criteria for solo consolidation of mortgage subsidiaries. The FSA also applies these criteria to other types of subsidiaries where they are proposed for solo consolidation. Where solo consolidation occurs societies should confirm annually in writing to the FSA that the solo consolidated subsidiaries continue to meet the criteria under which solo consolidation is agreed and that there has been no change in the type of business conducted by the subsidiary undertaking. Confirmation should be received within two months of the society's year end.

## **1.12 Mortgage Subsidiaries**

1.12.1 G The principle of solo consolidation can be applied not only to capital adequacy but also to large exposures (see Chapter 7 Large Exposures) and although these are two distinct issues the grounds for confusion are much reduced if it is possible and prudent to adopt a common approach in respect of specific subsidiaries or categories of subsidiaries. Provided they comply with certain criteria, mortgage subsidiaries are a suitable category for solo consolidation in respect of both large exposures and capital adequacy. To enable the FSA to make valid comparisons across the building society sector it is important that all mortgage subsidiaries which meet the criteria are treated in a similar manner; however, under the BCD the FSA is required to give its approval to applications from each society individually. All societies which have mortgage subsidiaries which:

- (1) are under the effective day to day control of the society's executives;
- (2) are at least 75 per cent owned by the society;
- (3) are not subject to the capital requirements of another regulator;

- (4) have no restrictions on winding up and upstreaming capital at any time;

and either:

- (5) have no third party creditors at all (this is not intended to include small administrative creditors such as the electricity bill); or
- (6) are constituted so that the society can substitute itself for the mortgage subsidiary and perform its obligations to third party creditors;

should apply to the FSA to solo consolidate these subsidiaries confirming that they meet the above mentioned criteria.

### **1.13 Exclusions from Consolidation**

1.13.1 G Subject to a limited degree of discretion allowed to the supervisory authorities, the BCD requires building societies to consolidate subsidiary undertakings which are financial or credit institutions (defined in Annex 1D) for the purposes of calculating their solvency ratio. However unless:

- (1) the inclusion of a particular non financial institution or non-credit institution subsidiary undertaking would result in a higher solvency ratio than if it were to be excluded; or
- (2) the FSA specifically requires the subsidiary undertaking to be excluded;

societies should include all their subsidiary undertakings when calculating their solvency ratio. Exclusion is likely where the FSA believes that a subsidiary's inclusion in the consolidation would be misleading or inappropriate. Life insurance, general insurance, reinsurance and insurance holding companies fall into this category: societies are already expected to deduct material insurance holdings from own funds (see section 1.8 above ). Societies should calculate their solvency ratio after reversing the impact of the investment in, or consolidation of, these subsidiary undertakings. In the society only ratio calculation, the

carrying value of the investment should be removed from the weighted asset total. In the consolidated ratio calculation, the weighted assets of the insurance subsidiary should be removed from the consolidated weighted assets. Societies should also note that the consolidation of asset management companies ( which for this purpose have the meaning given in the Handbook Glossary ) is now required by article 30 of the Financial Groups Directive, whether or not they come within the definition of a financial institution.

## **1.14 Mortgage Indemnity Insurance Captives**

1.14.1 G Societies which own a MIG Captive should include the captive when calculating their consolidated solvency ratio (for rules and guidance on mortgage indemnity insurance, see chapter 8). For the society only solvency ratio the FSA has adopted a composite treatment which recognises both that the capital invested in the captive bears a heavier risk of loss than the generality of investments in subsidiaries, and that the captive bears only the society's own lending risk, albeit in concentrated form, and is not using its capital to "gear up" and assume new external liabilities. Out of the total capital committed to the captive, whether fully paid or not, 25% (or, if greater, the actual capital requirement imposed by the local insurance supervisor) should be deducted from the society's own funds, in the society only calculation. The remainder should be risk-weighted at 100% as if an ordinary investment in a subsidiary.

## **1.15 Securitisation**

1.15.1 G In considering how to treat societies' securitisation transactions, the three key points are:

- (1) whether, and to what extent, to include securitised assets, which have been financed on a limited recourse basis, in the calculation of the society's (or society group's) solvency ratio (subject to their relevant risk weightings);
- (2) whether, and to what extent, to require the deduction from societies' own funds of quasi-capital exposures to securitisation transactions; and

- (3) how to reflect the largely unquantifiable risks that are left with a society after securitisation.

1.15.2 G In order to achieve consistency and simplicity, the FSA deals with these as follows:

- (1) securitisation transactions by, or involving, building societies will be analysed in the same way as similar transactions by, or involving, banks. The FSA will apply the principles and guidance contained in chapter SE of the IPSB for banks, which is set out, with additional guidance for building societies, as chapter 10 of this sourcebook. This will determine whether securitised assets are to be risk weighted and included in the solvency ratio calculation, and whether (and to what extent) quasi-capital exposures, such as first loss provisions or holdings of deeply subordinated notes, are to be deducted from own funds.
- (2) all other risks arising from securitisation will, collectively, be considered in the context of the process of appraisal that leads to the setting or reviewing of an individual society's threshold solvency ratio. Depending on the scale and nature of a society's securitisation activity, this could lead, other things being equal, to an increase in that threshold ratio.

1.15.3 G Some of the risks that securitisation leaves with a society are inherent in most, if not all, existing securitisation structures and are thus unavoidable. Particular examples are the risk from servicing and liability under warranties. But in other respects, particularly in relation to "moral hazard", there is much greater scope for conscious acceptance or avoidance of risk through the selection and adaptation of particular structures.

1.15.4 G While a society may endeavour to avoid the accumulation of such risks, to the extent that risk is accepted and/or is unavoidable, an assessment of the various residual risks will be made by the FSA as part of the appraisal for setting or reviewing the society's threshold solvency ratio. This assessment will reflect the scale and nature of a society's current and planned securitisation programme. It will also cover how the society has

addressed the residual risks in the structure(s) it proposes to use. Where, for example, securitisation activity is small-scale relative to the society's asset base, a "clean break" with borrowers has been achieved, the society has good errors and omissions insurance to cover servicing risk, and substantial audit of the pool of assets to be transferred has been carried out, the effect on the solvency threshold ratio is likely to be minimal and there may indeed be no actual change. While recognising that assessment through the solvency threshold appraisal process is less transparent for societies, the FSA considers that much is gained by simplicity and the avoidance of a proliferation of risk weightings or other formulae intended to capture individual, largely unquantifiable, risks.

## **1.16 Deductions in Respect of Holdings in Other Institutions**

1.16.1 G Articles 51.1 and 51.2 of the BCD prohibit a credit institution from having a "qualifying holding" in excess of 15% of its own funds in an undertaking or 60% in several undertakings which are neither credit institutions, financial institutions, nor undertakings which carry on "ancillary banking services".

1.16.2 G A qualifying holding is defined as "a direct or indirect holding in an undertaking which represents 10% or more of the capital or of the voting rights, or which makes it possible to exercise a significant influence over the management of the undertaking in which the holding subsists".

1.16.3 G The Directive gives member states the option not to apply the restrictions to life and general insurance companies or reinsurance companies; and not to apply them in other cases provided they require a deduction from the credit institution's own funds of 100% of the amount in excess of the 15% or 60% limits.

1.16.4 G The FSA has decided not to apply the limits to participation in insurance or reinsurance companies but under section 1.8 above - "material insurance holdings" – see Annex 1D for definitions - are already subject to deduction from the society's own funds : see also see section 1.13 on the exclusion of insurance subsidiaries from consolidation. The FSA has also decided not to apply the limits in other cases but to recommend a 100% deduction from own funds of the amount of the holding in excess of 15%.

## **1.17 Capital Cost and Pricing**

1.17.1 G When acquiring assets societies should consider what effect the profit or cost derived from those assets will have on their solvency ratios. The higher the weighting which an asset carries the greater the capital cost and societies will need to decide whether they can, or should, pass on such cost or accept a lower rate of return.

## **1.18. Capital Adequacy Directive (CAD)**

1.18.1 G Societies on the "Trading" approach to financial risk management (described in chapter 4, Financial Risk Management), under which they can trade securities and maintain unhedged foreign exchange positions within defined limits, should calculate the capital requirements for their trading book and foreign exchange positions separately in accordance with the FSA's guidance to banks (as set out in the IPSB for banks). In moving to the "Trading" approach societies will need to satisfy the FSA that they have the systems to calculate and report their capital position in accordance with the FSA's guidance.

## **1.19. Credit Derivatives**

1.19.1 G Where societies use credit derivatives, provided that they meet the criteria set out in Annex 4B to chapter 4, the risk weighting of an asset should be based on the position after taking account of the credit derivative applied to that asset.

## CALCULATION OF "OWN FUNDS"

### G

#### 1A.1 Tier 1 Capital

1A.1.1 Reserves as disclosed in the latest year end balance sheet;

plus

cumulative interim profits for the year to date which have been verified by the society's external auditors (see Annex 1E); or

less

cumulative losses (if any) for the year to date.

1A.1.2 Deferred shares which meet the requirements of chapter 2, currently PIBS, and deferred shares which were issued prior to the Building Societies (Deferred Shares) Order 1991 (SI 1991/701) and which met the statutory requirements then in force.

1A.1.3 Tier 1 minority interests in a subsidiary undertaking which meets the requirements of section 1.7.

1A.1.4 Deduct intangible assets from the sum of 1A.1.1, 1A.1.2 and 1A.1.3 to calculate Tier 1 capital.

1A.1.5 Societies may not include the following in own funds:

- (1) any unrealised gains or losses on cash flow hedges of financial instruments measured at cost or amortised cost;
- (2) any unrealised gains or losses on debt instruments held in the available-for-sale financial assets category;
- (3) any unrealised gains or losses, which are not attributable to changes in a



benchmark interest rate, arising when a building society, upon initial recognition, designates its financial liabilities as at fair value through profit or loss;

1A.1.6 Where a society has a defined benefit occupational pension scheme:

- (1) it may not include any defined benefit asset in own funds;
- (2) it may, for the purpose of calculating own funds, substitute for a defined benefit liability its deficit reduction amount, provided that the election is applied consistently in respect of any one financial year.

Definition of the terms used here are set out in 1.8.4G.

## **1A.2 Tier 2 Capital**

1A.2.1 Term subordinated debt and undated subordinated debt, which meet the requirements of chapter 2; together with general or collective provisions for bad debt and revaluation reserves.

1A.2.2 Tier 2 minority interests in a subsidiary undertaking which meets the requirements of section 1.7.

## **1A.3 General/Collective Provisions for Bad Debt**

1A.3.1 General or collective provisions should be made to cover possible losses, existing at the balance sheet or other reporting date, which have not been specifically identified. As such, they are freely available to the society to be utilised against any actual losses subsequently identified or arising and so conform with Article 35.1(a) of the BCD. But the BCD does not permit the inclusion in "own funds" of a provision which covers identified deterioration in particular assets, whether individual or group. Thus societies should not include the latter type of provision in own funds. Societies may only include general or collective provisions in their solvency ratio calculation to an amount less than or equal to that shown in the society's last audited accounts or the amount provided when interim profits were last verified by the external auditors.

## **1A.4 Revaluation Reserves**

1A.4.1 Societies may include revaluation reserves arising out of the differences between book values and the current market value of property fixed assets but only if:

- (1) the society applies the revaluation method to all of its property fixed assets, or all of its property fixed assets in a designated class and not selectively;
- (2) the values result from regular professional valuations of each property. If not annually, there should be:
  - (a) a rolling programme such that no professional valuation of a property is more than five years old;
  - (b) in the intervening year(s) in which a property is not professionally valued, an interpolation of value by the Board which takes into account any decline in property values disclosed by valuations of other properties in that year;
  - (c) where a society owns less than five properties, none of which are valued during the financial year, the valuation should be determined by the Board on the basis of their knowledge of appropriate property values in the area.

1A.4.2 If a society divides its fixed property assets into classes for the purposes of the valuation then it should advise the FSA of the basis of the division and the valuation policy in respect of each class.

1A.4.3 Any increase in revaluation reserve should be supported by a professional valuation.

1A.4.4 For the purposes of this calculation the revaluation reserve will be the amount standing to the credit of any revaluation reserve in the balance sheet or the amount of

any such reserve in the accounting records of the society, for the time being, whichever is the lesser amount.

## **1A.5 Limits on capital**

1A.5.5 Term Subordinated Debt which meets the guidance in chapter 2 may not exceed 50% of Tier 1 constituents minus intangible assets.

1A.5.6 Tier 2 capital resources in aggregate may not be included to an extent greater than 100% of Tier 1 constituents minus intangible assets.

1A.5.7 The total amount of minority interests which may be aggregated with Tier 1 or Tier 2 capital may not exceed 10% of the society's own funds in that category.

## **1A.6 Own funds**

1A.6.1 Gross own funds comprise Tier 1 capital plus Tier 2 capital. From this should be deducted:

- (1) all holdings of capital instruments of other credit or financial institutions, or in regulated broker-dealers (subject to CAD or an analogous regime);
- (2) the amount of capital deficit of any subsidiary undertaking which has such a deficit (for society only calculations);
- (3) the proportion attributable to outside minority interests in the capital deficit of any subsidiary undertaking which has such a deficit (for consolidated calculations);
- (4) any deductions in respect of insurance, reinsurance or insurance holding companies (section 1.8), MIG Captives (section 1.14),

holdings in other undertakings (section 1.16) and securitisation (paragraph 1.15.2);

to arrive at "own funds".

1A.6.2 Article 34.2(3) of the BCD allows "funds for general banking risks" to be counted as Tier 1 capital. Such funds are not general or collective provisions for bad debt but are akin to banks' "hidden reserves" and are therefore not applicable to building societies.

**RISK ASSET WEIGHTS****G****1B.1 General**

1B.1.1 Risk weights should be applied net of any specific or individual provision. Items subject to deduction from Own Funds should be zero weighted. Assets held by a subsidiary undertaking are weighted on the same basis as if held by the parent society.

**1B.2 Assets to be weighted at 0%**

1B.2.1 The following assets should be weighted at 0%:

- (1) Bank notes or coinage of any territory or country;
- (2) Deposits with:
  - (a) any Zone A Central Bank (see Annex 1G for Zone A countries);
  - (b) the National Savings Bank;
  - (c) any Zone B Central Bank denominated in local currency and funded by liabilities in the same currency (see Annex 1G for Zone B countries);
- (3) Certificates of Tax Deposit issued by the Treasury;
- (4) National Savings Bonds;
- (5) Loans granted at the society's administered rate and supported by the explicit guarantee of a Zone A central government or central bank.

### **1B.3 Assets to be weighted at 10%**

1B.3.1 The following assets should be weighted at 10%:

- (1) Deposits with any gilt edged market maker or participant in the UK gilt market supervised by a regulatory authority in the EEA provided they are collateralised by assets, which, if held directly, would have a weighting of not more than 20%.
- (2) Stock lending rights arising from the lending of securities issued in the UK by HM Government.
- (3) Fixed-rate securities with a residual maturity of one year or less or floating rate securities:
  - (a) issued or guaranteed by a Zone A Central government (including Ginnie Maes);
  - (b) issued or guaranteed by a Zone B Central government denominated in the local currency and funded by liabilities in the same currency;
  - (c) issued or guaranteed by the European Atomic Energy Community, European Coal and Steel Community or European Economic Community.
- (4) Loans either with a maturity of one year or less and granted on a fixed rate basis, or with any maturity and granted at a rate which is periodically reset at least annually against a market rate, and in either case supported by the explicit guarantee of a Zone A central government or central bank.

## **1B.4 Assets to be weighted at 20%**

1B.4.1 The following assets should be weighted at 20%:

- (1) Fixed rate securities, with a residual maturity over 1 year:
  - (a) issued or guaranteed by a Zone A Central government (including Ginnie Maes); or
  - (b) issued or guaranteed by the European Atomic Energy Community, European Coal and Steel Community or European Economic Community.
- (2) Deposits with or securities issued, guaranteed, or (in the case of bills of exchange) accepted by, any Zone A credit institution (see Annex 1G).
- (3) Deposits with, or securities issued, or (in the case of bills of exchange) accepted by any Zone B credit institution (see Annex 1G), with a maturity of one year or less.
- (4) Securities issued by, or loans to, any relevant authority (see Annex 1F for definition) or loans to the Department of Finance and Personnel (Northern Ireland).
- (5) Securities issued by, or loans to, Fannie Maes and Freddie Macs.
- (6) Securities issued or guaranteed by multilateral development banks as defined in the Handbook Glossary.

- (7) Cash items in the process of collection.
- (8) Loans with a maturity greater than one year that are either granted on a fixed rate basis, or at a market rate which is periodically reset less frequently than annually and, in either case, supported by the explicit guarantee of a Zone A central government or central bank.
- (9) Loans supported by an unconditional guarantee issued by a Zone A credit institution.
- (10) Loans, with a maturity of one year or less, supported by an unconditional guarantee issued by a Zone B credit institution.
- (11) Loans supported by the unconditional guarantee of a relevant authority (see Annex 1F).

## **1B.5 Assets to be weighted at 50%**

1B.5.1 The following assets should be weighted at 50%:

- (1) Mortgage-backed securities (MBS) issued by special purpose mortgage finance vehicles where the following conditions are met:
  - (a) the notes embody an express promise to repay the noteholder;
  - (b) the issue documentation contains provisions, which would ultimately enable noteholders to initiate legal proceedings directly against the issuer of the MBS. As an example such provisions would allow noteholders to proceed against the issuer where the trustee, having become bound to take steps and/or to proceed against the issuer, fails to do so within a reasonable time and such failure is continuing;



- (c) the documentation contains provisions which would ultimately enable noteholders to acquire the legal title to the security (i.e. the mortgagee's interest in it) and to realise the security in the event of a default by the mortgagor;
  - (d) under the issue:
    - (i) the mortgage loans themselves qualify for the 50% weighting (see Annex 1B.5.1 (2), (3) and (4)); and
    - (ii) the mortgage loans are not in default at the time at which they are transferred to the vehicle;
  - (e) the vehicle's activities are restricted by its articles of association to mortgage business. The vehicle may also hold assets qualifying for a risk weighting of less than 50%;
  - (f) the notes do not absorb more than their pro rata share of losses in the event of arrears or default (see chapter 10 for treatment of junior or B notes).
- (2) Loans to individuals fully secured by a first priority charge on residential property that is (or is to be) occupied by the borrower or is rented.
- (3) Loans to Registered Social Landlords, registered with the Housing Corporation, or Communities Scotland or the National Assembly for Wales or the Northern Ireland Department for Social Development, fully secured by a mortgage on residential property that is:
- (a) already let; or
  - (b) under development and will be let, on condition that the development attracts Social Housing Grant (SHG) and/or other public subsidy on

equivalent terms, of an amount equal to, or greater than, 50% of the approved total scheme cost, the security for which is subordinated to the loan, where the funding body has legally committed itself to the full payment of the subsidy.

- (4) Loans to public universities, fully secured by a mortgage on a residential property that is:
  - (a) already let; or
  - (b) under development and will be let, on condition that the lender is in possession of a certificate, issued by a quantity surveyor or architect appointed by the society, showing that work to the value of 20% of the projected finished end value of the project (excluding cost of land) has been completed, prior to any draw down under the loan; and can readily be sold or let on the non student market.

N.B. For the purposes of paragraphs 1B.5.1(3) and (4), once a property has been let it is not necessary to increase the weighting to 100% during a subsequent temporary void.

## **1B.6 Assets to be weighted at 100%**

1B.6.1 All other assets should be weighted at 100% including:

- (1) Deposits with, or securities issued or (in the case of bills of exchange) accepted by any Zone B credit institution authorised by the competent authorities of a member state of the European Community, with a maturity greater than one year.
- (2) Commercial Paper issued or guaranteed by companies of the types to which Directive 78/660/EEC on the annual accounts of certain types of company (as

amended by subsequent acts of accession) applies (that is, public or private companies limited by shares or by guarantee).

- (3) Securities issued by the European Telecommunications Satellite Organisation, International Monetary Fund, and European Company for the Financing of Railway Rolling Stock.
- (4) Other mortgages and MBS.
- (5) Unsecured loans and leasing receivables
- (6) Development and residential property:
  - land acquired
  - development projects
  - rented housing
  - equity interest in shared ownership schemes
- (7) Investments in connected undertakings, which are not subsidiary undertakings (except where treated as a deduction from own funds or netted on consolidation)
- (8) Premises, plant, equipment and other fixed assets
- (9) Prepayments, accrued income, sundry debtors etc (except where the asset represents a claim on a counterparty which normally attracts a weighting below 100%, e.g. UK central government (0%), local authorities or credit institutions (20%), in which case it should be weighted accordingly).

## **1B.7 Repos and Reverse Repos**

1B.7.1 Gilt edged securities subject to a repo transaction should be treated as remaining on the balance sheet of the seller throughout the repo period. The weightings for UK Government securities at 10% or 20% (according to residual maturity) apply. A

reverse repo should be treated as a collateralised loan and should be weighted on the basis of the collateral (i.e. the gilt) securing the loan at 10% or 20% according to residual maturity for the duration of the transaction.

## **1B.8 Gilt Strips**

1B.8.1 The weighting for gilt strips does not differ from that of traditional holdings in gilt-edged securities (10% or 20% according to residual maturity), but societies should bear in mind that considerable activity in the more sophisticated repos and strips markets will be taken into account and weighed against the expertise available when assessing their threshold solvency ratio.

## **1B.9 Stock Lending**

1B.9.1 Securities held in a liquid asset portfolio and loaned to the market will already be weighted for capital adequacy purposes in accordance with this Annex. A possible additional risk posed by the lending of the security will depend upon whether the transaction is collateralised. The lending of gilt edged securities, for example, should not attract any additional weighting for counterparty risk because it is fully collateralised under the terms of a stock lending agreement.

1B.9.2 However, stock lending which is not fully collateralised, such as that conducted through the Clearstream and Euroclear stock lending programmes, needs to take account of the counterparty risk. As Clearstream and Euroclear are both Zone A banks, an additional capital weighting of 20% should be applied.

## TREATMENT OF OFF-BALANCE SHEET ITEMS

### G

#### 1C Classification of Off-Balance Sheet Items (other than items related to interest rates and foreign exchange)

Degree of Risk	Credit Conversion Factor
1C.1 Full Risk	100%
<ul style="list-style-type: none"> <li>- Guarantees having the character of credit substitutes,</li> <li>- Acceptances,</li> <li>- Endorsements on bills not bearing the name of another credit institution,</li> <li>- Transactions with recourse,</li> <li>- Irrevocable standby letters of credit having the character of credit substitutes,</li> <li>- Asset sale and repurchase agreements (repos),</li> <li>- Assets purchased under outright forward purchase agreements,</li> <li>- Forward forward deposits,</li> <li>- The unpaid portion of partly-paid shares and securities.</li> </ul>	
1C.2 Medium Risk	50%
<ul style="list-style-type: none"> <li>- Documentary credits issued and confirmed (see also medium/low risk),</li> <li>- Warranties and indemnities (including tender, performance, customs and tax bonds)</li> </ul>	

and guarantees not having the character of credit substitutes,

- Irrevocable standby letters of credit not having the character of credit substitutes,
- Undrawn credit facilities (agreements to lend, purchase securities, provide guarantees or acceptance facilities) with an original maturity of more than one year,
- Note issuance facilities (NIFs) and revolving underwriting facilities (RUFs).

1C.3 Medium/low Risk

20%

- Documentary credits in which underlying shipment acts as collateral and other self-liquidating transactions.

1C.4 Low Risk

0%

- Undrawn credit facilities (agreements to lend, purchase securities, provide guarantees or acceptance facilities) with an original maturity of up to and including one year, or which may be cancelled unconditionally at anytime without notice (including facilities related to cheque guarantee cards, automated teller machine cards, credit cards and mortgage offer letters which are expressly stated to be subject to immediate cancellation).

Each item described in 1C.1 to 1C.4 should be multiplied by the appropriate credit conversion factor and then weighted by the risk weight applicable to the category of the counterparty for an on-balance sheet transaction.

The portion of unpaid capital subscribed to the European Investment Fund should be weighted at 20%.

### **1C.5 The treatment of off-balance sheet items using the "mark to market" approach.**

Societies may, of course, only enter into such contracts permitted by the 1986 Act, guidance in respect of which can be found in chapter 4.

#### **1C.5.1 Method**

1C.5.2 Step (a): by attaching current market values to contracts (mark to market) the current replacement cost of all contracts with positive values is obtained. (Societies should consult their external auditors if they require guidance on how to ascertain market values).

1C.5.3 Step (b): to obtain a figure for potential future credit exposure, the notional principal amounts or values underlying a society's aggregate book are multiplied by the following percentages:

Residual maturity	Interest rate contracts	Contracts concerning foreign exchange rates and gold	Contracts concerning equities	Contracts concerning precious metals except gold	Contracts concerning commodities other than precious metals
One year or less	0.0%	1%	6%	7%	10%
Over one year, less than five years	0.5%	5%	8%	7%	12%
Over five years	1.5%	7.5%	10%	8%	15%

1C.5.4 Contracts which do not fall within one of the five categories indicated in this table shall be treated as contracts concerning commodities other than precious metals.

1C.5.5 For contracts with multiple exchanges of principal, the percentages have to be multiplied by the number of remaining payments still to be made according to the contract.

1C.5.6 For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these dates, the residual maturity would be equal to the time until the next reset date. In the case of interest-rate contracts that meet these criteria and have a remaining maturity of over one year, the percentage shall be no lower than 0.5%.

1C.5.7 In the case of single-currency "floating/floating interest rate swaps" only the current replacement cost will be calculated (i.e. no future credit exposure).

1C.5.8 Step (c): the sum of current replacement cost and potential future credit exposure for each contract is multiplied by the risk weighting allocated to the relevant counterparties for on-balance sheet transactions, (except that the 100% weightings shall be replaced by 50% weightings) to give the risk-weighted amount relating to that contract which is to be included in the solvency ratio calculation.

1C.5.9 Societies should ensure that the notional amount to be taken into account is an appropriate yardstick for the risk inherent in the contract. Where, for instance, the contract provides for a multiplication of cashflows, the notional amount should be adjusted in order to take into account the effects of the multiplication on the risk structures of that contract.

1C.5.10 Interest-rate and foreign-exchange contracts traded on recognised exchanges where they are subject to daily margin requirements and foreign exchange contracts with an original maturity of 14 calendar days or less are excluded.

## **1C.6 Netting**



1C.6.1 Societies may treat as reducing risk and therefore as permitting weighting on a net, rather than gross basis:

- (1) bilateral contracts for novation between the society and its counterparty under which mutual claims and obligations are automatically amalgamated in such a way that this novation fixes one single net amount each time novation applies and thus creates a legally binding, single new contract extinguishing former contracts (in the case of foreign exchange transactions a separate single net amount should be fixed for each currency and value date);
- (2) other bilateral netting agreements between the society and its counterparty;

but only under the following conditions;

- (a) the society should have a contractual netting agreement with its counterparty which creates a single legal obligation, covering all included transactions, such that, in the event of a counterparty's failure to perform owing to default, bankruptcy, liquidation or any other similar circumstance, the society would have a claim to receive or an obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions;
- (b) the society should have made available to the FSA written and reasoned legal opinions to the effect that, in the event of a legal challenge, the relevant courts and administrative authorities would, in the cases described under (a), find that the society's claims and obligations would be limited to the net sum, as described in (a), under;
  - the law of the jurisdiction in which the counterparty is incorporated and, if a foreign branch of an undertaking is involved, also under the law of the jurisdiction in which the branch is located;

- the law that governs the individual transactions included;
  - the law that governs any contract or agreement necessary to effect the contractual netting.
- (c) the society should have provided assurances to the FSA that it has set in place procedures for ensuring that the legal validity of its contractual netting is kept under review in the light of possible changes in the relevant laws;
- (d) the society should have provided assurances to the FSA that it has adequate systems to monitor netting. Any society not on the comprehensive or trading approach should produce confirmation from its external auditors that its systems are adequate.

1C.6.2 No contract containing a provision which permits a non-defaulting counterparty to make limited payments only, or no payments at all to the defaulter, even if the defaulter is a net creditor (a 'walkaway' clause) should be recognised as risk reducing.

1C.6.3 The FSA will recognise as risk-reducing contractual-netting agreements covering foreign-exchange contracts with an original maturity of 14 calendar days or less, written options (where these are permitted by section 9A) or similar off-balance-sheet items to which this Annex does not apply because they bear only a negligible or no credit risk. If, depending on the positive or negative market value of these contracts, their inclusion in another netting agreement can result in an increase or decrease of the capital requirements, societies should use a consistent treatment.

1C.6.4 No contractual netting will be recognised as reducing risk until the FSA has confirmed that conditions (b), (c) and (d) above have been met and that it is satisfied that contractual netting is legally valid under the law of each of the relevant jurisdictions.

### **1C.6.5 Effects of Netting**

- (1) Contracts for novation
- (a) The single net amounts fixed by contracts for novation, rather than the gross amounts involved, may be weighted. Thus in:

Step (a) the current replacement cost, and in  
Step (b) the notional principal amounts or underlying values

may be obtained taking account of the contract for novation.

(2) Other Netting Agreements

- (a) In step (a) the current replacement cost for the contracts included in a netting agreement may be obtained by taking account of the actual hypothetical net replacement cost which results from the agreement; in the case where netting leads to a net obligation for the credit institution calculating the net replacement cost, the current replacement cost is calculated as “0”;

In step (b) the figure for potential future credit exposure for all contracts included in a netting agreement may be reduced according to the following equation:

$$PCE_{\text{red}} = 0.4 * PCE_{\text{gross}} + 0.6 * NGR * PCE_{\text{gross}}$$

Where:

$PCE_{\text{red}}$  = the reduced figure for potential future credit exposure for all contracts with a given counterparty included in a legally valid bilateral netting agreement,

$PCE_{\text{gross}}$  = the sum of the figures for potential future credit exposure for all contracts with a given counterparty which are included in a legally valid bilateral netting agreement and are calculated by multiplying their notional principal amounts by the percentages set out in the table in 1C.5.3,

NGR = “net-to-gross ratio”: this should be done as a separate calculation: the quotient of the net replacement cost for all contracts included in a legally valid bilateral netting agreement with a given counterparty (numerator) and the gross replacement cost for all contracts included in a legally valid bilateral netting agreement with that counterparty (denominator).

For the calculation of the potential future credit exposure according to the above formula perfectly matching contracts included in the netting agreement may be taken into account as a single contract with a notional principal equivalent to the net receipts. Perfectly matching contracts are forward foreign exchange contracts or similar contracts in which notional principal is equivalent to cash flows if the cash flows fall due on the same value date and fully or partly in the same currency.

## **1C.7 Types of Off-Balance Sheet Items to which the treatment in section 1C.5 above is to be applied.**

### **1C.7.1 Interest-rate contracts**

- Single-currency interest-rate swaps;
- Basis swaps;
- Forward-rate agreements;
- Interest-rate futures;
- Interest-rate options purchased;
- Other contracts of a similar nature.\*

### **1C.7.2 Foreign-exchange contracts and contracts concerning gold**

- Cross-currency interest-rate swaps;
- Forward foreign-exchange contracts;
- Currency futures;
- Currency options purchased;

- Other contracts of a similar nature\*
- Contracts concerning gold of a similar nature to the above items\*

Contracts of a nature similar to those in points above other than those marked

\* concerning other reference items or indices concerning:

- equities,
- precious metals except gold,
- commodities other than precious metals,
- other contracts of a similar nature.

1C.7.3 Where off balance sheet items carry explicit guarantees, they shall be weighted, to the extent of the guarantee as if they had been incurred on behalf of the guarantor rather than the counterparty. Where off balance sheet items are secured by collateral listed in Annex 1B.2.1(1), 1B.3.1(2) or 1B.4.1(3), they shall be weighted, to the extent of the collateral at the weight appropriate to the collateral by which they are secured.

1C.7.4 Societies may apply a 50% weighting to off balance sheet items which are sureties or guarantees having the character of credit substitutes and which are fully guaranteed by mortgages which would themselves attract a 50% weighting provided the guarantor has direct right to such collateral.

## DEDUCTIONS FROM "OWN FUNDS" G

### DEFINITIONS ( for section 1.8 )

**1D.1.1Capital Instruments** Includes without limitation any constituent of own funds (as set out in Article 34 of the BCD) or the equivalent in a financial institution

**1D.1.2Credit Institution** An undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account

**1D.1.3Financial Institution** An undertaking other than a credit institution the principal activity of which is to acquire holdings or to carry on one or more of the following activities:

- (1) lending
- (2) financial leasing
- (3) money transmission services
- (4) issuing and administering means of payment (e.g. credit cards, travellers cheques and bankers drafts)
- (5) guarantees and commitments
- (6) trading for own account or for account of customers in

- (a) money market instruments (cheques, bills, CDs etc)
  - (b) foreign exchange
  - (c) financial futures and options
  - (d) exchange and interest rate instruments
  - (e) transferable securities
- (7) participation in securities issues and the provision of services related to such issues
  - (8) advice to undertakings on capital structure, industrial strategy and related questions and advice and services relating to mergers and the purchase of undertakings
  - (9) money broking
  - (10) portfolio management and advice
  - (11) safekeeping and administration of securities

**1D.1.4 Material Insurance Holding**

means the higher of

- a. the book value of an investment held in an insurance undertaking, reinsurance undertaking, or insurance holding company ("investment" for this purpose is either a participation, or the investment in a subsidiary undertaking), or

- b. the society's proportionate share of that undertaking's local or notional regulatory capital requirement.

*Where the undertaking is a subsidiary and it has a solvency deficit, the subsidiary's local or notional regulatory requirement should be deducted in full.*

A description of how a notional capital requirement is to be calculated is set out in paragraphs 6.7 and 6.8 in Part 6 of PRU 8 Annex 1. A notional requirement should be calculated in all cases where the undertaking is not regulated to EEA or equivalent standards : this is also explained in paragraphs 6.7 and 6.8 in Part 6 of PRU 8 Annex 1.

### **1D.1.5 Participation**

means

- (1) a participating interest as defined in section 260 of the Companies Act 1985 (participating interests):  
or
- (2) *the direct or indirect ownership of 20% or more of the voting rights or capital of an undertaking.*



## INTERIM PROFITS: VERIFICATION PROCEDURES

### G

#### 1E.1 Verification of Interim Profits by External Auditors

1E.1.1 The FSA interprets "verified" to mean obtaining a reasonable degree of comfort on the accuracy of the reported interim results. For this purpose, the analytical review procedures commonly used by auditors in the normal course of their work can be helpful and a combination of some of them will provide adequate assurance that reported interim profits are of sufficient quality for inclusion in the capital base, provided that the society has complied in all material respects with the relevant accounting valuation principles.

1E.1.2 The particular procedures which the FSA considers appropriate for this purpose are listed below. A full scope audit is not required, but in situations where the scope of work carried out differs materially from that set out in this chapter, the FSA will expect to be informed by the auditor in his report.

1E.1.3 Verification by auditors should in normal circumstances entail at least the following:

- (1) satisfying themselves that the figures forming the basis of the interim profits have been properly extracted from the underlying accounting records and that the reliability of any major change to the systems, upon which the accounting records are dependent, has been considered;
- (2) reviewing the accounting policies used in calculating the interim profits so as to obtain comfort that they are consistent with those normally adopted by the society in drawing up its annual financial statements and are in accordance with the relevant accounting principles;

- (3) performing analytical procedures on the result to date, including comparisons of actual performance to date with budget and with the results of prior period(s);
- (4) discussing with management the overall performance and financial position of the society;
- (5) obtaining adequate comfort that the implications of current and prospective litigation, all known claims and commitments, and changes in business activities been properly taken into account in arriving at the interim profits;
- (6) following up problem areas of which the auditors are already aware in the course of auditing the society's financial statements;
- (7) enquiring into the adequacy of provisions for bad and doubtful debt.

1E.1.4 The external auditors should submit an opinion to the society on whether the interim results are fairly stated. Proformas for the text of the reports are set out below. Proforma 1 is for building societies where the external auditor is submitting an opinion on the interim profits in the year in which the building society is publishing its first financial statements under international accounting standards. Proforma 2 is for all other years.

#### Proforma 1

"Dear Sirs

In accordance with your letter of instruction dated [ ] we have reviewed [name of society's] current year interim profits for the period [ ] as reported on Form QFS1, a copy of which is attached for identification. Our review, which did not constitute an audit, has been carried out having regard to the FSA's Interim Prudential Sourcebook for building societies Chapter 1.

On the basis of the results of that review, nothing came to our attention to indicate that:

- (1) the interim profits as reported on QSF1 have not been calculated on the basis of the accounting policies adopted by the society to report under international accounting standards for the year to [ ]. These accounting policies are not necessarily consistent with those used in preparing the society's latest statutory accounts for the year to [ ];
- (2) the accounting policies adopted by the society to report under international accounting standards differ in any material respects from those required by the international accounting standards adopted from time to time by the European Commission in accordance with EC Regulation No. 1606/2002 [except for.....];
- (3) the interim profits amounting to £[ ] as so reported are not fairly stated."

Proforma 2:

"Dear Sirs

In accordance with your letter of instruction dated [ ] we have reviewed [name of society's] current year interim profits for the period [ ] as reported on Form QFS1, a copy of which is attached for identification. Our review, which did not constitute an audit, has been carried out having regard to the FSA's Interim Prudential Sourcebook for building societies Chapter 1.

On the basis of the results of our review, nothing came to our attention to indicate that:

- (1) the interim profits as reported on QFS1 have not been calculated on the basis of the accounting policies adopted by the society in preparing its latest statutory accounts for the year to [ ], [except for];
- (2) those accounting policies differ in any material respects from those required by the Accounts Regulations [*or, where relevant, the international accounting*

standards adopted from time to time by the European Commission in accordance with EC Regulation No. 1606/2002] [except for .....];

(3) the interim profits amounting to £[ ] as so reported are not fairly stated."

**DEFINITION OF RELEVANT AUTHORITY**

**G**

1F.1 "Relevant authority" means any of the following:

- (1) a local authority;
- (2) any authority all the members of which are appointed or elected by one or more local authorities;
- (3) any authority the majority of the members of which are appointed or elected by one or more local authorities in the United Kingdom, being an authority which by virtue of any enactment has power to issue a precept to a local authority in England and Wales, or a requisition to a local authority in Scotland, or to the expenses of which, by virtue of any enactment, a local authority in the United Kingdom is or can be required to contribute;
- (4) the Receiver for a combined police authority (within the meaning of the Police Act 1964);
- (5) a Passenger Transport Executive within the meaning of section 9(1) of the Transport Act 1968;
- (6) a residuary body within the meaning of section 105(1) of the Local Government Act 1985.

**DEFINITIONS OF ZONE A AND ZONE B COUNTRIES**

**G**

**1G.1 ZONE A:**

1G.1.1 For the definition of *Zone A country* see the *Handbook Glossary*.

**1G.2 ZONE B:**

1G.2.1 All other countries.

Note: A United Kingdom branch of a credit institution which has its head office in a Zone B country is regarded as a Zone B institution even though its United Kingdom branch is authorised by the FSA.

**SOCIETY ONLY SOLVENCY RATIO CALCULATIONS DEFINITIONS**

**G**

- 1H.1 "Gross assets" - being the sum of ASSETS according to Balance Sheet Format 2 in Schedule 4 of the Companies Act 1985 (or any alternative accounting regulations under which a subsidiary undertaking may be required to prepare its financial statements), which is equivalent to the total of ASSETS according to the Format of Society Balance Sheet under Schedule 2 Part I of the Accounts Regulations.
- 1H.2 "Income" - being the sum of turnover, other operating income, income from shares in group undertakings income from participating interests, income from other fixed asset investments and other interest receivable and similar income according to Profit and Loss Account Format 1 in Schedule 4 of the Companies Act 1985 (or any alternative accounting regulations under which a subsidiary undertaking may be required to prepare its financial statements), which is equivalent to the sum of interest receivable, income from investments, fees and commissions receivable, net profit on financial operations and other operating income according to the Format of Society Income and Expenditure Account under Schedule 1 Part I of the Accounts Regulations.
- 1H.3 "Profit" or "Loss" - being the profit or loss for the financial year according to Profit and Loss Account Formats 1 and 2 in Schedule 4 of the Companies Act 1985 (or any alternative accounting regulations under which a subsidiary undertaking may be required to prepare its financial statements), which is equivalent to profit or loss for the financial year according to the Format of Society Income and Expenditure Account under Schedule 1 Part I of the Accounts Regulations.

**G  
CONFIDENTIAL**

**Society Threshold Appraisal Sheet**

**Date of Appraisal:**

Society : Deposit Limit :  
 Total Assets : Liquidity Limit :  
 Associate : Treasury Approach :  
 Manager : External Auditors :

Summary grades	This assessment	Last Consistency Review	Any Subsequent Change & Date
Board Competence			
Management Competence			
Systems			
Asset Quality			
Treasury			
Planning/Diversification			
Operational Risk Profile			

Summary

Grading and Threshold	Threshold Ratio Recommended at this Review	Position at Last Consistency Review	Any Subsequent Change & Date
Overall grade			
Threshold ratio			
Own funds required			
Surplus/(deficit) Own Funds available against required			
Surplus/(deficit) as % of Own Funds available			



A. BOARD COMPETENCE	COMMENTS	GRADE
1. Range of Skills		
2. Range of ages and succession planning		
3. Effectiveness of Chairman		
4. Effectiveness of Non Executives		
5. Summary		

B. MANAGEMENT COMPETENCE	COMMENTS	GRADE
1. Range and depth of skills		
2. Succession planning, reliance on key person		
3. Effectiveness of Chief Executive		
4. Existence of "four eyes" management responsibility		
5. Management and corporate culture, dominance of Chief Executive		
6. Delegation and Control, quality of 2nd Tier Management		
7. Quality of communications with FSA staff and responsiveness to FSA concerns		
8. Summary		

C. SYSTEMS	COMMENTS	GRADE
1. Adequacy of business control systems and their documentation, Delegation of authority, Risk Management, Operational Controls.		
2. Quality of Policy documents: Liquidity, Treasury, Funding, Lending, etc.		
3. Independence, quality and effectiveness of internal and external audit and compliance function.		
4. Adequacy of IT systems, existence of a tested contingency plan		
(i) Ability to maintain and amend software		
(ii) Ability to absorb future upgrades and development costs		
(iii) Computer literacy of Board, Senior Management, and Internal Audit		
5. Quality of management information		
6. Summary		

D. ASSET QUALITY	COMMENTS	GRADE
1. Philosophic approach to risk/ reward in lending		
2. Controls on lending and arrears management and approach to provisioning		
3. Actual levels of mortgage arrears		
4. Extent of large exposures		
5. Mortgage Indemnity cover		
6. Summary		

E. TREASURY	COMMENTS	GRADE
1. Volatility of retail funds/reliance on special products, exposure to large shareholdings.		
2. Level of wholesale funding relative to industry, reliance on short-term deposits		
3. Approach to hedging and level of position risk accepted		
4. Adequacy of Treasury management skills, inc. information output and internal skills		
5. "Quality" of liquidity/observance of minimum 7 day and adjusted net liquidity limits, availability of undrawn committed facilities.		
6. Adequate Senior Management oversight of Treasury		
7. Summary		

F. PLANNING/DIVERSIFICATION	COMMENTS	GRADE
1. Quality of corporate planning		
2. Quality of planning, execution and control of new initiatives (including proper consultation with FSA)		
3. Approach and extent of diversification, impact of diversification mix on overall business.		
4. Level of commitment of management resource to new ventures or subsidiary operations		
5. Availability at NXD level, of specialist expertise to query/challenge management plans/proposals for subsidiaries or new ventures		
6. Significant commitment to new ventures - not easily reversed if unsuccessful		
7. Potential for risks incurred by, or systems failures within subsidiaries (or other diversifications) to cause financial or reputational problems for the parent society.		
8. Reliability of forecasting		
9. Summary		

G. OPERATIONAL RISK PROFILE	COMMENTS	GRADE
1. Geographic concentration		
2. Vulnerability on account of small size		
3. Stability of profit track record		
4. Ability to cover management expenses, in the face of narrowing interest margins, loss of fee income or reduction of profit from other causes.		
5. Adequacy and quality of capital, reliance on Tier 2 and 3, cost of servicing capital, headroom for future issues, timing of repayment or amortisation of Tier 2 and Tier 3 Capital and impact on business.		
6. Risk from service activities not covered in asset risk weighting		
7. Summary		

# **Interim Prudential Sourcebook for Building Societies**

## **2 ISSUED CAPITAL**

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# Interim Prudential Sourcebook for Building Societies

## 2 Issued Capital

### 2.1 Introduction

2.1.1 G This chapter replaces PN 1998/2 issued by the Commission. It contains guidance for societies on issued capital to amplify the Threshold Condition set out in Schedule 6, paragraph 4(1) of the Act (the resources of a firm must, in the opinion of the FSA, be adequate in relation to the regulated activities it seeks to carry on ) – see also COND 2.4 - and Principle 4 (“a firm must maintain adequate financial resources”). It should be read in conjunction with Chapter 1.

2.1.2 G This chapter is relevant only to those societies that have issued, or propose to issue, capital instruments to supplement their reserves. It explains the terms and conditions on which capital should be issued if it is to count as own funds. It advises prior consultation with the FSA before issuing capital and describes the documentation which societies should submit to the FSA before including the issue as own funds. Capital which was issued prior to N2, and which does not conform with the guidance in this chapter, will continue to count as own funds provided that at the time it was issued it complied with the statutory instruments or Prudential Note in force at that time.

### 2.2 Types of Issued Capital

2.2.1 G The FSA will recognise PIBS, Undated Subordinated Debt, and Term Subordinated Debt as own funds qualifying for inclusion in the calculation for capital adequacy, provided they conform with the guidance in this chapter.

2.2.2 G The FSA will not recognise as own funds any capital where the issue terms include clauses which would inhibit mergers or transfers in circumstances where the FSA gives a direction under section 42 B (1), (3), or (4) of the 1986 Act.

2.2.3 G The BCD distinguishes between several classes of capital and sets limits on the proportion of the lower classes of capital which may be held in relation to the highest class (the classes are referred to as Tier 1, Tier 2, and Upper Tier 2 capital). Provided they conform to the guidance in this chapter, PIBS count as Tier 1, Undated Subordinated Debt counts as Upper Tier 2 and Term Subordinated Debt counts as Tier 2.

## **2.3 Rules of the Society**

2.3.1 G The rules of the society should, in the event of conflict, take precedence over any separate terms in respect of issued capital. Provisions in such terms of issue purporting to override the society's rules are inconsistent with this, as are provisions purporting to restrict the society's freedom to amend its rules. Societies should also note that for issued capital to count as own funds there should be no provision in the issuing society's rules permitting the write down of shares, other than deferred shares as defined in the Building Societies (Deferred Shares) Order 1991 (SI 1991/701).

## **2.4 Interest Terms**

2.4.1 G The terms of the capital issue may provide for variation of either the rate of interest, or the interest margin over a bench mark market rate during the life of the instrument. But the extent of such variation should be such that it will not create a presumption, at the time of issue, that the society will in practice elect (with the agreement of the FSA) to repay the debt where the terms of issue give the society that option. Accordingly no term should provide for variation in either the interest rate or the margin which is:

- (1) greater than 0.5% p.a. in the first ten years of the issue; or
- (2) greater than 1% p.a. over the whole life of the issue;

whether in a single step, or a series of steps. Any new bench mark should be of a broadly similar type to the previous one and no change in bench mark should take place within five years of the

previous one. Capital may be issued on the basis that the interest rate is capped and/or floored at a specified rate.

2.4.2 G These limits are not intended to set a "market norm" for such variation as that is for societies to negotiate. They can be seen as the maximum level of increase that can be provided for without creating expectations, through the exercise of a repayment option, that the capital will be repaid before maturity or, in the case of permanent instruments, repaid at a certain date.

## **2.5 Amount Eligible as Own Funds**

2.5.1 G Only fully paid up funds, together with premia if any, should be counted as own funds, although deductions for reasonable fees or commission incurred in arranging the issue may be disregarded for this purpose.

## **2.6 Permanent Interest Bearing Shares**

2.6.1 G PIBS are a sub-set of deferred shares which comply both with the Building Societies (Deferred Shares) Order 1991 (SI 1991/701) and the BCD. PIBS are usually listed on the London Stock Exchange. To be eligible for inclusion in the calculation for capital adequacy, the PIBS issue should meet the conditions in paragraphs 2.6.2 to 2.6.9.

### **Permanence**

2.6.2 G PIBS are perpetual instruments. Repayment may normally only occur on the winding up of a society, and no other events of default entitling the holders of PIBS to repayment are possible. However, PIBS may be issued on terms which permit the issuing society, in accordance with a board resolution, to repay PIBS but only subject to the prior consent of the FSA (SI 1991/701 Article 3 and Schedule). The decision to repay PIBS should be genuinely at the instance of the society's board. Such consent would only be given if the FSA were satisfied that the remaining capital would be adequate for the society's present and foreseeable future needs. It is unlikely to be given within five years of the issue date.

## **Subordination**

2.6.3 G On winding up PIBS should rank after all types of ordinary (i.e. non-deferred) shares and all other liabilities including subordinated debt.

## **Waiver of Interest - Non-cumulative**

2.6.4 G In order for PIBS to be effective as a protection against running losses, the issue terms should provide that interest payments due on PIBS at a particular date may be reduced or cancelled by the board of the issuing society if the society is, or after the payment would be, in breach of capital adequacy requirements. The issue terms should also provide that no interest is payable on PIBS if the society has cancelled, or failed to pay, interest or dividend upon other shares of any class (other than deferred shares) or deposits with the society. Interest on PIBS so cancelled is non-cumulative. A term of issue may allow a society to issue further PIBS as fully paid by application of reserves to the extent that interest is foregone.

## **Conversions/Takeovers/Mergers**

2.6.5 G The issue terms should provide that, if a society transfers its business to a commercial company, the PIBS will be transformed into undated subordinated debt of the successor company, ranking behind any undated subordinated debt previously issued by the society. The issue terms should provide that the issue should continue to rank as PIBS in the successor society after an amalgamation or transfer of engagements.

## **Notice to Subscribers**

2.6.6 G At the time of issue the attention of subscribers should be drawn to the deferred nature of PIBS and to their exclusion from the deposit sub-scheme of the Financial Services Compensation Scheme and this information should also be shown prominently on any documents of title (SI 1991/701 Article 3 (2)).

## **Limits**

2.6.7 G Not only does the issuing of PIBS directly reduce the endowment effect of reserves but, by increasing the potential to issue Tier 2 capital, it provides scope for reducing the endowment effect still further. The FSA would not expect a society to issue PIBS in excess of 50% of its reserves.

## **Secondary Market: Stockbrokers**

2.6.8 G A stockbroking subsidiary of a society may accept orders for the purchase and sale of the society's PIBS but, to ensure that the society's capital in the form of PIBS is not reduced except with FSA consent, neither the society nor any subsidiary undertaking may trade, buying and reselling on its own account, as opposed to executing client orders.

## **Retail Issues**

2.6.9 G Societies issuing PIBS as retail instruments directly to the public will be expected to take the utmost care that retail investors are made fully aware of the risks of investing in PIBS as opposed to investing in societies' normal investment share accounts. Issues of PIBS, whether retail or not, should be restricted to minimum denominations of not less than £1000.

## **Controllers**

2.6.10 G Societies issuing PIBS should be aware of the requirements on controllers and potential controllers to notify the FSA under sections 178 and 190 of the Act of the acquisition of, or a change in control, where the exemption set out in the Financial Services and Markets Act 2000 (Controllers) (Exemption) (No.2) Order (SI 2001/3338) does not apply. Guidance on when the exemption does not apply is set out in SUP 11.3.2A G. Societies should also be aware of the requirements on firms in SUP 11.4 to notify the FSA of changes in Control, as well as those in SUP 16.4 to submit an annual controller report to the FSA.

## **2.7 Undated Subordinated Debt**

2.7.1 G To be eligible for inclusion in the calculation for capital adequacy, any issue of Undated Subordinated Debt should meet the conditions in paragraphs 2.7.2 to 2.7.7.

### **Permanence**

2.7.2 G Undated Subordinated Debt should be permanent. Repayment may normally only occur on the winding up of a society and no other events of default entitling the holders of such debt to repayment are possible. However, undated debt may be issued on terms which permit the society, in accordance with a board resolution, to repay undated debt, subject to the prior consent of the FSA. The decision to repay the debt should be genuinely at the instance of the society's board. Such consent would only be given if the FSA were satisfied that the remaining capital would be adequate for the society's present, and future foreseeable needs. It is unlikely to be given within the first five years of issue.

### **Subordination**

2.7.3 G In the event of winding up, Undated Subordinated Debt should, together with deferred shares, rank so as to support the solvency of the society. That is to say, the terms of the issue should provide that the claims of a holder of Undated Subordinated Debt, in the winding up of the borrower, shall be limited to such amount as would have been payable if, immediately prior to the commencement of a winding up, the holder held deferred shares of equivalent value instead of subordinated debt. Upon winding up, the holders of Undated Subordinated Debt should rank after all creditors and holders of non-deferred shares, including creditors in respect of term subordinated debt but their claims should, nevertheless, rank ahead of any existing PIBS or other deferred shares in issue by that society.

### **Interest Deferral**

2.7.4 G Interest payments on Undated Subordinated Debt should rank after those on all other deposits, including other types of Subordinated Debt, and all non-deferred shares. The terms of

issue should prohibit the payment, or crediting, of interest on Undated Subordinated Debt unless all amounts payable on non-deferred shares, or deposits with the society, in respect of any earlier or concurrent period, have been paid.

2.7.5 G The interest payment due on Undated Subordinated Debt at a particular date may be deferred by the board if, after the payment, the society would otherwise be in breach of capital adequacy requirements. However, such interest need only be deferred, not cancelled, i.e. it may be cumulative. Societies may make a scrip issue of Undated Subordinated Debt in satisfaction of the interest payments.

2.7.6 G The terms of issue should allow for the extreme situation by prohibiting the society from paying interest on Undated Subordinated Debt if the society is insolvent, or would be insolvent, after making the payment.

### **Conversions/Takeovers/ Mergers**

2.7.7 G The issue terms should provide that the loss absorption characteristics of Undated Subordinated Debt will continue as a feature of the corresponding liability of the successor company in the case of transfer of business to a company or the successor society in the case of a merger. In order to preserve, as far as possible, the relative rankings of PIBS-holders and holders of Undated Subordinated Debt through the conversion process, issues of PIBS should become a form of Undated Subordinated Debt on conversion, ranking behind any Undated Subordinated Debt previously issued by the society. This avoids the situation in which, upon conversion, PIBS could have become, say, 10 year term subordinated debt of the successor company and be repaid ahead of undated subordinated debt already in issue by the society. This stipulation was first introduced on 15 April 1994 and may not feature in earlier issues of PIBS.

## **2.8 Term Subordinated debt**

2.8.1 G To be eligible for inclusion in the calculation for capital adequacy, any issue of Term Subordinated Debt should meet the conditions in paragraphs 2.8.2 to 2.8.11.

## **Subordination**

2.8.2 G On winding up, Term Subordinated Debt should rank after all types of ordinary (i.e. non-deferred) shares, and interest due thereon, and other liabilities excluding PIBS and Undated Subordinated Debt.

## **Maturity**

2.8.3 G The original maturity should be not less than five years and one day. Where the debt is drawn down in tranches the minimum term should be calculated from the date of the last draw down.

## **Amount Eligible as Own Funds**

2.8.4 G With a discounted issue it is the amount actually received, not the amount due to be repaid at the end of the term, which counts as own funds.

2.8.5 G Subordinated loan capital in its final four years to maturity should not count in full as part of own funds but should be amortised on a straight line basis by 20% p.a. The debt should be included in the capital base according to the following schedule:

<b>Years to maturity</b>	<b>Amount included in own funds</b>
More than 4	100%
Less than and including 4 but more than 3	80%
Less than and including 3 but more than 2	60%
Less than and including 2 but more than 1	40%
Less than and including 1	20%

2.8.6 G If repayment is by instalments then either:



- (1) the debt is divided into its constituent instalments and during the five years preceding the repayment of any instalment of debt, its contribution to own funds is written down on a straight line basis; or
- (2) where the debt repayment schedule is of equal annual, semi annual, or quarterly instalments over the last three to five years of the debt term, the amounts which may be counted as own funds during the last five years of its term are calculated by multiplying the principal debt outstanding by the residual term outstanding, and dividing the result by five.

### **Early Repayment**

2.8.7 G There should be no provision allowing early repayment of the debt other than in the event of approval being granted by the FSA. Only a society or its successor may request this approval for repayment.

2.8.8 G Early repayment should not be capable of being triggered by performance conditions, cross-default clauses, negative pledges, or by mergers, or transfers - in circumstances where the FSA gives a direction under section 42 B (1), (3) or (4) of the 1986 Act.

2.8.9 G However, the loan terms may require the borrower to consult the lender(s) and/or trustee about partial transfers of engagements, or transfer of business where the lender(s) or trustee is not satisfied that the successor company will keep its authorisation under the Act.

2.8.10 G The terms may also provide for certain events of default which would allow the lender or his trustee to require early repayment of the loan but only in a winding up/dissolution of a society or in a winding up of its successor. The permitted events of default should be restricted to:

- (1) the commencement of the winding up of the society or its successor;

- (2) the commencement of the dissolution of a society where it is dissolved otherwise than by virtue of any one or more of sections 93(5), 94(10) or 97(9) and 97(10) of the 1986 Act;
- (3) the cancellation of a society's registration under the 1986 Act otherwise than under section 103 (1)(a) of the 1986 Act.

2.8.11 G The FSA would consider any request for early repayment in the light of the projected capital position of the society if repayment were allowed. Approval would only be given where the FSA was satisfied that the society's capital would remain adequate after repayment for the society's existing and proposed business.

## **2.9 Notification to the FSA**

2.9.1 G It is the responsibility of the society's board to satisfy itself that the terms of issue (which include the relevant sections of the society's rules) meet the guidance in this chapter and the 1986 Act: this would normally be on the basis of specialist legal advice. Before including any issued capital in a society's calculation of its solvency ratio for capital adequacy purposes the FSA expects to receive from the society:

- (1) evidence, usually in the form of a certified board minute, that the board has considered the specialist legal advice provided to the society, and that the board is satisfied that the society has the power to make the issue and that the issue will meet the guidance in this chapter;
- (2) a copy of the legal opinion provided to the society which should cover at least the following points:
  - (a) that the society has the power to make the issue (having made the necessary amendments to rules, etc.);

- (b) that any terms not contained within the society's rules are consistent with the rules;
- (c) that the terms of the issue (including the terms within the society's rules) comply with the guidance set out in this chapter.

# Interim Prudential Source Book for Building Societies

## 3 BOARDS AND MANAGEMENT

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## **Interim Prudential Sourcebook for Building Societies**

### **3 Boards and Management**

#### **3.1 Introduction**

3.1.1 G This chapter replaces PN 1998/3 (Boards and Management) and PN 1992/2 (New Business Developments and New Initiatives) published by the Commission. It provides additional guidance for building societies supplemental to other FSA rules and guidance in this area, especially the FSA Statements of Principle for Approved Persons and the Code of Practice (see APER) and the rules and guidance on senior management arrangements (see SYSC).

3.1.2 G It also provides additional guidance on the provisions of Part VII (Management of Building Societies) of the 1986 Act.

3.1.3 G Building societies have a particular constitutional form not shared by the generality of deposit-taking firms regulated by the FSA. They are mutual institutions run for the benefit of their members (i.e. their borrowers and savers). This mutual structure means that a society cannot be owned or controlled by an outside institution or major shareholders. Society boards and management have a special responsibility to protect the interests of their customers through the highest standards of corporate governance.

#### **3.2 Corporate Governance**

3.2.1 G As for all firms, the FSA regards the board and senior management as the focus for the accountability of the society for the conduct of its business. Accordingly, the FSA will take into account its assessment of the standards of governance, and board and management competence (relative to the nature, scale and complexity of the society's business), in setting the society's threshold solvency ratio.

3.2.2 G Although societies are not publicly quoted, they should have regard to the Combined Code, developed by the Committee on Corporate Governance for listed companies, when establishing and reviewing their own corporate governance arrangements. A sample Code of Governance is attached as Annex 3A, which is a version of the Combined

Code, adapted for the particular circumstances of building societies. Societies are encouraged to adopt this code to apply principles of good governance practice within their business.

### **3.3 Fit and Proper**

3.3.1 G As set out in SUP, all directors of building societies, including non-executives, will be Approved Persons and thus are expected to meet the “fit and proper” criteria and comply with the Principles for Approved Persons and the Code of Practice. The attention of societies is drawn to the distinction between the controlled functions of director and non-executive director set out in SUP 10.6.2 to 10.6.10.

3.3.2 G Under section 60 of the 1986 Act, directors of building societies are elected by the members, and subsection (4) makes clear that, subject to certain conditions, any natural person is eligible to be elected a director. (Subsection (4A) however provides that a person subject to a prohibition order under section 56(2) of the Act is not eligible.) Members have the right under a society’s rules to nominate candidates and the FSA has no power to intervene in elections for board directors. Where members nominate a candidate, in the FSA’s view it is not open to the board to refuse to accept a candidate’s nomination on the grounds that, in the board’s view, he (or she) is not fit and proper (except, of course, in the limited circumstances of a prohibition order being in force in relation to that person). However, the board should, prior to the election, take such steps as are practicably open to it to establish whether there are any matters concerning the candidate’s fitness and propriety of which the members should be aware in advance of the election. If there are such matters, the board should bring them to the attention of the members. The FSA will not vet candidates for election.

3.3.3 G On election, all directors, whether recommended by the board or nominated by members, have the same status. The FSA would, in the exercise of its responsibilities under the Act concerning the regulation of Approved Persons, apply the requirements for approval equally to all directors upon election (i.e. before the elected individuals can take up controlled functions).

### **3.4 Other requirements and guidance**

3.4.1 G Part VII of the 1986 Act contains requirements relating to the management of building societies. This section contains further guidance on this Part of the 1986 Act and

sets out some factors the FSA will take into account in assessing the adequacy of a society's board and management arrangements for the purposes of setting its threshold solvency ratio.

3.4.2 G Section 58(2) of the 1986 Act requires each building society to have a chairman and this person plays a key role in the strategic direction of the society. The chairman should not have any executive post in the society. This assists in the separation of strategic direction from the day to day running of the business and helps the chairman take an independent view of management performance. It also protects against undue concentration of power.

3.4.3 G Given the mutual status of building societies, a clear majority of directors on a society's board should be non-executive. The appropriate ratio of non-executives to executives will vary with the scale, nature and complexity of the society's business. The board should have an appropriate range of skills and experience to control and direct the society's activities effectively. The composition of the board should be reviewed at regular intervals.

3.4.4 G It will rarely be appropriate or desirable for a chief executive or other executive director to remain as a non-executive board member after his or her retirement.

3.4.5 G The composition of a board should change progressively over time in a planned manner. As societies increasingly innovate in their mainstream business and use wider powers, so they should recognise the need to enhance their overall board and management resources and expertise accordingly. Non-executive directors should not be given the expectation that they will remain on the board, automatically standing for re-election every 3 years, until the retirement age in the society's rules. They should serve for fixed terms, both initially and for any subsequent term.

3.4.6 G Each society is required by section 59(1) of the 1986 Act to have a chief executive. The chief executive plays a key role in the running of the society and has specific responsibilities in SYSC. He or she should be a member of the board.

3.4.7 G Smaller societies may not need as many executives on the board as larger societies, but every society should have at least one executive director on the board.

3.4.8 G Where executives are appointed under formal service contracts, the board should consider carefully the terms of such contracts. It should have regard not only to the need to

attract or retain executives but also to the need to preserve the board's freedom, considering the potential associated costs, to make a change if circumstances so require. A board should consider in particular the period of notice the society must give and the potential liability to the society if it wishes to terminate the contract otherwise than on grounds of misconduct. The objective should be for notice or contract periods to be one year or less.

3.4.9 G Societies are required under the Accounts Regulations to give particulars of the service contracts of directors and chief executives in their annual Report and Accounts. Where there are no such service contracts in existence, societies should say so.

3.4.10 G Each society is required by section 59(2) of the 1986 Act to have a secretary. The secretary plays a key role within the society, with the responsibility of a company secretary to ensure that board procedures are followed and regularly reviewed and to provide guidance on the board's responsibilities and how they should be discharged.

3.4.11 G In assessing the adequacy of society's corporate governance arrangements, the FSA will consider whether the society has established committees of the board appropriate to the scale and nature of its business. Such committees should include at least an audit committee (see Chapter 9 Systems) and may also include an asset and liability committee (ALCO) and a remuneration committee.

3.4.12 G Paragraphs 15.3.7 to 15.3.10 of SUP give guidance on how the FSA will assess compliance with Principle 11 ("A firm must deal with its regulators in an open and co-operative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice"). They indicate that firms should notify the FSA of any "proposed restructuring, reorganisation or business expansion which could have a significant impact on the firm's risk profile or resources". A society entering a new area of activity should ensure that it has appropriate board and management skills properly to manage and control that activity. It is for boards to satisfy themselves on the commercial aspects of any such new venture and to be satisfied that such a venture will not put the society at undue risk, that capital remains adequate and that adequate systems of control have been established.



### **3.5 Dealings with Directors**

3.5.1 G Dealings with directors (and other officers) of societies are subject to restrictions contained in Part VII of the 1986 Act. These include limitations on specified financial transactions, requirements for directors to disclose their interests in any existing or proposed contracts, and the requirement for permitted dealings to be reported. The requirements are concerned with issues of particular sensitivity to a society and its members. In view of this, and the risk of damage to a society's reputation, the board should satisfy itself that there are written procedures and controls in place to ensure compliance with statutory requirements for dealings with directors.

#### **Loans to Directors**

3.5.2 G Section 65 of the 1986 Act places restrictions on the loans societies can make to directors or connected persons (as defined in the 1986 Act). Given this, it would be inappropriate for a society simply to follow its usual loan procedures when a loan application is made by a director or a person connected with a director. The responsibility for approving such loans should not rest with staff members, even if the loan could otherwise be decided within staff mandates. A board should ensure that the society has written procedures for dealing with loan applications from directors or persons connected with them and that all directors are familiar with such procedures. They should include consideration by the board or a board committee before approval and should require a review of the proposed terms of a loan, including legal advice, if necessary, to ensure that the loan is allowed by the 1986 Act. Such transactions should take place at arm's length. There should be written procedures to identify applications for director-connected loans.

### **3.6 Reporting Requirements**

3.6.1 G The Accounts Regulations set out specific legal and regulatory requirements about the form and content of the annual report and accounts, summary financial statements, etc., that societies and their directors must produce. A board should present to the members an assessment of the society's position which is balanced (that is, setbacks should be reported as well as successes) and understandable.

3.6.2 G A key principle behind the requirements in the Accounts Regulations is that the members of a society should be given additional disclosure in the annual report and accounts about the interests in the society of directors, the chief executive (on the matter of service contracts) and other officers (on the matter of options to subscribe for share or debentures). The reporting requirements in the Accounts Regulations accordingly include individual directors' remuneration, particulars of service contracts for the directors and chief executive, additional retirement benefits to current and past directors and interests in shares or debentures of connected undertakings. In the interests of transparency, societies should say in their annual report whether they adhere to the sample code of governance in Annex 3A and, if not, in what respects.

## **Sample Code of Governance**

3A.1 G This sample Code of Governance is an adapted version of the Combined Code, which is considered suitable for building societies.

### **The board**

3A.2 G The board should have procedures to ensure that due consideration is given before the appointment of any director or manager to whether the candidate is fit and proper.

3A.3 G The chairman of a building society should not have any executive post in the society.

3A.4 G All directors should bring an independent judgement to bear on issues of strategy, performance, resources (including key appointments) and standards of conduct.

3A.5 G A board should review its composition at appropriate intervals or when considering a major new activity.

3A.6 G A clear majority of directors on a society board should be non-executive.

3A.7 G A society should have at least one executive director on the board.

3A.8 G A non-executive director should serve for specified initial and subsequent terms (if any). Towards the end of each term the board should review whether to recommend re-election.

3A.9 G The chief executive should be a member of the board.

### **Executive Directors and Other Executives**

3A.10 G The terms of an executive's service contract should reflect a reasonable balance between attracting or retaining executives of the requisite calibre and preserving the board's freedom to make a change. The objective should be for notice or contract periods to be one year or less.

## **Board Procedures**

3A.11 G A board should establish a remuneration committee, consisting only of non-executive directors, to develop a general policy, and to make recommendations, on the pay of executive directors.

3A.12 G A board should establish an audit committee of non-executive directors consisting of at least three members.

3A.13 G It is a board's responsibility to ensure that an objective and professional relationship is maintained with the external auditors.

3A.14 G A board should ensure that the society has specific written procedures for the consideration of loan applications by directors or persons connected with them and that all directors are familiar with these procedures.

3A.15 G If a director or any person connected with a director participates in an existing share option scheme, that director should not be allowed to vote on, or to use any discussion to promote, any transaction (such as sale of a subsidiary undertaking) under which that director or connected person would benefit financially.

3A.16 G A board should have a procedure that enables individual directors to obtain independent professional advice at the society's expense for the furtherance of their duties.

3A.17 G Each director should have access to the advice and services of the secretary and any separately appointed compliance officer(s).

## **Reporting**

3A.18 G A board should present a balanced and understandable assessment of the society's position to the members.

3A.19 G Directors should explain their responsibility for preparing the accounts next to a statement by the external auditors about their reporting responsibilities.

3A.20 G Directors should (if it be the case) report that the society is a going concern, with supporting assumptions or qualifications as necessary.

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## 4 FINANCIAL RISK MANAGEMENT

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## 4.1 Introduction

4.1.1 G This chapter replaces PN 1998/4, issued by the Commission, and contains rules and guidance for societies on financial risk management, a key part of compliance with Principle 3 (“a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems”).

4.1.2 G This chapter describes the key financial risks to which societies are exposed, explains the statutory restrictions on funding, market making, trading and use of derivative instruments, sets out the framework within which the FSA will supervise the treasury activities of societies, including details of the five “approach” categories (Administered, Matched, Extended, Comprehensive and Trading) applied, and emphasises the respective responsibilities of boards and management for monitoring and controlling financial risks. (Unless otherwise explicitly stated, references in this chapter to “societies” are to society groups, consolidated to include all subsidiary undertakings.)

## 4.2. Rules

**4.2.1 R A society must have an adequate system for managing and containing financial risks to the net worth of its business, and risks to its net income, whether arising from fluctuations in interest or exchange rates or from other factors.**

4.2.2 G Societies should have systems and procedures for identifying, monitoring and controlling all material maturity mismatch, interest rate, foreign exchange and similar (e.g. index related) risks, and for reporting exposures to senior management and the board on a regular, and timely, basis. Societies should also have interest margin management systems in place to estimate the expected profitability of new mortgage and savings products, and to project forward the cumulative effect of mortgage incentives and loyalty schemes.

4.2.3 G Societies should have credit limits in place for all counterparties both for placing liquidity and for transacting derivative contracts (further guidance also in Chapter 5 (Liquidity)) and in PRU 5.1 – stress testing and scenario analysis, and contingency funding plans).

4.2.4 G Societies' boards should ensure that there are adequate internal controls in place covering all treasury activities, including appropriate segregation of duties between initiation of a transaction and confirmation/settlement/ accounting for it, such controls to be the subject of regular review by internal auditors with the requisite skills and experience.

**4.2.5 R A society must maintain, and submit to the FSA, a board-approved policy statement on financial risk management.**

**4.2.6 R A society making any significant change to its policy statement on financial risk management must provide the FSA with a copy of the amended statement as soon as possible after it has been adopted.**

4.2.7 G Boards have ultimate responsibility for understanding and controlling the degree of risk, by type, which is being taken by their societies. They should approve the general business strategies, including the treasury section of the society's corporate plan, and the risk management policies that control the extent of risk which is taken, and should give clear guidance on the level of risk considered to be acceptable – such strategies and guidance to be reviewed regularly by the board.

4.2.8 G The policy statement establishes guidelines for the society's senior managers on the control of financial risks, including: operational risk; structural risk; funding risk; and counterparty credit (including settlement) risk. Such documents should be consistent with the type of business undertaken by the society and compliant with sections 7 and 9A of the 1986 Act.

4.2.9 G Policy statements should set out the strategic framework for treasury operations, recording the rationale for that framework i.e. why and how treasury activities are expected to support the society's core business, and the "approach" category being followed, derived, where possible, from the results of a financial risk audit. They should clearly state the conditions under which authority is delegated to a board sub-committee, or to management. The documents should establish the operating limits and high level controls that will maintain exposures within levels consistent with the policy, and the procedures/controls on the introduction of new products or activities. Copies of the policy statements should be made available to, and read by, all personnel involved in treasury operations.

## **4.3 Financial risks**

### **Funding risks**

4.3.1 G Building societies' current core business, financing long-term residential mortgages with short-term personal savings, necessarily involves a high degree of maturity transformation, and this constitutes the major financial risk that all societies need to manage.

4.3.2 G Wholesale deposit funding, available from a range of sources, provides a useful supplement to the stocks, and inflows, of personal savings. Wholesale markets typically provide funding at longer and/or more definite maturity, often at advantageous rates, but may concentrate the refinancing risks societies face.

4.3.3 G The particular constitution of building societies means that the scale of deposit funding has a significant impact on the position of investor members. The public perceives building society share accounts to be as secure as (or even more secure than) bank deposits. However, unlike depositors with banks, share account investors are contributories, not creditors, so they rank after deposit funders, including suppliers of wholesale funding. A society which gears itself up significantly with wholesale funds thereby dilutes the security of its share account investors, whilst at the same time increasing its refinancing and liquidity risks.

4.3.4 G Guidance on the management of short-term cashflow mismatches, and the liquidity requirements which flow from such positions, is given in Chapter 5 (Liquidity). Risks arising from the interest basis/structure or currency of the funding are covered later in this chapter.

### **Structural risks**

4.3.5 G Most societies are susceptible to interest rate exposure arising not only as a result of changes (or potential changes) in the general level of interest rates or the relationship between short term and long term rates, but also from divergence of rates for different balance sheet elements ("basis" risk), for example, the risk that it may not be possible to increase administered mortgage rates in line with increases in money market (LIBOR) rates, resulting in a margin squeeze where funding is LIBOR-based. In this chapter, risks which arise from the different interest rate or currency



characteristics of assets and liabilities, and from transactions based on other financial reference rates or indices, are referred to as “structural” risks.

### **Operational risks**

4.3.6 G The extension of building society activities into new forms of funding, liquidity and off balance sheet instruments has dramatically increased the operational risks involved. The documentation, accounting treatment and settlement procedures for such instruments can be highly complex, with significant costs and penalties arising from operational mistakes. Societies involved in these areas of activity need rigorous management procedures and control systems to ensure that robust legal documentation is used, that compliance with market practice is achieved, and that deal recording and settlement systems are effective (with appropriate contingency arrangements in place).

### **Key risk categories**

4.3.7 G The key financial risks which, in order to comply with Rule 4.2.1, societies should manage and control are:

- (1) Maturity mismatch, including the risks:
  - (a) that the society may be unable to refinance term wholesale borrowings on a rollover date due to general market conditions (which may or may not be related to the position of the society itself);
  - (b) associated with the bunching of roll-over dates for wholesale funding or maturities of term retail funding;
  - (c) from concentration on a limited number of funding providers, giving rise to increased dependence particularly on roll-over days; and
  - (d) arising from the prepayment (early redemption) profile of mortgages, and those inherent in the early withdrawal characteristics of retail savings products (i.e. behavioural v. contractual maturity risks);

(2) Interest rate risk to a society's earnings (most significantly, to its interest margin) and to its economic value (the present value of future cashflows) arising from:

- (a) repricing mismatches, e.g. where, in a rising interest rate environment, liabilities reprice earlier than the assets which they are funding, or, in a falling rate environment, assets reprice earlier than the liabilities funding them (in both cases leaving the society with a reduction in future income); repricing risk is inherent in fixed rate instruments, the market value of which will change with interest rate movements (e.g. Gilts), and unhedged fixed rate retail products (e.g. unhedged fixed rate mortgages funded by variable rate liabilities would yield less margin should the cost of the liabilities increase due to changes in market rates);
- (b) yield curve risk, where unanticipated changes to the shape or slope of the yield curve will cause assets and liabilities to reprice relative to each other - possibly exposing positions which were hedged against a parallel shift in rates only;
- (c) interest basis mismatches, arising from the imperfect correlation of rates on instruments with similar repricing characteristics, e.g. between LIBOR rates and mortgage rates (both of which are variable but are subject to different market forces), or between LIBOR and reference Gilt rates, or between 3 and 12 month LIBOR rates etc. Risk can also arise where the underlying market rate is the same for matching assets and liabilities, but the margin paid relative to the offer rate diverges from the margin received relative to the bid rate;
- (d) balance sheet composition, where an increase in the proportion of assets and liabilities repricing at fixed or variable wholesale market rates implies a reduced administered rate element in the balance sheet - which will nevertheless have to bear (at least in the short term) the full brunt of any rate changes required in order for a society to widen its margins, if necessary for business or profitability reasons (e.g. in the event of a significant credit

deterioration leading to rising provision levels);

- (e) optionality (i.e. explicit/contracted option contracts, such as “caps”, “collars” and “floors”, which confer the right, but not the obligation, to fix an interest rate for an agreed amount and for an agreed period. and embedded/implied options included within products, such as early withdrawal or redemption entitlements), magnifying the effect of other interest rate risks: in particular, societies may be subject to implied optionality in respect of retail savings rates (for which a minimum rate payable - a “floor” - above 0% may need to be assumed), and from prepayment of mortgages/pre-withdrawal of deposits (where the customer may effectively have an “option” which may not be adequately “hedged” by way of early redemption charges); and
  - (f) product pricing, arising particularly where products are not immediately profitable and where longer term payback is dependent upon the achievement of specific cost and/or pricing assumptions.
- (3) Currency risk, arising from the effects of changing exchange rates on unmatched assets and liabilities denominated in different currencies; and
  - (4) Index related risk, arising from the effects of movements in an index of financial assets (e.g. the FTSE 100), or similar reference rate, on unmatched assets or liabilities paying or receiving a return based on that index/rate.

#### 4.3.8 G Societies’ financial risk management policies should also cover:

- (1) Settlement risk: the risk of losses arising from failure to settle transactions accurately, or on a timely basis;
- (2) Counterparty risk: associated with settlement risk, where a counterparty cannot or will not complete a transaction;
- (3) Investment risk: associated with the financial consequences of capital projects including diversification investments; and

- (4) Operational risk: including failure of internal controls or procedures, and the risk arising from errors in legal documentation.
- (5) Credit risk: the control and mitigation of the risk of borrower default, whether relating to wholesale assets, such as large commercial loans or items of liquidity, or to retail assets such as residential mortgages. Societies should take account of the requirements at 6.2.1R and 6.2.2R for assessing the ability and willingness of borrowers to repay their loans, and for a board-approved policy statement on lending. 5B.2.4G provides guidance on credit risk on liquidity.

## **4.4 Statutory restrictions**

### **Funding limit**

4.4.1 G Section 7 of the 1986 Act provides that at least 50% of the funds (excluding those qualifying as own funds) of a building society (or, if appropriate, of the society's group) must be raised in the form of shares held by individual members of the society (excluding share accounts held by individuals as bare trustees for corporate bodies).

### **Structural risk management restrictions**

4.4.2 G Section 9A prohibits a society or its subsidiary undertakings (subject to certain defined exemptions) from:

- (1) acting as a market maker in securities, commodities, or currencies;
- (2) trading in commodities or currencies; or
- (3) entering into any transactions involving derivative investments.

4.4.3 G Section 9A contains definitions of the above terms, and societies are directed particularly to section 9A(9) for the purposes of compliance monitoring.

4.4.4 G Section 9A also includes a “purpose” test for entering into derivatives contracts and a “safe harbour” clause for society counterparties stating that any transaction in contravention of the section 9A prohibitions is not, however, thereby invalid and may be enforced against the society.

4.4.5 G The exemptions in section 9A fall into two broad categories:

- (1) those which allow a society or subsidiary undertaking to provide certain retail services to its customers, including:
  - (a) acting as market maker in currency or securities transactions of less than £100,000;
  - (b) trading in currencies (but not commodities) up to a value of £100,000 per transaction;
  - (c) entering into “contracts for differences” in respect of customers who wish to hedge exposures arising from their own loans or deposits with, the society group; or
  - (d) acting as market maker or entering into “derivative investments” in its capacity as manager of a collective investment scheme; and
- (2) those which allow a society or subsidiary undertaking to use “derivative investments” in order to limit the extent to which it, or a connected undertaking, will be affected by changes in interest rates, exchange rates, any index of retail prices, any index of residential property prices, any index of the prices of securities, or the creditworthiness of any borrower(s).

4.4.6 G The Treasury may, by negative resolution order, amend the £100,000 transaction limit and may add factors to, or remove factors from, the list in 4.4.5(2) above. The factor relating to credit worthiness was added to the original list in section 9A(4)(b) by the Building Societies (Restricted Transactions) Order 2001 (SI 2001/1826). The Treasury may, by affirmative resolution order, make more significant amendments to section 9A.

4.4.7 G Boards should have procedures and controls to ensure that use of section 9A exemptions by their society (and subsidiary undertakings, if any) is within the law. The exemptions permitting transactions of up to £100,000 (as market-maker in currency or securities transactions, or trading currencies) may not be abused by artificially breaking up larger transactions into a number of smaller amounts falling within the £100,000 ceiling (section 9A(8) is the relevant anti-avoidance provision). Compliance with the 1986 Act may be assisted by specifying the purposes and circumstances in which hedging transactions may be undertaken, or derivatives used, both in the financial risk management policy documents and in the internal arrangements for delegation, identifying the specific authority in section 9A. Whatever the hedging policies adopted, and however the control and authorisation arrangements are organised, it is important that they should be accurately and fully documented.

## **4.5 Supervisory approach**

### **Funding limits**

4.5.1 G Whilst the section 7 funding limit is expressed as a minimum of 50% share account funding, societies should, for prudential monitoring purposes, draw up a funding policy which incorporates an internal policy limit based on a maximum level of deposit liabilities (i.e. an inversion of the “nature limit”). In order to avoid any possibility of an inadvertent breach of the 1986 Act, it is expected that such internal limits will be set at levels below the 50% statutory maximum.

4.5.2 G In setting funding limits, the board should consider wholesale and other deposit funding requirements over the period of their society’s current corporate plan, and avoid setting limits at levels where usage is either unplanned or highly unlikely. Where societies have significant levels of offshore deposit funding or commercial deposit funding, boards should set policy sub-limits for these sources (e.g., a society might set an overall deposit liabilities limit of 30%, with sub-limits of 25% for wholesale funding and 10% for offshore funding - the total of the sub-limits exceeding the overall limit only on the basis that both could not be used to their full extent simultaneously).

### **Supervisory standards for treasury activities**

4.5.3 G Under section 5 of the 1986 Act, a society's principal purpose is residential mortgage lending, financed by members' savings, not undertaking, and trading in, financial risk for profit. Societies should therefore adopt a risk-averse approach to maturity mismatch and to structural risk management. A degree of maturity mismatch and structural risk is inherent in normal building society operations, but boards should set risk limits which either:

- (1) ensure that, as far as possible, such exposures are minimised; or
- (2) where interest rate positions are to be taken, restrict potential reductions in income or economic value, estimated under robust stress testing scenarios, to levels which would not compromise the current or future viability of their societies.

4.5.4 G Societies should aim to eliminate, as far as is practicable, all exposures to risk arising from movements in currency exchange rates.

4.5.5 G To comply with rule 4.2.1, a society's system for financial risk management must be **adequate**. The policy statement required under rule 4.2.5 must be appropriate for the society's business needs and the complexity of its existing and proposed treasury activities. The FSA has devised five models, described as supervisory approaches, of increasing sophistication, to assist societies to comply with these rules. The approaches are described as "administered", "matched", "extended", "comprehensive" and "trading". A society that conducts its treasury activities in accordance with the most suitable (for it) of these five models, can readily demonstrate that it complies with rules 4.2.1 and 4.2.5. But these models are neither mandatory nor exhaustive. Guidance on the characteristics of each approach is set out in Annex 4A.

### **Supervisory discussions on change of approach**

4.5.6 G The FSA anticipates that societies will wish to develop further their treasury expertise, and that a change of "approach" may be necessary. In this respect, the "approach" categories should be seen, not as discrete compartments, but rather as stages in the continuous evolution of financial risk management, with a change of "approach" marking a milestone in that progress. Societies should develop their financial risk management and systems to the level appropriate to support the scale and nature of their business and the FSA will be encouraging societies to enhance their treasury

capabilities where this is considered to be necessary.

4.5.7 G Whilst the “approach” benchmarks have no legal significance, the process of moving between approaches provides a useful opportunity for the FSA to review a society's progress, and to satisfy itself that policies, limits and systems are appropriate for the treasury activities planned, and that therefore compliance with rule 4.2.1 is adequately established.

4.5.8 G Any society which wishes to move between approaches should contact the FSA at an early stage. The FSA will wish to be satisfied that the society has the requisite expertise, management information systems, accounting systems and controls before any significant change in the society's treasury activities is implemented.

## **4.6 Management responsibilities**

4.6.1 G Senior management of a society are responsible for:

- (1) ensuring that board policies for managing treasury risk are implemented through the operation of effective:
  - (a) control procedures;
  - (b) risk measurement systems; and
  - (c) risk reporting systems; and
  
- (2) maintaining clear lines of authority and responsibility for controlling treasury risk, including:
  - (a) recruitment of sufficient personnel (including ensuring adequate cover for sickness and holidays) with appropriate specialist skills and expertise to control and monitor structural risk;
  
  - (b) setting and monitoring appropriate control limits within the board policy levels delegated; and



- (c) maintaining effective internal controls through daily monitoring of treasury activities, and appropriate segregation of duties.

## **4.7 Risk management systems**

4.7.1 G In order to demonstrate compliance with rule 4.2.1, a society should have in place information systems that are capable of:

- (1) measuring the level of maturity mismatch and structural risk inherent in its balance sheet;
- (2) assessing the potential impact of interest rate (and, if applicable, currency exchange rate) changes on its earnings and its economic value;
- (3) reporting accurately, and promptly, on risk positions - to management, to the board and, if requested, to the FSA;
- (4) recording accurately, and on a timely basis, all new transactions and/or cashflows which will affect calculations of structural risk exposures;
- (5) managing the settlement timetable and processes for individual treasury instruments;  
and
- (6) monitoring credit risk and settlement risk positions incurred with individual and groups of counterparties.

4.7.2 G The scale and scope of the risk measurement system employed should reflect the sophistication of a society's treasury operations, those societies wishing to adopt the “Comprehensive” or “Trading” approaches requiring more complex techniques to capture different facets of risk.

### **Control limits**

4.7.3 G Control limits confine structural risk positions within levels considered by board and management to be prudent, given the size, complexity and capital needs of the society's business. Where applicable, limits should also be applied to individual instrument types, asset/liability portfolios, and to separate business activities or subsidiaries. The size of the limits set will be a factor in the FSA's assessment of the overall risk profile of the society, and thus in the threshold solvency ratio which is set for it.

4.7.4 G The structure of limits should enable the board and management to monitor actual levels of sensitivity, under different pre-defined market index, interest rate and exchange rate scenarios, against the policy specified maxima, to ensure that corrective action can be taken if required.

4.7.5 G The number and type of limits which should be applied will depend upon the relative sophistication of a society's treasury operations, and further guidance on the FSA's expectations for each policy approach is set out in Annex 4A.

4.7.6 G Where limits are set as part of the overall board policy, these should be treated as absolute, and therefore no excesses should be tolerated. Any limit exceptions should be reported immediately to executive managers, and the policy should make clear what action is expected of management in such circumstances (including arrangements for informing the board and the FSA of the breach). Limits set by management should similarly be subject to clear guidelines covering the circumstances and periods for which breaches may be permitted (if at all) and the arrangements for notification of exceptions.

### **Stress testing**

4.7.7 G The risk measurement systems put in place should evaluate the impact, on income or economic value as appropriate, of abnormal market conditions. The amount and type of such stress testing required will depend upon the sophistication of treasury operations undertaken, and the level of risk taken, but where required should be regular and systematic. Boards and management should, periodically, review the extent of such stress testing to ensure that any "worst case" scenarios remain valid. Contingency plans should be in place to deal with the consequences should such scenarios become reality. Rules and guidance on stress testing, scenario analysis and contingency funding plans specifically for liquidity risk are in PRU 1.2 and PRU 5.1.

## **Board information reporting**

4.7.8 G The FSA attaches considerable importance to the quality, timeliness, and frequency of the management information which the board uses to inform itself of the society's risk positions and to satisfy itself that treasury activities are being undertaken in accordance with its policies and guidelines. Information obtained by the board should not be confined to the current position, but should include regular and systematic stress testing, as described above, which should be taken into account when policies and limits are established or reviewed.

## **4.8 Counterparty risk**

4.8.1 G Counterparty limits should cover:

- (1) full risk exposures (e.g. deposits or marketable instruments);
- (2) market risk exposures (e.g. mark to market positive value of swaps, plus appropriate addition for potential future exposure increases arising from changes in market rates);  
and
- (3) settlement risk exposures (e.g. currency deals where amounts are paid out before funds are received).

4.8.2 G Boards should determine the extent to which authority to set counterparty limits is delegated to management, but delegation to a single individual should not be permitted. Personnel with dealing mandates should not be given authority to set new or increased counterparty limits. No dealings should take place with counterparties which do not have a pre-approved limit.

4.8.3 G Limits should be established on the basis of a robust methodology, which should be fully documented and reviewed regularly. For societies with more active treasury operations, a separate credit risk committee with responsibility for preparing a credit policy statement and counterparty list may be appropriate - less active societies may incorporate a section on credit risk within their liquidity policy statements, with appropriate cross-references to other policy and procedures statements. In all

cases, the counterparty list and individual limits should be subject to formal credit review at least annually, with interim arrangements in place to add, amend or remove limits as appropriate.

4.8.4 G Where reliance is placed on sources of information or opinion external to both the society and the counterparty (e.g. rating agencies), the nature of the source, and arrangements for ensuring that the information relied upon is kept up to date, should be made explicit in the credit risk policy document and in procedures manuals. Where ratings are reduced (or put on “watch” with “negative implications”), or where a society becomes aware of information on a counterparty which might affect its perceived creditworthiness, it should have systems for reviewing individual counterparty limits and, possibly, suspending/removing individual names from authorised lists in an expeditious manner. Arrangements for obtaining published information on counterparties should also be included in procedures manuals.

4.8.5 G Exposures to counterparties should be monitored on a consolidated basis, aggregating exposures of the society and any subsidiaries (where applicable), and setting total exposure limits for groups of connected counterparties (e.g. a commercial bank and its merchant bank subsidiary). Similarly, country, sector and market concentrations should be monitored continuously against agreed limits.

### **Large shareholdings and deposits**

4.8.6 G Undue dependence on individual funding sources that account for a large proportion of a society’s overall liabilities will involve risk of liquidity problems should those funds be withdrawn or not be available for roll-over. These potential problems apply whether the funds in question are raised from the retail or the wholesale markets.

4.8.7 G A small society is relatively more exposed to this type of risk, and should consider the implications of concentration on individual shareholders or depositors when assessing its liquidity levels and need for committed facilities. In the management of large retail investment accounts, a society should normally avoid:

- (1) obtaining funding from a single shareholder or depositor which exceeds 1% of shares, deposits and loans; and

- (2) allowing the aggregate total of funding, from those single shareholders or depositors which individually represent more than one-quarter of 1% of shares, deposits and loans, to exceed 5% of shares, deposits and loans.

### **Committed facilities**

4.8.8 G A society with high levels of maturing funding, or vulnerability to withdrawal of individual deposits, should consider arranging committed facilities (or to maintain higher than average levels of liquidity). In arranging committed facilities, a society should consider:

- (1) the credit standing and capacity of the provider of the facility;
- (2) the documented basis of the commitment (i.e. is it an unconditional commitment or a “best endeavours” arrangement); and
- (3) the cost/fee structure compared to alternatives.

In extreme cases, there remains a risk that a provider may renege on a contractual commitment to provide funding, or purport to rely on widely drawn “events of default” or “material adverse change” clauses, and face the legal consequences (if any) rather than lend money to a society in difficulties. Societies should not, therefore, become over reliant on committed facilities to plug short term cashflow difficulties.

## **4.9 Operational risk**

### **General**

4.9.1 G Treasury is an area which is particularly vulnerable to losses arising out of errors, fraud, or wilful override of controls in order to “trade out” of loss making positions.

### **Segregation of duties**

4.9.2 G Societies should ensure that, for all transactions undertaken, separate individuals are responsible for agreeing the deal, for preparing settlement instructions and for authorising payments. Societies should aim to ensure that there is complete segregation of duties between:

- (1) dealers,
- (2) those responsible for confirming the deals with counterparties and making and receiving the payments resulting from the deals, and
- (3) those reconciling bank statements.

4.9.3 G In more active treasuries duties should be split between a “front office” (dealing and deal support), a “middle office” (risk management) - essential only for those societies with more complex treasury operations - and a “back office” (confirmation, and settlement), with accounting and payment functions carried out either by the back office, or by a separate finance department. Physical segregation of the dealers from the settlement staff, to ensure that the former have no access to post or fax facilities used for confirmations, should be in place where accommodation and numbers of staff permit.

### **Reporting lines**

4.9.4 G Where treasury activity and personnel numbers are high enough to allow the creation of separate “front” and “back offices”, the reporting line for the latter should be independent of the former, so as to ensure that no conflicts of interest arise at the next level of management.

4.9.5 G A society adopting the “Comprehensive” or “Trading” approach should ensure that its “middle office” risk management function has clearly defined duties, and reports structural risk exposures directly to senior management and the board. The risk function should be independent of the profit centres of the society.

### **Remuneration policy**

4.9.6 G Whilst it is clearly important that societies should offer salary levels sufficient to attract

treasury personnel with the required qualifications and experience, remuneration policies should not encourage individual risk taking at the society's expense. In particular, bonus schemes for treasury staff should not be based on numbers of transactions or gross income targets.

## **IT security**

4.9.7 G Reliance on computerised dealing, information, treasury management and risk assessment systems renders societies particularly vulnerable to software or hardware failure. In accordance with Chapter 9 (Systems), boards of societies should:

- (1) have in place tested contingency plans for business recovery in the event of unforeseen disaster;
- (2) ensure that treasury IT systems access, both physical and logical, is subject to robust security;
- (3) exercise strong control over the development and modification of treasury IT systems; and
- (4) involve internal audit in reviewing the development or modification of treasury IT systems.

## **4.10 Independent review and controls**

### **Internal audit**

4.10.1 G Each board should ensure that its society's internal audit department has the skills and resources available to undertake an audit of the treasury function. Internal audit should evaluate, on a continuing basis, the adequacy and integrity of the society's controls over maturity mismatch, over the level of structural risk taken and should assess the effectiveness of treasury management procedures.

4.10.2 G Societies with complex treasuries or lacking internal auditors with treasury expertise may outsource treasury audit to an audit firm with the appropriate expertise and experience. The work of

outsourced internal audit should be fully integrated into the society's overall audit procedures and plans, with appropriate reporting lines into the audit committee. However, in order to avoid conflicts of interest, internal audit should not be contracted out to the society's own external auditors – even if the function were to be performed by a completely different branch of the audit firm (see also chapter 11 on Outsourcing).

### **External audit**

4.10.3 G The FSA may commission reports on treasury systems from external auditors under section 166 of the Act or from other appropriate skilled persons, whenever a society seeks to broaden the scope of its treasury operations. Societies which move to the “Comprehensive” or “Trading” approaches should carry out a post-implementation review in conjunction with their external auditors or other professional advisers. The FSA may, from time to time, commission an external review of a society's treasury, procedures and controls, in order to satisfy the FSA that these remain adequate and appropriate.



## 4A.1 Supervisory approach categories

4A.1.1 G This Annex provides guidance on the five models, or supervisory approaches, to financial risk management described in paragraph 4.5.5G. Where societies have subsidiary treasury operations, it is expected that these will fall into the same approach category as that of the parent society. An outline description of each approach is set out below, and table 4A.7G “Summary of the five approaches” at the end of this Annex summarises the key features.

## 4A.2 “Administered” approach

4A.2.1 G Societies in this category are expected to have balance sheets where loan assets and funding liabilities are entirely in Sterling and predominantly (>95%) subject to administered rates. In general, it is anticipated that the “Administered” approach will:

- (1) tend to suit small or very small societies;
- (2) where balance sheet management is typically undertaken by the Chief Executive in conjunction with the board - existence of a specific finance function (and Finance Director) being unlikely.

4A.2.2 G Societies adopting this approach:

- (1) should not offer fixed rate products (defined as repricing more than one year and one day later than the current date) on either side on the balance sheet;
- (2) should have policies limiting the levels of deposit funding to less than 10% of share and deposit liabilities unless a higher limit of up to 35% has been discussed with the FSA to accommodate those societies who take significant commercial deposits but funding from the wholesale markets will be limited to 10% of share and deposit liabilities;

- (3) will hold a simple range of liquid assets (whether counting as prudential liquidity or not), with marketable fixed rate instruments held only provided that these have a residual maturity of 5 years or less; and
- (4) should place no fixed rate time deposits having a maturity greater than 1 year.

4A.2.3 G Societies adopting the “Administered” approach do not need specific risk management reporting, but the market value of fixed rate investments with maturities of more than one year, as compared to their purchase price, will be monitored by the monthly monitoring returns.

### **4A.3 “Matched” approach**

4A.3.1 G Societies adopting this approach should have balance sheets where assets and liabilities are entirely in Sterling and use hedging contracts (or internal matching of assets and liabilities with similar interest rate and maturity features) to neutralise the risk arising from loans or funding other than at administered rates, on a tranche by tranche, product by product basis. Characteristic of small to medium sized societies, with limited treasury skills or resources, typically the Chief Executive of such societies will be supported by a Finance Director or Finance Manager, and report direct to the board on treasury matters (or through a board sub-committee).

4A.3.2 G Societies adopting this approach should:

- (1) have in place policy statements covering the intention to offer fixed rate (i.e. >1 year to repricing date) products on one or both sides of the balance sheet;
- (2) set limits (as a % of total assets) for fixed rate loan assets and share or deposit liabilities, and for holdings of fixed rate liquid assets (whether counting as prudential liquidity or not);
- (3) set an overall limit for hedging transactions (nominal value of transactions %SDL);

- (4) have in place policies limiting the levels of deposit funding to less than 25% of share and deposit liabilities unless a higher limit of up to 35% has been discussed with the FSA to accommodate those societies who take significant commercial deposits but funding from the wholesale markets will be limited to 25% of share and deposit liabilities.

4A.3.3 G The policies of such societies can allow use of standard hedging products for transactions permitted by section 9A, e.g.:

- (1) swaps (including FTSE index swaps);
- (2) Forward Rate Agreements; and
- (3) plain vanilla over the counter (“OTC”) options such as swaptions, caps, collars and floors (options purchased only);

for the purpose only of matching individual products and within the exemptions permitted by section 9A - structural hedging of the whole balance sheet should not be permitted.

4A.3.4 G Risk management for such societies will be achieved internally through:

- (1) matching reports (detailing individual products and the hedging instruments associated with them); and
- (2) gap analysis - for gapping purposes, reserves will need to be treated as having no fixed repricing date, and gap limits should be set at the minimum level required to give flexibility in timing the hedges for individual mortgage and investment products, with some allowance for residual risks (those too small to be economic to hedge) and for holdings of fixed rate liquid assets. Basis risk should be minimised by setting cautious limits for fixed rate and market rate assets and liabilities.

4A.3.5 G Gap monitoring reports should be updated and considered by the board at least monthly.

By implication, societies adopting this approach should not be taking an interest rate view for the purposes of determining a hedging strategy.

#### **4A.4 “Extended” approach**

4A.4.1 G The principal difference between the “Matched” and the “Extended” approaches lies in the capability to measure and hedge structural risk across the whole balance sheet, including reserves, rather than just hedging individual transactions. The approach will thus allow a society to allocate reserves to specific repricing bands representing a considered view of the characteristics of such reserves and/or the assets deemed to “represent” such reserves, or to manage interest rate gaps as part of a strategy for hedging the endowment effect of interest free reserves against adverse interest rate movements. Risk analysis should also enable it to position its balance sheet to take advantage of a particular interest view. Societies adopting this approach will have the capability to fund in currency and to hold a limited range of currency liquid assets (see Chapter 5, Liquidity), subject to aiming for elimination of all currency exchange mismatch, within an expected maximum limit of 2% of own funds.

4A.4.2 G As a result, a society adopting the “Extended” approach will:

- (1) adopt policies and systems to enable it to undertake the hedging of individual transactions within the context of an overall strategy for structural hedging, based on detailed analysis of its balance sheet; and
- (2) use the output of such analysis to enable it to position its balance sheet to take advantage of a particular interest view.

4A.4.3 G Management of interest risk for such societies will typically be controlled by the board acting through an Assets and Liabilities Committee (ALCO) or equivalent sub-committee, which will normally be responsible for agreeing any interest rate view. Reporting to the ALCO, there will typically be a Treasurer running a small treasury department with appropriate segregation between dealing and settlement activities.

4A.4.4 G Hedging instruments available to be authorised by the board will be the same as for the “Matched” approach, with the addition of (as far as permitted by section 9A):

- (1) exchange traded futures/options and FTSE (or similar) OTC swaps/options (options to be purchased only);
- (2) foreign exchange swaps and forward contracts, used to hedge currency funding; and
- (3) credit derivatives.

4A.4.5 G Risk management systems should be based on:

- (1) full balance sheet gap analysis;
- (2) possibly supplemented by static simulation.

4A.4.6 G Gap limits could allow leeway for risk positions - to be controlled by sensitivity limits covering potential changes in both earnings and economic value.

4A.4.7 G Basis risk should be controlled through limits on the minimum levels of administered rate assets and liabilities, and limits on the extent of mismatch between LIBOR-based and administered rate balances.

4A.4.8 G Positions should be monitored internally by way of frequent updates (monthly minimum).

## **4A.5 “Comprehensive” approach**

4A.5.1 G The principal differences between the “Extended” and the “Comprehensive” approaches lie in:

- (1) the depth and quality of the risk management systems put in place to monitor and control structural risk;

- (2) the frequency of analysis undertaken; and
- (3) the currencies in which treasury operations would be undertaken.

4A.5.2 G Like the “Extended” approach societies, “Comprehensive” approach societies will manage risk using a board/ALCO/Treasurer reporting structure, but the latter will typically subdivide the treasury department further with a separate “middle office” risk management function, segregated from “front office” (dealing) and “back office” (settlement/accounting).

4A.5.3 G Hedging instruments available for use under agreed board policy will include those for the “Extended” approach plus (as far as permitted by section 9A):

- (1) currency options.

4A.5.4 G Risk analysis should extend beyond static gap/static sensitivity analysis to:

- (1) dynamic simulation (projecting forward balance sheet elements and simulating the impact of different interest rate scenarios);
- (2) possibly duration (modified or dollar, reflecting the change in percentage or money value of positions for a given change in interest rates) for individual portfolio elements, or present value of a basis point move (PVBPM) calculations, to highlight sensitivity to non-parallel shifts in the yield curve; and
- (3) possibly value at risk (VaR), using correlation/historic simulation and/or Monte Carlo simulation;

the impact on both earnings and economic value being assessed internally on a very regular basis.

4A.5.5 G Risk positions could reflect an interest view, subject to sensitivity limits set by board/ALCO and incorporating basis risk assessment/control. Foreign exchange mismatch ( i.e. exchange rate exposure) is expected to be limited to less than 2% own funds (within Capital Adequacy Directive de minimis levels).

## **4A.6 “Trading” approach**

4A.6.1 G A category for those societies which wish to take advantage of the ability to trade in securities. Essentially, such societies will adopt the “Comprehensive” approach for the purpose of managing interest risk arising in their “banking books”, but with additional policies, financial instruments, systems and expertise for managing the market risks inherent in running separate “trading books”. Currency positions exceeding 2% of own funds are permitted, but are expected to be subject to overall board limits.

4A.6.2 G Such a society should control the additional market risks through a Market Risk Committee of the board and risk management systems should include complex portfolio management, option pricing and VaR models.

4A.6.3 G Societies adopting this approach will be subject to the Capital Adequacy Directive in respect of their trading books – see Chapter 1 (Solvency).

#### 4A.7G Summary of the five approaches

POLICY APPROACH	RISK MANAGEMENT	RISK ANALYSIS	HEDGING INSTRUMENTS	FUNDING	PRUDENTIAL & OTHER LIQUIDITY	LOAN ASSETS
ADMINISTERED	CE (+FD) & board Dealing/settlement segregation (minimum 2 persons)	None (But, if fixed rate liquid assets held, then mark to market value and sensitivity analysis required)	None	Sterling only Deposit Liabilities < 35%SDL No fixed rate (> 1 Year) provided that funds received from the wholesale market do not exceed 10% SDL	Sterling only No non-marketable > 1 Yr. No marketable > 5 Yrs	No fixed rate (1 Yr. +)
MATCHED	CE/FD (or FM), (ALCO) & board Dealing/settlement segregation (minimum 2 persons)	Matching report & Monthly (minimum) Gap analysis (Reserves NFR) - No structural hedging No Interest View Minimal limits (to cover residual balances + pipeline products only)	Interest rate & FTSE index Swaps/FRAs/ Caps/Collars/ Floors (purchase only)	Sterling only Deposit Liabilities <35%SDL provided that funds received from the wholesale market do not exceed 25% SDL	Sterling only	Limit on fixed rate (1 Yr. +)
EXTENDED	(CE)/FD/Treasurer + ALCO & board Treasury segregation (front office/back office)	Monthly (minimum) Static Gap (& Static Simulation) - Reserves hedged Interest view Sensitivity limits (earnings, economic value & basis risk) No FX mismatch	Interest Rate & FTSE index Swaps/FRAs/ Caps/Collars/ Floors/Futures/FTSE Options (purchase only) FX Swaps/Forward Contracts Retail derivatives & FX contracts permitted. Credit derivatives	Sterling + Currency Minimum level of administered rate liabilities	Sterling + Currency (limited range of currency instruments)	Minimum Level Of administered Rate Assets
COMPREHENSIVE	FD/Treasurer/Risk Manager + ALCO & board Treasury segregation (front office/middle office/back office)	Very frequent Gap (Reserves Hedged)+ Duration/ Simulation/ (VaR) Sensitivity limits (earnings & economic value) Basis risk limits FX mismatch <2% Own Funds	Interest Rate & FTSE index Swaps/FRAs/ Caps/Collars/ Floors/Futures/FTSE Options Exotic Options FX Swaps/Forward Contracts/ Options Retail derivatives & FX contracts permitted. Credit derivatives	Sterling + Currency	Sterling + Currency	Sterling + Currency
TRADING	FD/Treasurer/Risk Manager + Market Risk Committee/ ALCO & board Treasury segregation (front office/middle office/back office) + banking book/trading book	Banking Book: Daily (minimum) Gap (Reserves Hedged)+ Duration/ Simulation/ (VaR) Trading Book: VaR - CAD capability	Interest Rate & FTSE index Swaps/FRAs/ Caps/Collars/ Floors/Futures/FTSE Options/ Exotic Options Retail derivatives/FX permitted. FX Swaps/Forward Contracts/ Options Equity Options Credit derivatives	Sterling + Currency	Sterling + Currency	Sterling + Currency



### **4B Credit Derivatives**

#### **4B.1 Introduction**

4B.1.1 G This annex contains guidance for building societies on credit derivatives.

4B.1.2G This annex consists of the guidance for banks on credit derivatives (chapter CD of IPRU(BANK)) as modified by additional guidance specific to building societies set out below.

#### **4B.2 Additional Guidance for Building Societies**

4B.2.1G This annex sets out additional guidance on credit derivatives for building societies over and above that set out in chapter CD of IPRU(BANK). These additions mostly arise as a result of the particular constitutional structure of building societies and the provisions of the 1986 Act. The FSA will expect societies, when planning to use credit derivatives, to consider these issues in formulating their policies.

4B.2.2G A building society intending to use credit derivatives should have effective systems to measure, record, monitor and control the exposure to each protection seller that is incurred and to identify any residual exposure (net of protection) to the underlying assets for which it is buying protection.

4B.2.3G As with securitisation, the extensive use of credit derivatives to facilitate risk transfer may lead to a change in the profile of the assets for which the society retains the full risk. The FSA will consider this, where relevant, in assessing a society's threshold solvency ratio.

4B.2.4G Nothing in chapter CD should be taken as contradicting the statutory requirements under the 1986 Act, in particular section 9A, which take precedence, as necessary, over chapter CD.

4B.2.5G The guidance contained in chapter CD applies to building societies with the

following modifications:

- (1) All references to banks should be taken to include building societies.
- (2) References to the Capital Overview and Large Exposures chapters of IPRU(BANK) do not apply to building societies. They should be taken to refer, instead, to chapters 1 (Solvency) and 7 (Large Exposures) in Volume 1 of IPRU(BSOC). The guidance in chapter CD relating to capital requirements, large exposures, liquidity or solvency should be construed in accordance with the relevant IPRU(BSOC) rules and guidance.
- (3) References to the trading book contained elsewhere in the chapter, apart from the material set out in 4B.2.7 below, will not normally be relevant to building societies

4B.2.6G Sections 1, 2, 3, 5, 9 and 10 of chapter CD will normally apply to all building societies proposing to use credit derivatives. Section 8, which deals with credit spread options, is unlikely to be relevant to building societies.

4B.2.7G Sections 4, 6 and 7 of chapter CD will not normally be relevant to building societies, because:

- (1) section 6 of chapter CD deals with banks as protection sellers, and because of the overriding provisions of section 9A of the 1986 Act, a building society can normally use credit derivatives only as a protection buyer and not as a protection seller.
- (2) sections 4 and 7, which deal with banking/trading book division, and trading book treatments, are unlikely to apply to building societies, because all derivatives are allocated to the banking book for building societies.

4B.2.8G Societies adopting the Extended, Comprehensive and Trading approaches (see Annex 4A) are free to use credit derivatives, but not all such societies may wish to do so. The FSA considers that those societies on the Administered or Matched approaches should not use credit derivatives.

## CREDIT DERIVATIVES

### 1 INTRODUCTION

#### 1.1 Legal Sources

1 The FSA's supervisory approach has been developed through consultation with market practitioners and other regulators internationally, and policy will be reviewed as the market continues to develop. There are no internationally agreed regulations explicitly covering credit derivatives under the Basel Accord and EU directives though the treatment of credit derivatives is relevant to the assessment of capital adequacy, and large exposures. The FSA aims to achieve consistency where possible with the capital and large exposures treatment of other similar instruments. The sources identified in the Legal Sources sections of the Capital Overview and Large Exposures chapters are relevant to this chapter.

2 The policy is set out in a separate chapter because it results from the application of a few general principles. Where these principles feed into the mechanism for calculating capital and large exposures, there are cross references to the relevant chapter of the IPRU (BANK).

#### 1.2 Application

3 These obligations apply to all UK banks which use credit derivatives as either protection buyer or protection seller.

See s2.1

- a) Protection buyer and credit risk seller are used interchangeably, as are protection seller/credit risk buyer. These terms are defined below.

4 The policy set out in this chapter does not apply to overseas and EEA banks.

#### 1.3 How this chapter is organised

5 Section 2 outlines basic types of credit derivative and the rationale for their use by banks.

Section 3 highlights risk management issues raised by credit derivatives.

Section 4 covers the trading book/banking book division and valuation.

Sections 5 and 6 cover factors determining the capital treatment of credit derivatives in the banking book for the protection buyer and protection seller, respectively. This section does not cover credit spread options.

Section 7 covers the capital treatment of credit derivatives in the trading book, excluding credit spread options.

Section 8 covers the capital treatment of credit spread options.

Section 9 covers risk transfer requirements.

Section 10 covers factors determining exposures recorded for large exposures purposes.

## 2 DEFINITIONS, RATIONALE AND TYPES OF PRODUCT

### 2.1 Definitions and rationale

1 *Credit derivatives* is a general term used to describe various swap and option contracts designed to transfer credit risk on loans or other assets from one party, the *protection buyer*, to another party, the *protection seller*. The protection seller receives premium or interest-related payments in return for contracting to make payments to the protection buyer, which are linked to the credit standing of a *reference asset* or assets. The term credit derivative may also be used to describe cash instruments where repayment of principal is linked to the credit standing of a reference asset.

- a) *Protection buyer* and *credit risk seller* are used interchangeably in this chapter, as are *protection seller* and *credit risk buyer*.
- b) A *reference asset* is an asset to which payments under the credit derivative contract or instrument are linked; it is usually a security, but could also be a loan or another form of obligation (such as a counterparty exposure under an off balance sheet transaction).

2 Transfer of credit risk may be for the whole life of the reference asset or for a shorter period, and it may be for the full amount of the asset or part of it. A credit derivative may be referenced to a single asset or to a basket of obligations of a single *borrower* or several borrowers.

- a) *Borrower* and *obligor* are used interchangeably to describe the entity generating the reference asset.

3 Banks may use credit derivatives for a number of reasons. These include:

- reducing capital required to support assets on the balance sheet;
  - reducing *credit risk concentrations*;
  - freeing up credit lines;
  - creating *new assets and synthetic assets* to meet wider investor demand; and
  - managing assets on a portfolio basis.
- a) Credit derivatives may be used to reduce *credit risk concentrations* without damaging an existing relationship with the borrower, since there is no transfer of title of the asset.

- b) *New assets and synthetic assets* may widen investment opportunities by, for example, filling gaps in the maturity and credit quality spectrum and providing investment opportunities which some investors would otherwise be unable to access.

## 2.2 Types of credit derivative

### 2.2.1 General

4 There are four common types of credit derivative:

- credit default products;
- total return swaps;
- credit linked notes;
- credit spread options.

5 The following examples illustrate how A can assume credit risk on a bond issued by X using various types of credit derivative. B, the counterparty in these transactions, is assumed to own bond X, and is hedging (or laying off) the risk on it. B might, alternatively, have no existing exposure to bond X, in which case it would be taking an unhedged short position in bond X; or B might have an asset similar to bond X, in which case it would be partially hedging that *underlying asset*, but could be exposed to basis risk between the *underlying asset* and bond X (the *reference asset*).

- a) *An underlying asset* is the asset that a protection buyer is seeking to hedge, which is not necessarily identical to the reference asset of the credit derivative used.

See s2.1

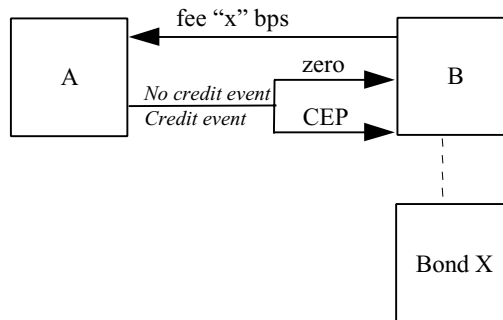
- b) *Reference asset* is defined in section 2.1 above.

6 These examples assume that risk is transferred directly from the risk seller to the risk buyer. In practice, there is often an intermediate transfer to an *SPV*, which then issues notes to risk buyers.

- a) *SPV* - special purpose vehicle.
- b) Where the risk transfer is made through an unfunded credit derivative (credit default product or a total return swap), the vehicle often invests the funds received from the note issue in a *collateral security* in order to achieve a return on the cash; this return can be paid to investors in addition to the risk seller's payment for the protection.
- i) *Collateral securities* are usually government or other bonds.

2.2.2 *Credit default product*

7 A sells credit protection to B for five years on \$50 million nominal of bond X. B pays A a fee of x basis points. Under the terms of the contract, if a defined *credit event* occurs on bond X, A will pay B the *credit event payment* 90 days after the event. If no credit event occurs, the contract will expire after 5 years without any payment from A to B.

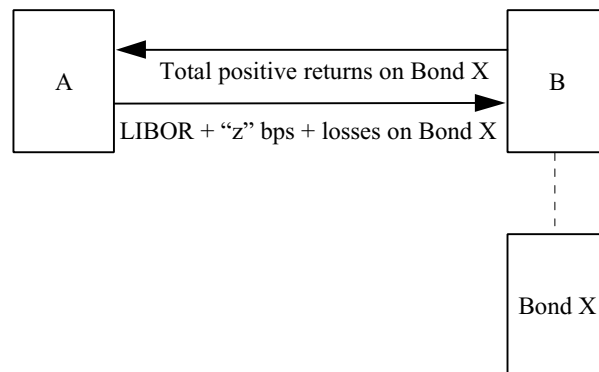


- a) Credit default products (CDPs) are structured so that a payout occurs only when a contractually defined *credit event* (or one of several events) occurs. Credit events normally include bankruptcy, and any payment default on the reference asset and reschedulings, but may also include lesser events such as ratings downgrades. In some contracts a pre-determined materiality (or loss) threshold must also be exceeded for the payment to be triggered.
- b) The *credit event payment* (CEP) is the amount that is paid following a credit event. This is defined in the contract, and is normally one of three types:
  - payment of par value in exchange for physical delivery of the reference asset; some contracts may allow delivery of a variety of assets of the reference name;
  - payment of a fixed amount (sometimes known as a *binary payout*);
  - or
  - payment of par less recovery value. (The reference asset will normally retain some value after a credit event has triggered settlement of the contract. The recovery value is normally determined at a date up to three months after the credit event, by means of a dealer poll or auction.)
- c) Although CDPs may have some of the characteristics of an option, they are often documented as a swap and are treated as a swap by the FSA for capital purposes.

8 In the above example, A has assumed the default risk on bond X from B without funding the position. B has hedged its default risk on bond X, but has acquired a credit exposure to A, since B depends on A to make the credit event payment.

**2.2.3 Total return swap**

9 A and B enter into a total return swap (TRS) for five years referenced to a notional amount of \$50 million nominal of bond X. B makes periodic payments to A of all cashflows arising from bond X plus any increase in the market value of bond X since the last payment date. On the same dates, A makes payments to B of an interest rate related flow (e.g. LIBOR + z basis points) plus any decrease in the market value of bond X. (Payments may be exchanged on a net basis). If there is a defined credit event, the TRS will usually terminate and the credit event payment will be calculated as though the next normal payment date had been brought forward.

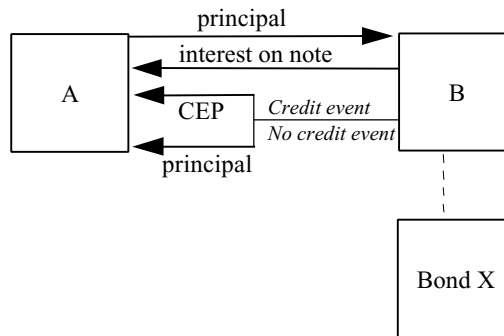


10 B has transferred to A the total performance of bond X (including market risk and default risk) for the duration of the contract, or until there is a credit event. A has assumed this risk without having to fund its position. A and B have acquired credit exposure to each other, since each depends on the other to make payments due under the swap.

**2.2.4 Credit linked note**

11 B issues \$50 million nominal of a five-year note referenced to bond X, and the note pays a fixed or floating rate interest. If no credit event occurs on bond X, the note will mature at par in five years. If a defined credit event occurs on bond X, the note will be redeemed for the credit event payment, 90 days after the credit event.





12 A has assumed the credit risk on bond X, and has to fund the position (in contrast to the credit default swap illustrated above). It has also acquired exposure to B of the full amount of the funding it has provided. B has hedged its risk on bond X without acquiring any credit exposure to A, as it has received full cash funding from A.

2.2.5 **Credit spread product**

13 Credit spread products are diverse. A typical example might be as follows: A sells to B a put option on \$50 million nominal of an asset swap on bond X, exercisable at any time in the next year, in exchange for a payment of premium. The option gives B the right to put the asset swap on bond X to A at a strike spread over a pre-determined benchmark rate.

- a) A credit spread option may include further features, for example, relating to a ratings downgrade of bond X.

14 A and B have acquired exposure to changes in the credit spread of bond X relative to the benchmark rate which are characteristic of a barrier option. B has also acquired credit exposure to A, since B depends on A to pay amounts due on exercise of the option.

### **3 RISK MANAGEMENT ISSUES**

#### **3.1 Introduction**

1 Credit derivatives raise many of the same risk management issues as other new products, credit products, and derivatives. This section highlights areas that are of particular relevance to credit derivatives. Additional conditions to be met before risk transfer is recognised for capital adequacy purposes are set out in section 9.

#### **3.2 Systems**

2 Banks using credit derivatives should have adequate systems in place to manage the associated risks.

3 These are likely include:

- adequate management information systems to make senior management aware of the risks being undertaken. This might include information on the level of activity in each of the different products; the ability of the bank (if it is the risk buying organisation) to pursue the underlying borrower when a credit event payment has been triggered; and contractual characteristics of the products (such as fall-back provisions should a dealer poll fail to determine a recovery value following a credit event, and tailoring of standard documentation for particular transactions).
- procedures for ensuring that the credit risk of a reference asset acquired through a credit derivative transaction and any counterparty credit risk arising from an unfunded OTC credit derivative is captured within the bank's normal credit approval and monitoring regime. Banks should be able assess the initial credit risk involved in undertaking the transaction and also to monitor the credit risk on an on-going basis. Information asymmetry (between the buyer and seller of credit risk) may be a significant issue if there is no widely-traded asset of the reference obligor.
- systems to assess and take account of the possibility of default correlation between the reference asset and the protection provider.
- valuation procedures (including assessment and monitoring of the liquidity of the credit derivative and the reference asset) and procedures to determine an appropriate liquidity reserve to be held against uncertainty in valuation. This is particularly important for credit derivatives where the reference asset is illiquid (e.g., a loan), or if the derivative has multiple reference obligors.

### 3.3 Other operational risks

- 4 The FSA takes into account significant operational risks when setting a bank's minimum (or "individual") capital ratio, and may in exceptional cases set an explicit capital requirement against such risk.
- 5 Banks should consider how to limit and monitor any legal and reputational risk associated with credit derivatives.
- a) Banks should consider, amongst other things, whether credit derivatives require regulation as insurance business in any of the relevant jurisdictions.
  - b) Banks should consider whether conflicts of interest might arise within the institution in respect of privileged information if there is no widely traded asset of the reference obligor.
  - c) Banks should ensure that transfer of credit risk through a credit derivative does not contravene any terms and conditions relating to the reference asset, and where necessary all consents have been obtained
  - d) Where credit risk to many obligors has been transferred as a package, the bank should consider whether the reputation of the bank might be damaged by subsequent deterioration in the quality of these assets

### 3.4 Liquidity

- 6 Where a bank has transferred significant credit risk using funded credit derivatives it should be able to demonstrate capability to refinance the exposures that have been transferred.
- a) For example, where the bank has bought protection of shorter maturity than the assets being protected, it should consider how it would obtain funding if a replacement contract were not to be found on maturity of the protection.
- 7 Where a bank has hedged significant credit risk using unfunded credit derivatives of shorter maturity than the underlying exposures, it should consider whether it would have sufficient capital to support the risk in the event of a replacement contract being unavailable immediately on maturity of the credit risk protection, or how such "rollover" risk could otherwise be avoided or limited.

### 3.5 Remaining asset base

See ch SE

- 8 As with securitisation, the extensive use of credit derivatives to facilitate risk transfer may lead to a change in the profile of the assets remaining on a bank's supervisory balance sheet, in terms of both quality and spread. The FSA will consider these implications in assessing the bank's overall capital requirements.

## 4 TRADING BOOK/BANKING BOOK DIVISION

### 4.1 Introduction

#### 4.1.1 *General principles*

1 Credit derivatives should meet the standard criteria applied to other financial instruments in order to be eligible to be held in a bank's trading book. The standard criteria include ability of the bank to mark to market positions daily on a prudent and consistent basis, and demonstration of trading intent. As with other financial instruments, inclusion of credit derivatives should be within each bank's trading book policy statement agreed with the FSA.

See s5, 6, 7 and 8

2 Credit derivatives not included in the trading book should be included in the banking book. Capital treatment of credit derivatives in the banking book is covered in sections 5, 6 and 8 and in the trading book in sections 7 and 8.

See ch CB

a) The criteria for the trading book are set out in the chapter on the trading book/banking book division.

See s9

b) The activity of issuing credit linked notes with trading intent is eligible to be included in the trading book subject to the risk transfer requirements set out in section 9.

c) Credit derivatives referenced to relatively illiquid reference assets (such as loans) are eligible to be included in the trading book, but an appropriate reserve against uncertainty in valuation should be agreed for illiquid credit risky positions in the trading book policy statement.

#### 4.1.2 *Marking to market*

3 Where credit derivatives referenced to relatively illiquid assets are included in the trading book, the FSA may require significant extra capital to be held against uncertainty in valuation.

#### 4.1.3 *Trading intent*

4 In assessing whether a bank has demonstrated trading intent in relation to credit derivatives business; the FSA may take into account the market structure available to support the business.

a) Factors taken into consideration could include how the positions are managed, the use of standard documentation and market conventions, the number of market makers in the product and in instruments hedging it, and the availability of screen prices.

## 5 BANKING BOOK - PROTECTION BUYER

### 5.1 Introduction

1 This section sets out the factors that determine the banking book capital treatment for a protection buyer. Capital needed will depend on the particular structure of the contract/instrument.

See s9 2 The following section assumes that the risk transfer conditions set out in section 9 of this chapter have been met.

See s8 3 This section does not apply to credit spread options. The capital treatment for credit spread options is set out in section 8.

### 5.2 Funded or unfunded

4 Where an asset is protected in full or in part by a *funded credit derivative*, the FSA recognises the transfer of credit risk by reducing the risk weighted exposure to the reference/underlying asset. The extent to which the risk weighted exposure can be reduced depends on the amount of the funding received and the other factors set out below.

a) A *funded credit derivative* usually refers to a credit linked note. However, both total return swaps and credit default products may also be structured so that exposure to the reference/underlying is funded at inception.

b) This treatment is parallel to that of a loan sub-participation.

See ch BC s3 5 Where an asset is protected in full or in part by an *unfunded credit derivative*, banks may choose to replace the risk weighting of the protected asset with the risk weighting of the counterparty to the credit derivative contract. The extent to which the risk weightings can be replaced depends on the amount of protection received under the contract and the other factors set out below.

a) An *unfunded credit derivative* usually refers to a total return swap or a credit default product.

b) This treatment is parallel to that of a guarantee.

c) If the risk weighting of the counterparty selling protection is higher than that of the protected asset, the risk weighting does not have to be increased.

6            *Materiality thresholds* may affect the amount of protection that is recognised. All credit derivatives involving materiality thresholds should be referred to the FSA.

- a) A *materiality threshold* may either determine the level of loss that must be reached before a credit event is triggered, or may reduce the amount of the payout.

### 5.3            **Payout structure**

7            Where the credit event payment is a fixed amount (or binary payout), exposure to the underlying is recognised as guaranteed/reduced by the amount that the bank will receive/retain if the credit event occurs.

8            Where the credit event payment is defined as par less a recovery amount or there is payment of par in exchange for physical delivery of the reference asset, exposure to the underlying asset can be recognised as guaranteed/reduced to zero for the amount protected under the contract.

### 5.4            **Asset mismatch**

9            Where the reference asset and the underlying are the same, protection will be recognised subject to the other factors listed in this section.

10          Where the reference asset and the underlying asset being hedged are different, protection can still be recognised if the following criteria are met:

- reference and underlying asset are of the same obligor; and
  - reference asset ranks *pari passu* with, or is more junior in a liquidation than the asset being hedged; and
  - there are cross default clauses between the reference asset and the underlying asset.
- a) The FSA may be prepared to accept asset mismatches where there are not cross default clauses if the bank can demonstrate, to the FSA's satisfaction that there are other structural features which eliminate the basis risk between the reference asset and the underlying asset.

## 5.5 Currency mismatch

11 Where the credit derivative is denominated in a different currency from the reference/underlying asset, the amount of credit protection recognised is reduced by 8% to take account of the contingent foreign currency risk.

- a) For example, a bank has a £1million asset which is protected by a \$ denominated, recovery based, single asset, maturity matched credit derivative, of, say, \$1.5million. If the exchange rate at the outset is \$1.5: £1, the amount of protection recognised would be £920k. If the amount of protection purchased were \$1.62million, the asset would be recognised as fully protected.
- b) The FSA may consider disapplying the 8% reduction in protection where a bank can demonstrate to the FSA's satisfaction that it has hedged the contingent foreign currency risk.

12 Foreign currency positions created by credit derivatives should also be recorded when measuring the bank's foreign exchange exposure. Funded credit derivatives should be treated like all other cash positions. Unfunded credit derivatives should be treated like guarantees.

See ch FX

- a) Further guidance on the calculation of a bank's foreign exchange exposure is contained in the chapter on foreign exchange risk.

## 5.6 Maturity of the credit derivative compared with the reference/underlying asset

13 Where the maturity of the credit derivative matches that of the underlying asset, the exposure is recognised as guaranteed/reduced and no additional capital is considered to be needed.

14 Where the maturity of the credit derivative is less than that of the underlying asset, recognition of the protection depends on the residual maturity of the credit derivative.

- a) The maturity of credit derivatives with a *step up* and call option is assumed to be the date of the call.
- b) If the protection seller has the option to terminate the credit derivative, the maturity is deemed to be the date at which the option is first exercisable.

i) A *step up* is an increase in the protection payment.

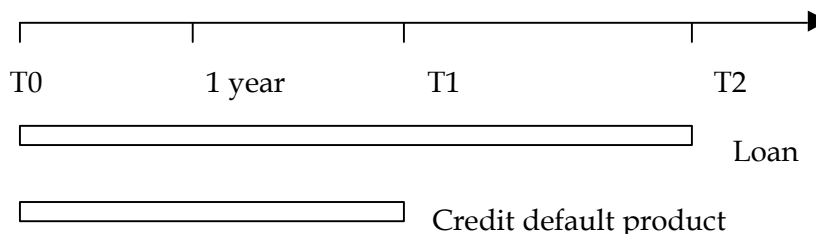
15 If the residual maturity of the credit derivative is less than one year, no protection is recognised.

See ch BC s4

16 If the residual maturity of the credit derivative is one year or over, protection is recognised, but an additional capital charge is made for forward credit exposure to the underlying asset when the credit derivative contract matures. This forward exposure is treated like a commitment with uncertain drawdown, i.e. it attracts a 50% credit conversion factor ('CCF') against the risk weight of the underlying asset.

Example :

*time scale:*



Suppose that the underlying asset is a loan to a corporate of a tenor equal to T2, risk weighted at 100%, and credit risk protection is bought from a Zone A bank in the form of a credit default product maturing at T1:

At T0, the risk weight on the loan is reduced to 20% (guaranteed portion of the exposure) with an additional capital charge for the forward exposure of 50% (CCF) x 100%. So the total capital charge is 20% + 50%, = 70%.

Once the residual maturity to T1 reaches one year, protection ceases to be recognised and the risk weight of the loan reverts to 100%.

If the underlying position is an undrawn commitment, the capital treatment resulting from the acquisition of maturity mismatched unfunded protection at T0 is: 20% [risk weight for a Zone A bank] x 50% (CCF) + 50% (original risk weight of corporate x CCF) x 50% (CCF). So the total capital charge is 10% + 25%, = 35%.



17 If the sum of the capital needed for the underlying asset (after protection has been recognised) plus the forward exposure exceeds the original capital requirement for the underlying asset, the credit derivative can be ignored and the underlying asset weighted as normal.

### 5.7 Multiple names

See s9

18 Where the credit derivative is referenced to more than one obligor (sometimes known as a basket or multiple name product) the nature of the credit protection provided depends on the structure of the contract. Additional conditions would need to be met to ensure transfer of credit risk is not jeopardised by reputational risk, as set out in section 9 of this chapter.

19 If the contract terminates and pays out on the first asset to default in the basket, then protection is only recognised against one asset in the basket. Banks may choose which asset in the basket attracts protection.

20 If the contract allocates protection proportionately amongst assets in the basket (sometimes known as a *green bottle structure*) protection is recognised in setting capital requirements against all the assets in the basket according to the proportions in the contract.

See s9

21 If a bank provides credit enhancement to a special purpose vehicle to which it has transferred credit risk through credit derivatives, the credit enhancement is treated as a deduction from capital in accordance with the FSA's policy on securitisation.

### 5.8 Open short positions and unrecognised protection

22 Where a bank buys protection in the absence of an underlying exposure (i.e., it has an open short position), or where bought protection is not recognised in calculating the capital needed for an underlying exposure, the credit derivative is ignored for capital adequacy purposes.

## **6 BANKING BOOK - PROTECTION SELLER**

### **6.1 Introduction**

1 This section sets out the factors that determine the banking book capital treatment of a protection seller.

See s8

2 This section does not apply to credit spread options. The capital treatment of credit spread options is set out in section 8.

### **6.2 Funded or unfunded**

3 Through a funded credit derivative, a bank acquires exposure to the reference asset (since performance of the credit derivative depends on that of the reference asset), and also to the credit derivative counterparty (since the bank relies on the counterparty to pass on funds during the life of the contract, and on maturity or following a credit event). Where the counterparty is an SPV, a bank may also have exposure to the collateral securities purchased with the money received from the issuance of securities.

4 The amount at risk is limited to the funding provided, however, and this on-balance-sheet exposure is recorded at the higher of the risk weights of the reference obligor and the counterparty holding the funds and, where applicable, the collateral security.

See ch BC

5 Where a bank has sold protection through an unfunded credit derivative, it acquires exposure to the reference asset only. This *exposure* is recorded as a direct credit substitute weighted according to the risk weight of the reference asset.

a) The *exposure* will be the maximum payout under the contract.

### **6.3 Multiple names**

See s6.2

6 Credit derivatives referenced to single names are treated as set out above.

7 Where credit derivatives are referenced to more than one obligor (a basket or multiple name product), the nature of the credit risk acquired depends on the structure of the contract.

8 If the contract terminates and pays out on the first asset to default in the basket, the bank should hold capital against all the names in the basket. Where it pays out upon the second asset to default, the bank should hold capital against all the names in the basket except one. The bank can choose which one to exclude.

- a) The FSA may consider that this is not needed where a bank can demonstrate, to the FSA's satisfaction, a very strong correlation between the assets in the basket.

9 This means that risk weightings are applied to the maximum payout amount under the contract for all (or all but one, in the case of the second to default) of the names in the basket, capped at the equivalent of a deduction from capital. However, in the case of a first or second to default credit linked note which is rated such as to meet the conditions for recognition as a qualifying debt item, the bank may choose to hold capital against one name in the basket. However, the bank should choose the one with the highest risk weight.

- a) Chapter II defines qualifying debt item.

10 A structure which is referenced to the assets in the basket proportionately should be risk weighted according to the assets in the basket in the proportions set out in the contract.

#### **6.4 Payout structure**

11 Where the amount of the protection is fixed in the contract, the risk weighted exposure to the reference asset(s) is the amount of the payout.

12 Where the credit amount payment is based on par less recovery value or where there is physical delivery in exchange for par value, the risk weighted exposure to the reference asset(s) is the maximum payout under the contract.

## **7 TRADING BOOK TREATMENT**

### **7.1 Introduction**

1 This section sets out the capital treatment considered to be applicable to credit derivatives in the trading book.

See s8 2 This section does not apply to credit spread options. The capital treatment for credit spread options is set out in section 8.

### **7.2 Models**

See chs TS and TV 3 Banks may apply to the FSA to include credit derivatives in recognised models under CAD1 and also VaR models. Banks may apply for recognition of VaR models which quantify partial offsets of specific risk positions where there is a maturity or asset mismatch.

See chs TS and ch TV 4 For details of the benchmarking approach to such models see elsewhere.

See s7.3 5 Banks which do not have recognised models covering credit derivatives should follow the standard approach set out below.

### **7.3 Standard approach**

#### **7.3.1 Introduction**

See ch TI 6 This section describes the positions to be recorded for credit derivatives for the purposes of calculating specific risk and general market risk charges under the standard approach. The calculation of specific and general market risk charges is described in the chapter on interest rate position risk.

#### **7.3.2 General principles**

7 Total return swaps are represented as two legs: one is a notional position in the reference asset with general and specific risk of the reference asset; the other, representing interest payments under the swap, is a notional position in a Zone A government bond with the appropriate fixed or floating rate.

8 Credit default products are represented as a notional position in the specific risk of the reference asset only (i.e., no general risk position is created in the reference asset). If premium or interest payments are due under the swap, these cashflows are represented as a notional position in a Zone A government bond with the appropriate fixed or floating rate.

9 Credit linked notes are treated as a position in the note itself, with an embedded credit default product. The credit linked note has specific risk of the issuer and general market risk according to the coupon or interest rate of the note. The embedded credit default product creates a notional position in the specific risk of the reference asset (with no additional general market risk position created).

### 7.3.3 *Specific risk - single reference asset*

See s5.2 10 As noted above, total return swaps, credit default products and credit-linked notes create a specific risk position in the reference asset; the credit risk seller has a short position and the credit risk buyer has a long position.

See ch II 46G a) For the specific risk position to be treated as a qualifying debt item, the reference asset should meet the standard conditions for a qualifying debt item as defined in the chapter on interest rate position risk.

11 The buyer of a funded credit derivative should also record a long position in the specific risk of the note issuer.

### 7.3.4 *Specific risk - multiple reference assets*

12 Where a total return swap is referenced to multiple names, and the returns on assets are exchanged according to their proportions in the basket, the bank should record long or short positions in all the reference assets according to the proportions underlying the swap.

See s5.2 13 Where credit default products and credit linked notes are referenced to multiple names the positions recorded depend on the structure of the contract.

14 The credit risk seller of a first to default product or note should record a short position in one reference asset in the basket only. Banks may choose which asset in the basket to record as a short position.

15 The credit risk buyer in a first to default product or note should record long positions in each of the assets in the basket, whilst a second to default note should be treated as long positions in each of the assets in the basket except one. The bank can choose which one to exclude. The total capital charge for either product can be capped at the equivalent of deduction from capital.

a) The amount of each position recorded will be the value of the note.

- b) 17 below gives an exception to this 'additive approach'. In addition, the FSA may consider that this is not needed where a bank can demonstrate, to the FSA's satisfaction, is a very strong correlation between the assets in the basket.

16 Where the credit default product or credit linked note is a proportionate structure, positions should be recorded in the reference assets according to the proportions in the contract.

17 Where a multiple-name credit-linked note is rated such as to meet the conditions for recognition as a qualifying debt item, the buyer of credit risk may record the specific risk position in the reference assets as a single long specific risk position with specific risk of the note issuer.

See ch TI 46G

- a) Qualifying debt items are defined in the chapter on interest rate position risk.

18 The credit risk buyer of a funded credit derivative should also record a long position in the specific risk of the note issuer, whether the credit derivative meets the definition of qualifying or not.

### 7.3.5 *Specific risk offset*

19 Banks may net notional positions in reference assets created by credit derivatives with positions in underlying assets or other notional positions created by other credit derivatives if the following conditions are met:

- (a) the underlying and reference assets are issued by the same obligor;

See ch TI 37G

- (b) the underlying and reference asset specific risk positions meet the matching criteria set out in the chapter on interest rate position risk; and

See s9

- (c) the conditions set out below are met.

See s7.2

Where the reference asset and the underlying asset do not meet the criteria for netting, no offset is considered to be justified under the standard approach.

20 Materiality thresholds may reduce the amount of the specific risk offset. All credit derivatives involving materiality thresholds should be referred to the FSA.

See s5.2

- a) The definition of a materiality threshold is given elsewhere.

### 7.3.6 *Maturity mismatch*

21 Where a credit default product or credit linked note is of shorter maturity than the reference asset, a specific risk offset is allowed between long and short specific risk positions, but a forward position in specific risk of the reference asset is recorded. The net result is a single specific risk charge for the longer maturity position in the reference asset.

- a) The maturity of a credit derivative with a *step up* and call option is assumed to be the date of the call.

- i) A *step up* is an increase in the protection payment.

22 This treatment does not apply to total return swaps, where no forward position in specific risk of the reference asset is recorded in cases of maturity mismatch.

### 7.3.7 *General market risk*

23 Credit default products do not normally create a general market risk position.

24 Total return swaps create a long or short position in the reference asset and a short or long position in the notional bond representing the interest rate related leg of the contract.

25 Credit linked notes create a long position in the note itself for the credit risk buyer.

## 7.4 **Counterparty risk**

### 7.4.1 *General principles*

26 Each party to a total return swap relies on the other for payment, therefore each party records a counterparty risk charge.

See ch DU and  
TC

- a) The counterparty risk charge is calculated as set out in chapters DU and TC

27 The credit risk seller in credit default product relies on the credit risk buyer to pay the credit event payment if a credit event occurs, and therefore records a counterparty risk charge. The credit risk

buyer is exposed to the credit risk seller only if there are future premiums or interest rate related payments outstanding, and these are recorded as a sundry debtor and risk weighted in the normal way.

See chs DU and  
TC

- a) The counterparty risk charge is calculated as set out in the chapters on counterparty risk treatments common to the banking and the trading book and counterparty risk in the trading book.

28 There is no counterparty risk charge for credit linked notes.

#### **7.4.2 Potential future credit exposure (add-on)**

29 The add-on used when calculating the counterparty exposure for an unfunded OTC credit derivative is determined by whether the reference asset is recognised as a qualifying debt item. If the reference asset is a qualifying debt item, the counterparty risk charge is calculated using interest rate add-ons. Otherwise, equity add-ons should be used.

See ch TI 46G

- a) Qualifying debt items are defined in the chapter on interest rate position risk.

#### **7.5 Foreign exchange risk**

See ch FX

30 Where the credit derivative is denominated in a currency other than the reporting bank's base currency, it will feed into the bank's monitoring of its foreign exchange position in the normal way.



## **8 CREDIT SPREAD OPTIONS**

### **8.1 General**

1 The capital needed for credit spread options are analogous to those of other options on credit risk assets.

### **8.2 Banking book**

#### *8.2.1 Protection buyer*

2 The capital reduction/guarantee treatment set out in section 5 in respect of the underlying asset is not considered to be available to the purchaser of a credit spread option.

- a) The amount of protection provided by a credit spread option depends on its mark to market value. However the assumption underlying the banking book framework is accrual accounting.

See ch DU

3 Protection bought using a credit spread option is ignored for capital purposes.

#### *8.2.2 Protection seller*

4 Protection sold using a credit spread option is recorded as a direct credit substitute. The amount of exposure will be the par value of the nominal amount of the reference asset.

### **8.3 Trading book**

5 The option standard method should be used for credit spread options only after prior consultation with the FSA. Banks should normally apply for recognition of option models covering credit spread options.

## 9 RISK TRANSFER CRITERIA

### 9.1 Scope

- 1 This section sets out conditions to be met before risk transfer (i.e. protection)/short position is recognised in setting capital requirements for banks which buy protection using credit derivatives in the banking book (see section 6) or selling credit risk in the trading book (see section 7). This section does not apply to credit spread options (see section 8).
- 2 Where these criteria are not met, protection bought should be ignored in the banking book (and the bank should continue to weight the underlying asset as normal) and a short credit risk position recorded in the trading book should not be offset against another specific risk position.
- 3 Sections 9.2 to 9.4 apply to both the banking book and the trading book.
- 4 Section 9.2 applies to all credit derivatives, whether funded or unfunded, single name or multiple names.
- 5 Section 9.3 applies to funded credit derivatives referenced to single names or multiple names.
  - a) For the purposes of section 9, first to default structures referenced to multiple names are considered to be referenced to a *single* name. This is because protection is only recognised against one asset in the basket for capital purposes.
- 6 Section 9.4 applies to packaged credit derivative transactions, which are funded.
  - a) For the purposes of section 9, *packaged* transactions include proportionate credit derivatives referenced to multiple names, and structures which bundle together a series of single name credit derivatives.

### 9.2 General criteria

- 7 In order for the protection bought/short position to be recognised the following criteria should be met for all credit derivatives:
  - (a) The credit risk transfer should not contravene any terms and conditions relating to the reference asset and where necessary all consents should have been obtained;

- a) This relates mainly to reference assets which are loans.
- (b) At a minimum, the credit events in a credit default product or credit-linked note should cover credit events in the reference asset itself; and
- (c) The credit risk buyer should have no formal recourse to the credit risk seller for losses.

### 9.3 Criteria for funded single name credit derivatives

8 In order for protection/ offsetting short position to be recognised, the following criteria should be met:

- (a) the protection buyer should have no obligation to repay any funding received under the credit derivative except at termination or as a result of a defined credit event (in accordance with the terms of payment defined in the contract); and
  - a) The protection buyer may retain the option to repay funding, provided that the reference asset remains fully performing.
  - b) In proportionate transactions involving baskets of assets, the protection seller may retain the option to refinance where the pool of assets has been reduced by repayment to less than 10% of its maximum value but only where the reference assets are fully performing.
  - c) An exception to this restriction is where the obligation arises from warranties given in respect of the asset at the time of the transaction, provided that these are not in respect of the future creditworthiness of the reference asset.
- (b) the protection buyer should have given notice to the protection seller that it is under no obligation to repay the funding (except as defined in (a) above), nor to support any losses suffered by the protection seller, and that the protection seller acknowledges the absence of that obligation.
  - a) Notice and acknowledgement also applies to the ultimate investors, where the initial protection seller is an SPV.
  - b) This criterion may be met by a highly visible and unequivocal statement that the protection buyer does not stand behind the asset(s) and will not make good any losses suffered in the offering circular (or other analogous documentation).

See ch NE

- 9 For those unfunded transactions where collateral has been taken, the conditions in chapter NE in respect of collateral should also be met for the collateral to reduce/remove the exposure to the reference asset in the banking book or to offset the counterparty exposure in the trading book.

#### **9.4 Criteria for funded packaged transactions**

- 10 This section applies to funded credit derivatives referenced to multiple names which have a proportionate payout structure, or where a series of funded single name credit derivatives are packaged together. This section does not apply to unfunded structures or to multiple-name credit derivatives with a first to default structure.
- 11 Packaging of the credit risk of multiple assets for transfer may create operational risks which would be negligible for a single asset. For example, the commercial reputation of a protection buyer could be committed by association with a package of assets, and clean transfer of the risk could be jeopardised by pressure on the protection buyer subsequently to provide support to reduce losses of the credit risk buyer. Such reputational risk is less if the assets concerned are disclosed and they are freely tradable assets.
- 12 The following criteria should be met for protection/offsetting short position to be recognised. Some of these criteria may not need to be met if all the reference obligors are disclosed and all the reference assets are freely tradable assets.
- (a) The bank selling credit risk should be satisfied that the transaction protects it from any liability to the credit risk buyer and ultimate investors, except where the bank has been negligent.
    - a) Banks can achieve this by ensuring that their auditors and legal advisers are satisfied that the terms of the scheme protect them from liability to the credit risk buyer and ultimate investors and that the scheme meets the FSA's policy.
  - (b) The credit risk should initially be transferred to a special purpose vehicle (SPV). The protection buyer should not own any share capital or other form of proprietary interest in or control over the SPV, either directly or indirectly.
    - a) This applies also to any other group entity within the protection buyer's group that is covered by the FSA's consolidated supervision.

- b) Share capital includes for this purpose all classes of ordinary and preference share capital.
  - c) Control, for these purposes means that the Board of the company used as a vehicle should be independent of the credit risk seller, although the credit risk seller may have one director representing it.
- (c) The name of the SPV should not include the name of the protection buyer nor imply any connection with it.
- (d) The protection buyer should not directly reimburse the vehicle for any of the recurring expenses of the scheme. Although the credit risk seller may make a one off contribution at the initiation of the scheme to enhance the credit-worthiness of the vehicle. Any credit enhancement provided will be treated as a deduction from capital.
- a) Any such credit enhancement should be disclosed in the offering circular (or analogous documentation).
- (e) The credit risk seller should not fund the vehicle (other than the initial credit enhancement described above); in particular it should not provide temporary finance to a scheme to cover cash shortfalls.
- a) The credit risk seller may enter into interest rate and currency swaps with the SPV as long as they do not provide support for losses in the vehicle.

See ch NE

13

For those unfunded transactions where collateral has been taken, the criteria in chapter NE in respect of collateral should also be met for the collateral to reduce/remove the exposure to the reference asset in the banking book or to offset the counterparty exposure in the trading book.

## 10 LARGE EXPOSURES

### 10.1 Introduction

See ch LE

1 The factors that should be considered in determining large exposures recorded for credit derivatives are the same as those for determining capital adequacy, with the exception of the factors noted in this section. Large exposures are covered fully in the chapter on large exposures.

- a) The amount of protection recognised will normally be the same for large exposures as for capital adequacy purposes.

2 Sections 10.2 to 10.5 apply to credit default products, credit linked notes and total return swaps. Section 10.6 applies to credit spread options.

### 10.2 Banking book and trading book – protection buyer

#### 10.2.1 *Maturity mismatch*

3 For capital adequacy purposes forward credit exposure left by a maturity mismatched credit derivative is treated as an undrawn commitment. Undrawn commitments are treated as an exposure for large exposures purposes, and hence maturity mismatched credit derivatives do not reduce exposure to the underlying.

#### 10.2.2 *Currency*

4 Where the base currency of a funded credit derivative is different from that of the underlying asset, no protection is recognised for large exposures purposes.

#### 10.2.3 *Multiple names*

5 Protection bought/short position created through a credit derivative referenced to multiple names in a first to default structure is recognised for one asset in the basket only for both large exposures and capital adequacy. The same asset should be chosen in each case.

### 10.3 Banking book - protection buyer

#### 10.3.1 *Unfunded*

6 Where an unfunded credit derivative is treated as a guarantee for capital purposes, banks may choose to record their exposure either to the underlying or to the counterparty in the credit derivative

transaction, provided that the treatment adopted is in line with the bank's large exposures policy statement.

#### **10.4 Banking book - protection seller**

##### **10.4.1 *Funded***

7 Where a credit derivative is funded, banks should report exposure to both the reference asset(s) and the credit derivative counterparty/issuer for large exposures purposes.

- a) First to default multiple name credit derivatives result in exposures to more than one reference asset.

#### **10.5 Trading book**

##### **10.5.1 *Asset mismatch***

See ch LE

8 Offsetting of long and short positions should be calculated in accordance with the chapter on large exposures. Long and short positions may be offset provided the policy in that chapter is followed.

#### **10.6 Credit spread options**

This section applies to both the banking book and the trading book.

##### **10.6.1 *Protection buyer/credit risk seller***

9 No protection/offset is recognised for the purchaser of a credit spread option for LE purposes

##### **10.6.2 *Protection seller/credit risk buyer***

10 A credit spread option creates an exposure to the reference asset for LE purposes. The exposure is the par value of the nominal amount of the reference asset.





# Interim Prudential Sourcebook for Building Societies

## 5 LIQUIDITY

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# Interim Prudential Sourcebook for Building Societies

## 5 Liquidity

### 5.1 Introduction

5.1.1 G This chapter now sets out the FSA's quantitative regime for building societies' prudential liquidity, and further guidance specific to building societies on the management of their liquidity in accordance with the five approaches to financial risk management set out in chapter 4. This chapter complements PRU 5.1 (which contains rules and guidance for a wider range of firms on systems and controls appropriate for liquidity risk). Only certain provisions of PRU 5.1 apply to building societies, by virtue of PRU 5.1.3R and PRU 5.1.4R. Similarly it also complements PRU 1.2 (which sets out the high level requirements for liquidity that apply to deposit takers and own account dealers, as well as insurers). The chapter outlines the factors the FSA will take into account in assessing whether a society meets the rules set out in section 5.2 and PRU 1.2 and the guidance in PRU 5.1. A list of types of asset suitable for inclusion in prudential liquidity for societies on each of the approaches to financial risk management is set out in Annex 5A. "Prudential liquidity" has the meaning set out in paragraph 5.3.4G.

5.1.2 G Some material on liquidity systems and controls, previously in this chapter and superseded by PRU 5.1, has been deleted, but the original numbering has been retained: where an entire section has been deleted this is noted alongside the original section number. The new material in PRU 5.1 covers requirements for stress testing and scenario analysis, as well as contingency funding plans and their documentation.

### 5.2 Rules

5.2.1 R [Deleted]

5.2.2 G [Deleted]

5.2.3 G [Deleted]

- 5.2.4 E (1) A society should keep at least 3.5%SDL in 8 day liquidity.**
- (2) Contravention of 5.2.4(1) may be relied upon as tending to establish contravention of PRU 1.2.22R.**

5.2.5 G “SDL” is defined in paragraph 5.3.2.

5.2.6 G A list of assets acceptable as 8 day liquidity is set out in paragraph 5.4.3.

**5.2.7 R A society must maintain a board-approved policy statement on liquidity.**

5.2.8 G Guidance on the content of a liquidity policy statement is set out in 5.6.2 to 5.6.4 and in Annex 5B. Societies will also find guidance on the requirements (set out at PRU 1.2.26R, PRU 1.2.27R, PRU 1.2.31R, PRU 1.2.33R, PRU 1.2.35R, PRU 1.2.37R and PRU 1.2.38R) for stress testing and scenario analysis at PRU 5.1.58 to PRU 5.1.62. Further guidance on the requirements (set out at PRU 1.2.22R, PRU 1.2.35R and PRU 1.2.37R) on contingency funding plans and documentation is provided at PRU 5.1.85G – PRU 5.1.91G). Societies may, for convenience, wish to combine their documentation meeting these requirements with their liquidity policy statement, but need to be clear how any combined document meets the separate requirements.

**5.2.9 R [Deleted]**

### **5.3 The Prudential Regime for Liquidity**

5.3.1 G A building society specialises in long-term mortgage lending which is financed mainly by liabilities which are contractually short-term. This feature of societies’ business creates maturity mismatches which can give rise to cash flow imbalances. To ensure that it can meet its obligations as they fall due, a society should therefore keep an appropriate amount and mix of liquidity to meet any sudden adverse cash flow; the level of liquidity held should be sufficient to maintain public confidence that the society can meet its commitments.

5.3.2 G The amount of liquid assets held by a society should be expressed as a percentage of its share and deposit liabilities (SDL). For the purposes of this chapter, SDL is defined as the total of share and deposit liabilities, excluding amounts that qualify as own funds but including accrued interest not yet payable. Societies should show the board-approved range for liquidity expressed as a percentage of SDL in their liquidity policy statement.

5.3.3 G Funds borrowed from the wholesale money markets have a specified maturity date on which they have to be repaid or rolled over and thus carry the risk that they will be unable to be refinanced on that maturity date on terms acceptable to the society. Societies should take this risk into account in planning the maturity profile of their prudential liquidity. The same consideration applies to large positions in retail funds where, for example, fixed-rate bonds or Tessa accounts are due to mature. Societies should not run large exposed funding positions without having sufficient liquidity to re-finance part or all of the position on maturity. An effective maturity diary should be established for both funding and prudential liquidity.

5.3.4 G Liquid assets should be genuinely liquid i.e. they should be capable of being realised at very short notice. Only instruments or assets that are marketable (i.e. realisable in a secondary market) or have three months or less to run to maturity should (subject to the guidance in Annex 5A and in paragraph 5.5.2) be included in the calculation of liquidity for prudential purposes. Societies may hold other assets, but as an investment rather than liquidity.

5.3.5 G Committed standby facilities form an important element of societies' funding strategy and can be used to boost liquidity when needed. Societies should ensure that the lines are truly committed and that a diary is kept noting when the lines expire, allowing the facilities to be renewed on a timely basis. Societies not using committed standby facilities should increase their level of liquidity to compensate.

## **5.4 Short-term Liquidity**

5.4.1 G The FSA operates a short-term liquidity regime for building societies from sight to 8 calendar days forward.

5.4.2 G An asset maturing on a non-business day should be regarded as maturing on the succeeding business day.

5.4.3 G The following liquid assets may be counted as short-term liquidity:

- (1) cash, current account balances, Treasury, Local Authority and eligible bank bills;
- (2) deposits with relevant authorities (as defined in Annex 1F), banks and building societies with not more than 8 days' notice, or within 8 days of maturity;
- (3) all gilt-edged securities, subject to discounting according to maturity (see paragraph 5.4.4);
- (4) CDs (banks and building societies) with 3 months or less to maturity, commercial paper with residual maturity up to 1 month;
- (5) reserves that are held with the Bank of England as part of the Bank of England's framework for its operations in the sterling money markets, of the type set out in Section III of the Bank of England's paper 'Reform of the Bank of England's Operations in the Sterling Money Markets: A paper on the framework by the Bank of England', published 4 April 2005.

5.4.4 G All gilt-edged securities can be included within 8 day liquidity, but discounted back to sight according to maturity. Such discounting should help to offset the greater price volatility which can affect gilts at the longer end of the maturity range. The discount factors which should be applied to market value of holdings of gilt-edged securities are as follows:

<b>maturities</b>	<b>maturities</b>	<b>maturities</b>
<b>less than 1 year</b>	<b>1 to 5 years</b>	<b>over 5 years</b>
Zero	5%	10%

5.4.5 G Societies on the “Administered” approach (as described in chapter 4 on Financial Risk Management) should not hold marketable fixed-rate instruments, including gilts, unless their residual maturity is 5 years or less. Where such societies have historic holdings of such investments, they may continue to be counted as prudential liquidity subject to the discount factor for gilt-edged securities.

5.4.6 G Societies with extensive treasury operations and large holdings of gilts will typically mark-to-market their gilt book daily. Societies with less sophisticated treasury operations which hold gilts as liquidity should mark-to-market their holdings at least once a week and more often during times of market volatility. Where such holdings are held as 8 day liquidity, market valuations should be taken daily to obtain an accurate value for purposes of discounting and to establish the amount of prudential liquidity at any given time.

5.4.7 G Societies should not include excessive amounts of inter-society holdings in their 8 day liquidity calculation. Societies should include sub-limits for the 8 day liquidity band within their overall sector limits in the liquidity policy statement.

## **5.5 Supervisory Approach to Liquidity**

5.5.1 G Societies should adopt a risk-averse approach to the management of liquid assets. Societies should ensure that treasury systems and controls are adequate for the scale of activity undertaken and that treasury personnel have appropriate expertise and competence, including dealing, settlement and accounting skills. Chapter 4 suggests that dealings in certain categories of liquid assets should be confined to societies on an advanced approach to financial risk management.

5.5.2 G Annex 5A sets out the range of assets considered appropriate for societies to hold as prudential liquidity although each society should satisfy itself that any particular kind of asset is suitable to its needs. If a society wishes to hold an asset as prudential liquidity that is not listed in Annex 5A, it should consider the following factors:

- (1) the suitability of the asset for the structure of the society's balance sheet, taking into account, inter alia, interest rate risk and any currency risk;
- (2) the marketability of the asset i.e. the "depth" of its liquidity;
- (3) credit risk and market risk (price volatility);
- (4) the adequacy of the society's expertise and systems in the treasury area.

## 5.6 Board and Management Responsibilities

5.6.1 G Chapter 4 on Financial Risk Management refers to the potential risks to societies of treasury activities. In particular, the size and complexity of some transactions can make them vulnerable to losses and fraud, and the impact of losses on individual transactions in the treasury area can be significant and immediate. Boards have ultimate responsibility for deciding the degree of risk taken by their societies, including all categories of liquid assets and risks arising from the management of liquidity.

5.6.2 G Rule 5.2.7 requires each society to have a liquidity policy statement. This should be approved by the society's board and be consistent with the society's strategic plan and its financial risk management policy statement. Societies should also have regard to the rules and guidance in *PRU 1.2* and *PRU 5.1*, set out in more detail at *PRU 5.2.8G*.

5.6.3 G Policy statements should set out the board's objectives for liquidity, the limits within which liquidity should be maintained, the range of instruments in which liquidity can be invested and conditions under which authority is exercised. The document should establish the framework for operating limits and high level controls, and should set out the board's policy on credit assessment, ratings and exposure limits. Guidance on the content of liquidity policy statements is set out in Annex 5B.

5.6.4 G A liquidity policy statement should be a working document and personnel in the treasury and settlement areas should be familiar with its contents, as should members of ALCO or Finance Committee. When aspects of the policy or limits become out of date, the policy document should be amended and the revised copy must be sent to the FSA (see rule 5.2.9).

5.6.5 G Boards should establish the objectives for liquidity including meeting obligations as they fall due (including any unexpected adverse cash flow), smoothing out the effect of maturity mismatches and the maintenance of public confidence. The need to earn a return may also be recognised as an objective, although this should be secondary to the security of the assets. Societies should also have regard to the rules and guidance in *PRU 1.2* and *PRU 5.1*, set out in more detail at *PRU 5.2.8G*.

5.6.6 G Boards should decide the principles of remuneration for treasury dealing staff. Large bonuses linked to dealing-related profit targets should be discouraged as they can lead to unacceptable risk-taking on the part of those involved at the expense of the society.

5.6.7 G Management should regularly review the liquid asset portfolio. Some categories of asset are more complex than others and their characteristics (which can involve how the assets are held as well as the assets themselves, for example, securities subject to repo/reverse repo transactions) need to be fully assessed in any review of the portfolio.

5.6.8 G Board policies should be implemented through the operation of effective procedures and controls, risk measurement and reporting systems; senior management should maintain clear lines of authority and responsibility; sufficient personnel with specialist skills - in the settlements as well as in the dealing area - should be recruited; senior managers should have sufficient understanding of treasury operations to be able to carry out their responsibilities without relying exclusively on advice from the treasury team; and delegation of authority should be fully documented in procedures manuals and closely monitored.

## **5.7 Society-only Approach to Liquidity**

5.7.1 G Societies need not calculate liquidity on a group basis for prudential purposes. Each subsidiary undertaking will have its own liquidity requirements reflecting the particular nature of its business and it will not normally be appropriate to combine these with the parent society or with each other. Liquidity held offshore, for example, may be managed with a degree of autonomy and subject to the rules of another regulator. In either case, this can lead to a loss of control and there may be circumstances where liquid assets are not immediately callable overnight. Liquid assets which are held offshore or in a subsidiary undertaking (or both) should be excluded from a society's calculation of its prudential liquidity.

## **5.8 Outsourcing of Liquidity Management and Brokers' Advice**

5.8.1 G In considering whether to outsource a proportion of their liquidity to a fund manager, societies should take into account the guidance on outsourcing in chapter 11 and the following:



- (1) any agreement should be fully supported by legal documentation and societies should take legal advice on the terms and conditions;
- (2) the security of the assets should be no weaker when held to the order of a third party (the fund manager) than when held to the direct order of the society;
- (3) societies should ensure that the safety of the assets is the responsibility of the fund manager while they are under management, including while securities are out for settlement;
- (4) the assets under management should at all times be held in a separate client inventory identifying the society - there should be no credit exposure risk;
- (5) the fund manager should be given the terms and conditions under which it can act; this should include, inter alia, a copy of the society's liquidity policy statement;
- (6) the society should remain in control over policy decisions and be able to monitor the performance of the fund manager against independent benchmarks;
- (7) periodic meetings should be held between the society's senior management and senior management of the fund managers to discuss performance;
- (8) the board of the society should satisfy itself about procedures and controls, including internal audit, to obtain the level of comfort it needs over the operation.

5.8.2 G Most societies take advice from brokers regarding investment of their liquidity. Some, however, enter into a more formal arrangement where securities are delivered to and from the broker and a customer agreement between the broker and the society is completed. If so, societies should differentiate between advice and discretionary fund management. If the society has entered into an agreement involving the provision of advice, it should ensure that no transaction is undertaken without its prior consent. As with discretionary fund management,

societies should make certain that all transactions are within the terms of its liquidity policy statement.

## Prudential Liquidity

5A.1 G The following list of assets is available to societies for the management of prudential liquidity, according to the society's approach to financial risk management, as set out in chapter 4.

	Administered	Matched	Extended	Comprehensive	Trading
1.1 Bank notes or coinage of any country or territory or electronic money issued by a credit institution.	✓	✓	✓	✓	✓
1.2 Deposits with:					
(1) the central bank of any member country of the EEA and of Canada, Japan, Switzerland and the USA (sterling only);	✓	✓	✓	✓	✓
(2) National Savings Bank;	✓	✓	✓	✓	✓
(3) any credit institution authorised by the competent authorities of any member country of the EEA and Switzerland (sterling only);	✓	✓	✓	✓	✓
(4) wholly owned subsidiaries of UK banks and building societies in the Channel Islands and the Isle of Man;	✓	✓	✓	✓	✓
(5) any gilt-edged market maker or participant in the UK gilt market supervised by a regulatory authority in the EEA.	✓	✓	✓	✓	✓

1.3 Loans to:					
(1) the Department of Finance and Personnel (Northern Ireland);	✓	✓	✓	✓	✓
(2) any relevant authority ("relevant authority" is defined in Annex 1F).	✓	✓	✓	✓	✓
1.4 UK Government money market instruments (e.g., Treasury bills) and securities (gilts)					
(1) up to 5 years residual maturity;	✓	✓	✓	✓	✓
(2) over 5 years residual maturity	✗	✓	✓	✓	✓
1.5 Securities issued or fully guaranteed by the government of any other member country of the EEA and of Australia, Canada, Japan, New Zealand, Switzerland and the USA (sterling securities only).					
(1) either floating rate (of any maturity) or fixed-rate up to 5 years;	✓	✓	✓	✓	✓
(2) fixed-rate over 5 years.	✗	✓	✓	✓	✓
1.6 Securities issued, guaranteed or, in the case of bills of exchange, accepted by any credit institution authorised by the competent authorities of any member country of the EEA and Switzerland (sterling securities only).					
(1) either floating rate (of any maturity) or fixed-rate up to 5 years;	✓	✓	✓	✓	✓

(2) fixed-rate over 5 years.	✘	✓	✓	✓	✓
1.7 Securities issued by any relevant authority (as in 1.3(2)).					
(1) either floating rate (of any maturity) or fixed-rate up to 5 years;	✓	✓	✓	✓	✓
(2) fixed-rate over 5 years.	✘	✓	✓	✓	✓
1.8 National Savings Bonds.	✓	✓	✓	✓	✓
1.9 Foreign currency deposits with:					
(1) the central bank of any member country of the EEA and of Canada, Japan, Switzerland and the USA;	✘	✘	✓	✓	✓
(2) any credit institution authorised by the competent authorities of any member country of the EEA and Switzerland.	✘	✘	✓	✓	✓
1.10 Foreign currency securities issued or fully guaranteed by the government of any member country of the EEA and of Australia, Canada, Japan, New Zealand, Switzerland and the USA (this category does not apply to mortgage backed securities).	✘	✘	✓	✓	✓
1.11 Foreign currency securities issued, guaranteed or, in the case of bills of exchange, accepted by any credit institution authorised by the competent authorities of any member country of the EEA and Switzerland.	✘	✘	✓	✓	✓
1.12 Securities issued by international organisations the capital of which is subscribed in whole or in part by any member state of the EEA (known as “supranationals”).					

(a) securities in sterling	✓	✓	✓	✓	✓
(b) securities in foreign currencies	✗	✗	✓	✓	✓
1.13 Securities in the form of commercial paper (which should be redeemed before the first anniversary of the date of issue) issued or guaranteed by:					
(1) public companies whose registered office is domiciled in the EEA;	✗	✗	✗	✓	✓
(2) by public companies incorporated in Canada, Japan, Switzerland and the USA	✗	✗	✗	✓	✓
1.14 Mortgage backed securities.	✗	✗	✓ <sup>1</sup>	✓	✓
1.15 Stocklending rights arising from the lending of securities issued in the UK by HM Government.	✗	✓	✓	✓	✓
1.16 Gilt repo	✗	✓	✓	✓	✓
1.17 Repo in non-gilt-edged securities.	✗	✗	✗	✓	✓
1.18 Stocklending rights arising from the lending of securities under the rules of any depository or clearing agent.	✗	✗	✗	✓	✓

Note 1: Foreign currency deposits and foreign currency securities:

Societies should aim to hedge or match their foreign currency exposures. Any residual currency position should not exceed 2% of own funds, unless the society is on the Trading approach.

Note 2: Equities, or equity related stocks are excluded as prudential liquidity.

Note 3: Any guarantee should be unconditional in respect of the payment of both principal and of interest on all securities.

Note 4: Non-marketable assets (i.e., items 1.2, 1.3 and 1.9) are restricted to those with three months or less to residual maturity.

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<sup>1</sup> STERLING ONLY

## Policy Statement on Liquidity

### 5B.1 Overview

5B.1.1 G This Annex provides guidance on the issues which should be addressed in a liquidity policy statement. The list of issues is not exhaustive and not all points will be relevant to all societies.

### 5B.2 Policy Statement Contents

5B.2.1 G The introduction section should include:

- (1) Background to the society's approach to liquidity management;
- (2) Ratification process for obtaining board approval, including amendments to the policy statement as well as complete revisions;
- (3) Arrangements for, and frequency of, review (which should be conducted at least on an annual basis).

5B.2.2 G The objectives section should set out the Board's objectives for liquidity (see section 5.6.5 of this chapter).

5B.2.3 G The operational characteristics section should set out the society's business and operational characteristics, which impact on the amount and composition of liquidity, and the intended range for liquidity and liquidity net of mortgage commitments as a percentage of SDL.

5B.2.4 G The risk management section should include:

- (1) Exposure policies, including controls and limits as appropriate, for countries, sectors (with sub-limits for 8 day liquidity) and counterparties, including exposure to brokers;

- (2) The policy adopted for credit ratings, stating the minimum quality acceptable and procedures for ensuring credit ratings are up to date;
- (3) Policy of assessment to be adopted towards sectors that are non-rated, e.g., local authorities;
- (4) Operational and settlement risk, including: framework of board authorisation, delegations and operating limits (including, inter alia, dealer limits, transaction and day limits); deal authorisation, confirmation checking, segregation of duties;
- (5) Limits for pre-approved free of payment (FOP) exposures (NB: all FOP exposures should be pre-approved);
- (6) Procedures and criteria for exceptional overrides in relation to dealing, operational rules, limits and authorisation;
- (7) Policy for liquidity management information and reporting to the board.

5B.2.5 G The maturity structure section should include the policy for maturity mismatch and a “maturity ladder” covering prudential liquidity. This should give a clear view of the maturity pattern of the liquidity portfolio to be followed, showing the maximum proportions of liquidity to be included within each time band.

5B.2.6 G The categories of assets and activities section should set out the society’s policy for the following:

- (1) inter-society holdings;
- (2) repo/reverse repo (both gilt-edged stock and non-gilt-edged securities);
- (3) stocklending;



- (4) mortgage backed securities (including, where applicable, US MBS);
- (5) foreign currency securities and the handling of foreign currency exposures;
- (6) commercial paper.

5B.2.7 G The society's policy for membership and use of any clearing system or depository should be set out clearly, including a section dealing with authorisation and operational controls.

5B.2.8 G Liquidity implications and the role of standby facilities should be included in the policy statement.

5B.2.9 G The role of external professional advisers should be clearly stated, where applicable.

## **Inter-society Holdings**

5C.1 G Societies may hold other societies' liabilities as prudential liquidity. Such holdings may include deposits and holdings of all forms of securities and money market instruments issued by other societies, including commercial paper, but should exclude Permanent Interest Bearing Shares and other forms of issued capital.

5C.2 G A society's aggregate holding of other societies' liabilities should not exceed 5% SDL or £5m whichever is the higher. The total should also include undrawn as well as drawn amounts under committed facilities provided to other societies. This measure is to be continuous.

5C.3 G The FSA expects societies to invest no more than 20% of their prudential liquidity or £5m, whichever is the higher (up to a limit of 5% SDL or £5m whichever is the higher) in aggregate holdings of other societies' liabilities.

5C.4 G Committed facility agreements with other societies should be reported to the FSA in the MFS1 return (table D2). Only the amount drawn down (lent) will constitute a liquid asset, but the whole amount counts towards the aggregate exposure to other societies' liabilities as explained above.

5C.5 G Smaller societies (with total assets of less than £1 billion), can be, as a sub-sector, exposed to collective funding risk. Such risk would be exacerbated if smaller societies relied on committed facilities from each other. Accordingly, it would not, in the FSA's view, be prudent for smaller societies to rely on, or to provide, committed loan facilities from, or to, other smaller societies.

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## 6 LENDING

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## **Interim Prudential Sourcebook for Building Societies**

### **6 Lending**

#### **6.1 Introduction**

6.1.1 G This chapter replaces PN 1998/6 Lending issued by the Commission.

6.1.2 G Building societies remain subject to the statutory nature limit for lending in the 1986 Act. A minimum of 75% of group business assets must be made up of loans fully secured on residential property (calculated by reference to sections 6, 6A and 6B of the 1986 Act). Each society should ensure that its lending policy and associated business control systems will deliver continuing compliance with this nature limit on the basis of proper, consistent classification of the loan assets of the society and its group. Further guidance on the application of this nature limit is given in section 6.6.

#### **Scope of the Chapter**

6.1.3 G The FSA's Principle 3 requires a firm to organise and control its affairs responsibly and effectively, with adequate risk management systems. Principle 2 requires a firm to conduct its business with due skill, care and diligence. Experience shows that one of the most common causes for the failure of deposit-taking institutions is a deficiency in systems for controlling lending and credit risk. Accordingly, the principal theme of this chapter is the need for adequate and appropriate systems for controlling and managing risks arising from lending. The chapter also establishes a framework within which the FSA will judge the risk profile of individual societies' lending, in particular for the purpose of setting and reviewing each society's threshold solvency ratio, and for assessing whether the society complies with Principles 2 and 3.

6.1.4 G This chapter also sets out the FSA's views on good practice in a range of areas related to societies' lending, which are drawn from the experience with societies' activities of its

predecessor, the Commission, over a number of business cycles. Nothing in this chapter absolves the board of each society from its responsibility for developing and maintaining prudent controls over lending risk arising from its business activities and future business plans.

## **6.2 Rules**

**6.2.1 R A society must have adequate systems for managing and controlling risk arising from lending, including systems for assessing both the adequacy of security for loans and the ability and willingness of borrowers to repay their loans.**

**6.2.2 R A society must maintain, and submit to the FSA, a board-approved policy statement on lending, which must include plans for the management of arrears, and the procedures for making specific and general (or individual and collective) provisions against impaired loans.**

**6.2.3 R A society making any significant change to its policy statement on lending must provide the FSA with a copy of the amended policy statement as soon as possible after it has been adopted.**

6.2.4 G Each society's lending policy should be reviewed, by or on behalf of the board, not less than once a year.

6.2.5 G Chapter 1 on Solvency explains, inter alia, the need for adequate capital to support risks that arise from societies' lending activities. That chapter states that the setting of a threshold ratio by the FSA does not absolve society boards from the responsibility to maintain such higher solvency ratio as they consider appropriate for their business and future plans. Societies should hold sufficient capital to support the risks in their lending book and those arising from new lending initiatives. The FSA will take this into account in assessing compliance with Principle 4.

## **6.3 Principles of Lending**

6.3.1 G The basic principles of good lending practice that the FSA will take into account in assessing compliance with the rules in section 6.2 are as follows:-

- (1) lending activities should be within the capabilities, experience and expertise of a society's management and its board;
- (2) risk should be controlled at inception by sound underwriting procedures, exercised by individuals and/or a credit committee skilled in the type of lending mandated to them, or by fully tested credit scoring systems;
- (3) the pricing of loans should take account of the perceived risks;
- (4) adequate controls should be in place to avoid imprudent concentrations of risk in special products, non-traditional areas of lending and higher risk categories in traditional areas of lending;
- (5) adequate procedures should be in place for monitoring the performance of lending related to source, type, and period of origination, and for ensuring that lending experience feeds into the formulation of policy for new lending;
- (6) the frequency and quality of management and board information should be sufficient to monitor and control lending activities effectively;
- (7) commercial loans should be regularly reviewed;
- (8) systems should be in place for early and effective management of arrears cases and for managing the disposal of properties in possession;

- (9) prudent provisioning methodologies should be used and actual provisions regularly reviewed in the light of experience;
- (10) budgetary procedures should be in place to assess and control the effect on current and future profitability of lending at fixed or capped rates, at a fixed margin over a market reference rate and of price incentivised lending;
- (11) systems should be in place to combat mortgage or other loan fraud;
- (12) for subscribing societies, systems should be in place to ensure compliance with the CML Mortgage Code;
- (13) where external advice is required, professional firms of solicitors, accountants, valuers and other types of adviser should have experience in the type of transaction for which they have been instructed.

## **6.4 Lending Policy Statements**

6.4.1 G Rule 6.2.2 requires each society to have a statement of lending policy. Each society's board should determine, subject to the nature limit, the make up of its lending and its appetite for risk and should establish procedures for containing risk within this agreed policy. This section provides guidance on the content of lending policy statements and suggests factors that boards should consider when drawing up such statements.

6.4.2 G The statement should reflect the society's "philosophical" approach to lending, including the degree of risk the society is prepared to take to achieve a desired level of return, as well as more detailed aspects of controlling new lending risk and residual risk in a lending book. The statement should act as guidance to executives in designing new products as well as to staff involved in the underwriting process.

6.4.3 G The following paragraphs set out the broad areas societies should cover in their lending policy statement. Lending markets and the economic circumstances of borrowers, both personal and commercial, are subject to change and new lending risks may arise in the future. So, boards and management should review lending policy not less than once a year to take account of changing circumstances.

6.4.4 G A policy statement can usefully be structured in four parts: overview, organisation, risk management, and individual lending categories. The overview section could set the broad outline of the society's lending strategy, the degree of risk considered acceptable and the arrangements for its regular review. The organisation section could cover how lending is to be managed within the society, setting out which individuals or departments are responsible for which areas of lending or arrears management. The risk management section could describe how lending risk is controlled and monitored (including the use of exposure limits), how experience is to be fed back into policy and emphasise the importance of the borrower's covenant as the primary source of repayment (rather than the value of the security).

6.4.5 G The individual lending categories section could distinguish owner occupied residential lending, other lending secured on property and unsecured lending to individuals, each of which requires a different approach to product design and underwriting (see following table).

6.4.6 G Policies developed at the centre should be implemented properly and consistently across the organisation. The lending policy should be clearly explained to branch staff, including the society's attitude to risk. Ongoing adherence to the policy should be controlled by the lending function and reviewed by internal audit.



<b>OWNER OCCUPIED RESIDENTIAL LENDING</b>	<b>OTHER LENDING SECURED ON PROPERTY</b>	<b>UNSECURED LENDING TO INDIVIDUALS</b>
<b>Property Types and Location</b>	<b>Property types and location</b>	
<b>Loan types and features</b>	<b>Loan types</b>	<b>Loan types</b>
<b>Underwriting procedures</b>	<b>Underwriting procedures</b>	<b>Underwriting procedures</b>
<b>Repayment Sources and methods</b>	<b>Repayment and monitoring</b>	<b>Repayment methods</b>
<b>Pricing Policy</b>	<b>Pricing policy</b>	<b>Pricing policy</b>
<b>Mortgage Indemnity Insurance</b>	<b>Mortgage Indemnity Insurance (if applicable)</b>	
<b>Other Insurance</b>	<b>Other insurance</b>	
<b>Intermediary Introducers</b>	<b>Intermediary introducers</b>	<b>Credit brokers</b>
<b>Valuations</b>	<b>Valuations</b>	

OWNER OCCUPIED RESIDENTIAL LENDING	OTHER LENDING SECURED ON PROPERTY	UNSECURED LENDING TO INDIVIDUALS
Security	Security	
Management Information	Management Information	Management information

## **6.5 Risk Features of Mortgage Lending**

6.5.1 G The Commission's prudential guidance drew attention to the intrinsic "double security" in normal mortgage lending, i.e. the mortgage on a property, which has been professionally valued and the personal covenant of a borrower, whose ability to repay has been assessed carefully. Both elements should be given appropriate weight. This basic principle of mortgage lending is explicitly incorporated into the rule in paragraph 6.2.1. This neither stipulates how the valuation or assessment should be carried out, nor that they should be done in all cases, but the society's policy and procedures should be clearly documented. The extent to which such valuations and assessments for lending are not carried out will be a factor considered by the FSA when assessing a society's threshold solvency ratio.

### **Covenant of Borrower**

6.5.2 G Reliance on gross income multiples alone to measure a personal borrower's ability to repay provides only a limited indication of affordability and therefore of the strength of the borrower's covenant. Extending the assessment to a borrower's net income after fixed commitments will give a more reliable guide to the size of mortgage he or she can realistically service. When assessing affordability, the borrower's vulnerability to an increase in interest rates should also be taken into account.

6.5.3 G Assessing ability to repay is more difficult for personal borrowers who are self-employed, and more complex for commercial borrowers, both of which require skills in analysing financial accounts.

### **Valuation of Security**

6.5.4 G Valuers should have sufficient experience and expertise and should be free from conflicts of interest.

## **Managing Aggregate Lending Risk**

6.5.5 G Societies should be aware of the risk profile of their overall mortgage stock and of their new lending and should consider lessons arising from experience with their non-performing loans and adjust lending policy accordingly. These lessons should also inform general or collective provisioning policies.

6.5.6 G Societies adopting a strategy for growth should have rigorous controls on quality of lending and should take care not to set up unbalanced incentive structures for staff which reward new business volumes without also recognising responsibility for maintaining quality standards. Societies should maintain strict and documented controls over discretionary overrides to lending criteria and scorecard decisions and should monitor the extent to which overrides occur in practice.

6.5.7 G Each society should determine how it controls lending risks and document this clearly in its lending policy statement. The FSA strongly recommends quantitative exposure limits as a way of achieving this. Outlined below are types of lending and aspects of lending risk where exposure limits can be set:

- (1) Non-traditional lending: for example, secured lending to housing associations, lending on private rented properties or personal unsecured lending;
- (2) Lending at higher LTV ratios or higher income multiples (i.e. lower affordability): societies should set an exposure limit for residential mortgage lending at 90%+ LTV;
- (3) New or innovative products and incentivised loans;
- (4) Fixed rate and other non-administered rate products including foreign currency mortgages;
- (5) Large exposures: (see also Chapter 7 on Large Exposures);
- (6) Remortgage business;

- (7) Origination source;
- (8) Geographical spread (larger societies) and out of area lending (regional and local societies);
- (9) Business sector for commercial lending.

6.5.8 G If societies do not use exposure limits for controlling their mix of lending, they should have an alternative method, as effective as exposure limits, for controlling the risks in their lending books. Exposure limits should act as early triggers and should be set for lending periods (e.g. an annual limit) as well as for the lending book as a whole.

### **Management information**

6.5.9 G Societies should produce adequate and focused management information to monitor the performance of new lending and of the whole lending book against the risk parameters set down in the society's lending policy.

### **Lending to staff or directors**

6.5.10 G Societies should have a board-approved policy on staff lending, setting out whether or not the same criteria (e.g. on income or LTV), are used for staff as for other customers, how ability to repay is assessed, what concessionary terms are available and how staff in arrears will be treated. Staff lending on concessionary terms not available to ordinary borrowers should also be the subject of a separate periodic report to the board. Societies must meet the requirements of sections 65 and 68 of the 1986 Act regarding loans to directors and persons connected with directors.

## **6.6 Lending Nature Limit**

6.6.1 G Societies remain subject to the lending nature limit i.e. at least 75% of business assets must be in the form of loans fully secured on residential property. "Business assets" is a convenient, but non-statutory, collective term for a society's total assets (or total group

assets, where appropriate) plus any provision for bad or doubtful debts, less liquid assets, fixed assets, and any long-term insurance funds (see section 6 of the 1986 Act). “Residential property” is defined in section 5(10) of the 1986 Act as “land at least 40 per cent of which is normally used as, or in connection with, one or more dwellings, or has been, is being, or is to be developed or adapted for such use”.

6.6.2 G The Building Societies (Prescribed Equitable Interests) Order 1997 (SI 1997/2693) enables loans secured by any of three kinds of equitable security interests in property to qualify as fully secured on residential property if eligible in all other respects, and therefore count towards the lending nature limit. Loans fully secured on residential property in the European Economic Area (including here, the Channel Islands, the Isle of Man and Gibraltar) qualify for inclusion in the lending nature limit (section 6A(1)(c) of the 1986 Act).

## **6.7 Non-traditional Lending**

6.7.1 G Societies entering into new areas of lending, including lending to business (whether secured on residential property or not) and unsecured personal lending, should:

- (1) enter the new area in a carefully controlled way so that experience can be gained without incurring an unacceptable level of risk during the learning period;
- (2) have the necessary range of skills at management and board levels adequately to assess, manage and monitor the risks that arise;
- (3) have clearly defined and documented systems of control established before entering the new area, including the establishment of new organisational structures, such as a credit committee, where appropriate;
- (4) ensure that they obtain an adequate return on the new business, taking account of the risks;

- (5) employ appropriate professional advisers in the development of the activity, including legal advice on any new loan structures, documentation or security types, and specialist valuers.

### **Syndicated Lending**

6.7.2 G Societies may undertake syndicated lending, secured or unsecured, with one or more other co-participant(s) and whether, if the lending is secured, the security is held jointly or through a trustee. Syndicated loan assets can count towards the lending nature limit as provided in section 6(13) of the 1986 Act.

6.7.3 G Lending policy statements should address the additional risk aspects of syndication, including:

- (1) Limits: societies should set transactional limits for syndicated loans (e.g., size of participation and underwriting commitment) and an overall limit on the total of syndicated loan assets;
- (2) Loan and borrower types;
- (3) Systems and procedures: including experienced staff and access to appropriate professional advice;
- (4) Specialist Documentation;
- (5) Pricing;
- (6) Other parties: societies should consider which other institutions (or category of institutions) are considered as arranger/agent/trustee in a syndicated loan.

6.7.4 G Syndicated lending for market/consortium type credits is a complex activity, requiring special expertise on the part of the lender. The amounts involved may be large compared to normal lending, and the margins can be small for prime borrowers or where there is competition between lenders to acquire the business. There can be significant benefits for

lenders, but the associated risks also need to be considered. Societies should weigh these risks and rewards before deciding whether to put in place the personnel and systems to enable them to participate in the market.

## **6.8 Arrears Management**

6.8.1 G Rule 6.2.2 requires that each society include an arrears management plan within its lending policy statement. Success in managing arrears is based on early contact with borrowers in difficulty and good management information.

6.8.2 G Management information for reporting arrears should be comprehensive so that senior management and the board can monitor trends in arrears cases as they flow through the various bands of severity. A society's arrears position should be reviewed at senior level not less than monthly. The analysis of arrears for traditional mortgage lending should also track the performance of groups of loans which have characteristics in common, such as analysis by product, by cohort of lending, by geographical region, by LTV band, by size of loan, by income criteria, and by source (introducer, branch, mandate holder). Societies with significant exposures to commercial lending should produce a similar analysis by features such as business sector.

6.8.3 G Regular arrears analysis allows societies to identify the characteristics of lending most likely to lead to arrears and societies should regularly review their lending policy statements (and, if applicable, credit scoring systems) to ensure that exposure to those types of loan identified by the arrears analysis as "riskier" is adequately controlled. If the analysis reveals that, for example, loans in the 95%+ LTV band consistently generate arrears significantly worse than average, steps should be taken to minimise the risks from those loans, including the possibility, if arrears are extreme, of ceasing to undertake such business completely.



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## **7 LARGE EXPOSURES**

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## **Interim Prudential Sourcebook for Building Societies**

### **7 Large Exposures**

#### **7.1 Introduction**

7.1.1 G This chapter replaces PN 1998/7 issued by the Commission. It implements the large exposures provisions of the BCD for building societies. It also sets out rules and guidance on monitoring, controlling and reporting of large exposures by societies to the FSA.

#### **7.2 Scope of this Chapter**

7.2.1 G The purpose of the large exposures provisions of the BCD is to limit and control the extent to which credit institutions may commit themselves to large exposures to counterparties individually and in aggregate. Large exposures to a single counterparty and to a limited number of counterparties can create concentrations of risk in the balance sheet of a credit institution. It is the responsibility of each society's board to set its own limits for large exposures, within the general framework set by the BCD and the rules and guidance specific to societies contained in this chapter. The limits set out in this chapter are maxima. Each society should set its own prudential limits in order both to avoid the over-concentration of risk referred to above and to allow a margin for manoeuvre so as to ensure that the limits set out in this chapter can never be exceeded. Each society should set its own internal limits at a lower level than the maxima set out in this chapter.

7.2.2 G The large exposures provisions of the BCD cover all commercial asset exposures, liquid asset exposures, off balance sheet items and exposures to connected undertakings. The limits set out in this chapter therefore apply to all these areas. It should be noted that asset exposures where no counterparty is involved are not covered by the BCD (for example, fixed assets).

7.2.3 G Where societies are protecting large exposures by the use of credit derivatives, they should have regard to section 10 of chapter CD of IPRU(BANK) (see Annex 4B).

### 7.3 Definitions

7.3.1 G Under the terms of the BCD an exposure means any of the assets or off balance sheet items referred to in Article 43 or Annexes II and IV of the BCD respectively, before the application of risk weightings and credit conversion factors. Those items that are relevant to building societies are identified in Annexes 1B and 1C of chapter 1. In the BCD, an exposure to a counterparty or group of connected counterparties is defined as a large exposure where its value is equal to or exceeds 10% of own funds. The calculation of own funds for building societies is explained in chapter 1, particularly in Annex 1A.

7.3.2 G The BCD excludes from the definition of "exposure" the following:

- (1) all elements entirely covered by own funds provided that such own funds are not included in the calculation of the solvency ratio or of other monitoring ratios provided for in Community acts;
- (2) in the case of foreign exchange transactions, exposures incurred in the ordinary course of settlement during the 48 hours following payment;
- (3) in the case of transactions for the purchase or sale of securities, exposures incurred in the ordinary course of settlement during the five working days following payment or delivery of the securities, whichever is the earlier.

7.3.3 G A society considering the use of the option in paragraph 7.3.2(1) should consult the FSA well before it commits itself to a large exposure. The FSA will consider requests from societies wishing to exercise the option on a case by case basis.

7.3.4 G The calculation of the amount attributable to an off-balance sheet exposure follows the methodology established in the BCD and explained in Annex 1C. Full risk items are counted at full nominal value. For interest rate and foreign exchange contracts, the method set out in Annex 1C is to be used, but without any risk weighting by counterparty.

7.3.5 G Exposures are connected where a group of counterparties are connected: a group of connected counterparties is defined in the BCD as:

- (1) "two or more natural or legal persons who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly, has control over the other or others; or
- (2) two or more natural or legal persons between whom there is no relationship of control but who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, the other or all of the others would be likely to encounter repayment difficulties".

7.3.6 G Control in this context means the relationship between a parent undertaking and a subsidiary undertaking, as defined in Part VII of the Companies Act 1985 or Part VIII of the Companies (Northern Ireland) Order 1986 (which implemented Article 1 of Directive 83/349/EEC), or a similar relationship between any natural or legal person and an undertaking. All individual exposures to the same counterparty or to a group of connected counterparties should be aggregated for the purpose of calculating a large exposure.

## **7.4 Controls on Large Exposures**

7.4.1 G In accordance with the BCD, large exposures of societies which do not have any subsidiary undertakings should be monitored on an unconsolidated basis. Large exposures of societies with subsidiaries should, in general, be monitored on a fully consolidated basis. The basis of consolidation should be that set out in chapter 1. For convenience, the term "supervised group" is used in the following paragraphs to refer to a society and those subsidiaries subject to consolidated supervision, taken together, and in relation to a

supervised group "own funds" means the consolidated own funds of the group. Intra-group exposures (i.e. exposures to connected undertakings) are covered separately in paragraphs 7.5.1 to 7.5.3.

7.4.2 G In accordance with the BCD the following limits will apply:

- (1) A society or supervised group should not incur exposure to an individual counterparty or group of connected counterparties in excess of 25% of own funds;
- (2) the aggregate of all large exposures of a society or supervised group should not exceed 800% of own funds; the aggregate of these exposures should not exceed 300% without the FSA's written approval.

7.4.3 G The BCD allows certain exemptions from the limits on large exposures, giving the competent authorities in each Member State the discretion to use these as appropriate. It also allows for certain exposures to be reduced by the application of weighting factors (in effect, partially exempting those exposures). The exemptions which the FSA allows societies are set out in section 7.8.

## **7.5 Exposures to Connected Undertakings**

7.5.1 G The BCD takes a different approach to the control of exposures by a credit institution to counterparties with which it is connected (i.e. typically to other companies in the same group). Under Article 49.2, subject to applicable exemptions, all such exposures, collectively, are subject to a single aggregate limit of 20% of own funds. Building societies, however, have two particular features which are not shared by the generality of credit institutions. First, a building society will always be the parent entity in a group; it cannot be a subsidiary nor form a minor part of a diversified non-financial conglomerate. Second, under the 1986 Act, as originally enacted, building societies were able to carry out certain activities only through subsidiary companies or other associated undertakings. Although subsequent legislation allows activities to be carried out by the parent society which previously had to be carried out by subsidiaries, the FSA anticipates that societies may still wish to carry on certain activities in dedicated subsidiaries. Given this, the FSA applies, in relation to the single

aggregate limit of 20% of own funds, an exemption for all exposures to a society's own subsidiaries that are subject to consolidated supervision. At the same time, the FSA limits exposures to individual subsidiaries to 20% of own funds.

7.5.2 G The FSA's approach to consolidated supervision in relation to capital adequacy is set out in chapter 1, including the criteria for excluding a subsidiary undertaking from the calculation of the consolidated solvency ratio. The same approach will apply to the control of large exposures. The limits on a society's exposures to counterparties connected with it are therefore as follows:

- (1) in relation to any single subsidiary undertaking or sub-group of subsidiary undertakings within the supervised group, the society may not incur an exposure in excess of 20% of own funds;
- (2) the aggregate of all exposures of the supervised group to counterparties connected with the society but outside the supervised group may not exceed 20% of own funds;
- (3) large exposures to counterparties connected with the society still count towards the overall limit of 300% of own funds (or 800%, if the FSA agrees as set out in paragraph 7.4.2(2)) unless otherwise exempted.

7.5.3 G The FSA will also allow further partial exemption to societies in respect of exposures of the kind referred to in paragraph 7.5.2(1). This exemption will draw upon the principle of solo consolidation described in section 1.11. An exposure of the kind referred to in paragraph 7.5.2(1) will be exempt from the limits on large exposures in paragraphs 7.5.2(1) to 7.5.2(3) where it is agreed by the FSA that the subsidiary undertaking concerned may be solo consolidated. Subsidiary undertakings which fall into this category will probably be those undertaking core business but where the society has decided for structural reasons to undertake the business through a subsidiary. Sections 1.11 and 1.12 set out the criteria under which the FSA considers applications for solo consolidation. Societies will need to explain on what basis they consider it appropriate or necessary for solo consolidation to be granted. In all cases, the society should specify the maximum exposure that it is planning to incur.

## **7.6 Reporting and Notification of Large Exposures**

7.6.1 G The FSA may require large exposures to be reported quarterly and has included reporting of large exposures on a consolidated basis in Table L of the quarterly return QFS1 for building societies. Table L of QFS1 also collects additional information on off balance sheet exposures.

**7.6.2 R A society contemplating a new exposure which will exceed 20% of own funds (or when aggregated with an existing exposure to the same counterparty or group of connected counterparties would exceed 20% of own funds) must give prior notification to the FSA of such exposure, before making any commitment, using the standard reporting form, LEPR1, contained in Annex 7A. Exposures falling within this category should also be reported quarterly by means of Table L of QFS1.**

**7.6.3 R Exposures of between 10% and 20% of own funds must be reported by each society to the FSA. This information should be reported quarterly by means of Table L of QFS1.**

7.6.4 G If a society exceeds the 300% aggregate limit (or the 800% limit, if the FSA so agrees), this should be reported immediately to the FSA in writing.

7.6.5 G Societies should also report to the FSA within two months of the end of their financial year:

- (1) confirming that the criteria under which solo consolidation was granted continue to apply. If any do not continue to apply, details of the changed circumstances should be provided;
- (2) confirming that the activities of the subsidiary undertaking(s) continue to be limited to those engaged in at the time that the FSA approved solo consolidation;

- (3) in respect of each case where solo consolidation has been granted, the amount of the current exposure.

## **7.7 Systems: Rules and Guidance**

### **7.7.1 R Each society must maintain adequate systems and controls which enable it to:**

- (1) **monitor and control its large exposures in accordance with its large exposures policy (referred to in Rule 7.7.3); and**
- (2) **make timely and accurate reports to the FSA on its large exposures.**

7.7.2 G Each society should ensure its internal audit programme covers the system for monitoring and control of large exposures.

### **7.7.3 R Each society must set out its policy on large exposures as part of its Financial Risk Management, Liquidity and Lending Policy Statements.**

7.7.4 G Paragraphs 4.2.5, 4.2.6, 5.2.7, 5.2.9, 6.2.2 and 6.2.3 contain rules about policy statements and rule 7.7.3 should be read in conjunction with those rules.

## **7.8 Exemptions**

7.8.1 G This section sets out the exemptions which the FSA allows to societies. In some cases, the FSA allows partial exemption by applying a weighting to the asset amount. The weighting of asset items means multiplying the asset value in the balance sheet by the percentage weight and including the weighted amount in any calculation of large exposures. This process is distinct from, though having some similarities to, the risk weighting of asset items for solvency ratio purposes and it is important that the two processes, and the respective weightings, are not confused.

7.8.2 G Assets constituting claims on the central government or central banks of Zone A countries are fully exempt. Annex 1G defines Zone A and contains a full list of current Zone



A countries. Although the Channel Islands, Gibraltar, Bermuda and the Isle of Man may be regarded as OECD members for the purpose of calculating a society's solvency ratio they may not be so regarded for large exposure purposes.

7.8.3 G Assets constituting claims carrying the explicit guarantee of the central governments or central banks of the countries set out in paragraph 7.8.2 are fully exempt.

7.8.4 G Other exposures attributable to, or guaranteed by, the central governments or central banks of the countries set out in paragraph 7.8.2 are fully exempt.

7.8.5 G Asset items and other exposures effectively and legally secured by cash deposits with the society or with any subsidiary undertaking of the society which is also a credit institution (defined in the BCD as an undertaking with both a deposit taking and a lending business) are fully exempt. Societies should note that this definition excludes most existing subsidiaries.

7.8.6 G Claims on and exposures to other credit institutions (including to other building societies) are subject to weightings, for the purpose of calculating exposures, as follows:

- (1) Maturity of one year or less: 0% (i.e. fully exempt);
- (2) Subject to prior written agreement from the FSA, societies' derivative exposures to banks, other building societies and investment firms subject to the Capital Adequacy Directive (CAD) (or subject to a regime that the FSA deems to be equivalent to CAD) with a maturity of over one year but under three years: 20% (i.e. partially exempt)

except where the exposure represents the own funds (as defined in the BCD) of the other institution (e.g. subordinated debt), in which case the exemption does not apply.

7.8.7 G Societies should note that the exemptions in paragraph 7.8.6 do not apply to their own subsidiaries, which also happen to be credit institutions or investment firms subject to CAD.

SENSITIVE: COMMERCIAL

Building Society: Pre-Reporting Statement of Large Exposures Form  
LEPRI

Reporting Date: ...../...../20....

Name of Society:

[Empty box for Name of Society]

Statement completed by:

Name: [BLOCK CAPITALS]  
[Empty box]

Address:

[Multiple empty lines for Address]

Position Held:

[Empty box]

Signature:

[Empty box]

Telephone:

[Empty box]

Post Code:

Details of Large Exposure (£000)

The society wishes to take on the following exposure that represents more than 20% of its capital.

Lender Name	Name of counterparty or connected group	Actual Exposure	TOTAL Exposure	Security Value
.....	.....	.....	.....	.....

Please provide a brief description of the main elements of the proposed exposure

[Large empty box for description of exposure]

Own funds at latest financial quarter end:

Amount (£000)  
[Empty box]

SUBMISSION: This notification should be sent to the society's usual supervisory contact at the FSA.

Latest quarter end: ...../...../20....  
[Empty box]

# **Interim Prudential Sourcebook for Building Societies**

## **8 MORTGAGE INDEMNITY INSURANCE**

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# Interim Prudential Sourcebook for Building Societies

## 8 Mortgage Indemnity Insurance

### 8.1 Introduction

8.1.1 G This chapter replaces PN 1998/8 issued by the Commission and contains rules and guidance for societies on mortgage indemnity insurance. The acronym MIG (Mortgage Indemnity Guarantee) is used throughout, as it is widely understood as shorthand for mortgage indemnity insurance.

8.1.2 G The chapter outlines the types of cover available to societies to protect themselves against the risks of high loan to value (“LTV”) lending. These include the use of a captive insurance company, excess of loss and self-insurance as well as MIG provided by an external insurer, which may be the preferred option for most societies. The chapter sets out factors the FSA will take into account in assessing the adequacy of a society’s policy for protecting itself against high LTV risk and comments briefly on capital adequacy and systems.

### 8.2 Rules

**8.2.1 R A society undertaking any new lending at a high LTV ratio must have an adequate policy in place to provide protection against the greater risks involved with such lending. In this rule, “high LTV” means lending with an LTV ratio in excess of 80%.**

8.2.2 G The extent of the protection in place will be a factor in determining the society's threshold solvency ratio. Factors that the FSA will consider in assessing the adequacy of the policy required in 8.2.1 are set out in the guidance in the rest of this chapter.

### **8.3 Factors the FSA will consider in assessing compliance with rule 8.2.1**

8.3.1 G In deciding how to manage risk from high LTV lending, societies should assess the monetary value to them of the types of cover available and consider the risks and benefits associated with each type of cover, including the losses they could bear. They should assess the systems and accounting implications of changes to the type and level of cover provided.

8.3.2 G Societies have a number of options for managing risk from high LTV lending. They may dispense with MIG altogether, in conjunction with a change to lending policy to "re-balance" the risk profile of the society's loan portfolio. They may continue MIG cover on the best terms available or approach alternative MIG insurers, to establish whether cover on better terms than the standard MIG contract is available. They can consider other forms of insurance, such as excess of loss, self-insurance, and use of a captive insurance company. Credit derivatives may, appropriately used, provide an acceptable alternative to mortgage indemnity insurance (societies should refer to the guidance on credit derivatives set out at Annex 4B, which incorporates chapter CD from IPRU(BANK)).

8.3.3 G Whilst societies should regard the covenant of the borrower as their principal source of repayment, a comfortable margin in the value of the security is of vital importance. Past experience suggests that it would be imprudent to continue with high LTV lending without obtaining some form of additional protection against the risks involved.

8.3.4 G Therefore, societies undertaking high LTV lending that end their MIG cover and put nothing else in its place, should reduce substantially the proportion of new high LTV lending they undertake. If societies in this position decide not to reduce the level of high LTV lending, the FSA will take into account the society's increased risk profile in setting its threshold solvency ratio.

8.3.5 G The remainder of this chapter focuses on the types of protection against high LTV risk which are available.

## **8.4 Captive Mortgage Indemnity Insurance Companies (MIG Captives)**

8.4.1 G The use of a MIG captive can be a sensible way to manage risk from high LTV lending. This section sets out the factors the FSA will take into account when assessing whether the use of a captive by a society meets the requirement in rule 8.2.1.

8.4.2 G A captive is a means of retaining and managing risk, wholly or partially, within the group. A society should first consider whether, and to what extent, it wishes to retain risk before deciding on any particular mechanism for risk retention. It should consider what its objectives are for high LTV risk and then assess how various forms of cover, including a MIG captive, could meet the objectives. Under the standard MIG contract, the lender retains a significant portion of risk and a captive may be a suitable means for managing that risk.

8.4.3 G A captive could take on all or part of the society's mortgage indemnity business. A wholly-owned captive should not provide unlimited MIG cover to its parent society: cover should be capped in some way, perhaps with a limit on claims arising from any one year's lending. The terms of cover provided by the captive to the parent, and the premiums charged, should be reviewed at least annually. Very generous cover may mean that the captive cannot fully meet the claims on it, and if a captive is unable to meet those claims the loss will revert to the society.

8.4.4 G For smaller societies an "association captive", owned by a group of societies, can be suitable for handling their mortgage indemnity risks. There may be practical difficulties involved, for example, the need for each society to be comfortable with the lending policy of its fellow-owners and the need to pool information. Proper oversight is likely to be more difficult when a captive is multi-owned.

8.4.5 G Society MIG captives should normally be wholly-owned by one or more building societies and provide MIG cover only to the owner society/societies (or to respective subsidiaries). Any scheme which envisages wider ownership, writing MIG business for other lenders or other lines of insurance business should address the different risks involved. Such a company would, of course, not be a pure MIG captive and the FSA's capital requirements are likely to reflect this.

8.4.6 G Societies should consider how the captive will set its premiums. A sensible starting point might be the amount paid for the equivalent external MIG cover and information about the society's lending book, and its claims propensity, should be collected to enable the business to be rated accurately in future. Initial assumptions about the size and frequency of claims should be tested against actual experience. If the captive underprices the cover it may be difficult for the society, because of borrower resistance or competitive pressures, if the captive were to increase premiums later.

8.4.7 G Societies should consider over what period income can prudently be recognised by the captive, having regard to industry good practice for this kind of business and the likely timescale for emergence of claims. Regular reviews should compare the profit earning period chosen with actual claims experience. Societies should undertake detailed financial modelling to show what premium the captive can be expected to receive and what claims will arise for each annual tranche of lending over, say, a 10 year period. This will involve a full analysis of the performance of the society's mortgage book and societies should take the appropriate professional, including actuarial, advice.

8.4.8 G A captive is an appropriate vehicle for carrying normal MIG losses but is unsuitable for bearing exceptional losses over and above the normal level. Societies with or intending to establish MIG captives should obtain reinsurance to cover the risk of exceptional losses. Societies should consider what price the captive can pay for reinsurance and still remain commercially viable. Societies should also assess the terms on which reinsurance cover is offered, especially any restrictions on lending criteria, the financial standing of the reinsurer and its commitment to the MIG market.

8.4.9 G A captive may be exposed to greater risk in its early years of operation and societies should consider additional protection during this period. A captive may, for example, take out financial reinsurance or finite risk insurance to smooth cashflow.

8.4.10 G A captive needs capital to ensure that it can meet claims in all circumstances. In setting capital for a captive, societies should consider whether the captive is robust enough to weather exceptional losses arising from a "severe adverse case". Such a case might include high interest rates, a high level of borrower default and falls in both house prices and turnover

- comparable to the worst experience during the period 1989-1992. It would be reasonable to assume that the "severe adverse case" would affect three consecutive years' lending.

8.4.11 G The captive should assess its probable maximum liability to claims at any one time, on each year of lending, based on a "severe adverse case". The residual risk to the captive from each year of lending can be calculated taking into account this probable maximum liability, capped by reinsurance if used, and offset by the amount built up from net premiums and investment income. This is the "risk gap" for that year of lending. The relevant local insurance supervisors (most captives are located offshore) will impose their own capital requirements, and the FSA expects societies to comply with these. However, societies and their advisers should develop their own methodologies for assessing the prudent level of capital for the captive over and above the regulatory minimum. The FSA will take into account the society's methodology for setting capital (including the concepts set out above) in assessing the adequacy of a society's policy for managing high LTV risk.

8.4.12 G A society may either make the full amount of its capital commitment available immediately to the captive as fully paid share capital or keep part of its commitment in reserve. At least the capital requirements of the local insurance supervisor should be met through fully paid share capital. Societies can provide part of the overall capital commitment in the form of issued but uncalled, or partly paid share capital - where the captive is entitled to call for payment at any time and at its sole discretion.

8.4.13 G For solvency ratio purposes, a subsidiary MIG captive should be included in the consolidated calculation in accordance with Chapter 1 (Solvency). In calculating the society only solvency ratio, the FSA has adopted a composite treatment for building societies which recognises both that the capital invested in the captive bears a heavier risk of loss than the generality of investments in subsidiaries, and that the captive bears only the society's own lending risk and is not using its capital to "gear up" and assume new external liabilities. Of the total capital committed to the captive, whether fully paid or not, 25% (or, if greater, the capital requirement of the local insurance supervisor) should be deducted from the society's own funds, in the society-only calculation. The remainder should be risk-weighted at 100% as an investment in a subsidiary.



8.4.14 G Societies should consider where any captive should be domiciled and the choice of location should be made according to clear criteria (including convenience to facilitate effective oversight). Whichever location is chosen, the captive will need to obtain authorisation from the local supervisory authority and the FSA will communicate with that body about any application for authorisation.

8.4.15 G The society should put in place controls to oversee the operation of its captive. The captive should be overseen at a high level within the society and within a department (e.g. finance) independent of the lending/marketing function. The society should consider what regular information the captive should provide to the parent to enable proper oversight.

8.4.16 G The captive managers should meet regularly with the captive's board to discuss issues such as the adequacy of reserves and premium rates. The FSA also expects societies to commission an external review of the performance of the captive including actuarial advice on the same issues, say every two years, with a minimum of every three years.

8.4.17 G Local insurance supervisors have detailed rules about the type of asset which count towards the captive's solvency margin. The captive's investment policy should be clearly documented, specifying acceptable types of instrument and counterparties. The captive's directors should set investment policy rather than the captive managers or fund managers. In the early years of the captive's life, the funds should be invested in a prudent combination of bank/building society deposits, government securities and other high quality securities. The captive may deposit funds with the parent society provided the society meets the criteria specified in the captive's investment policy (although local insurance supervisors are unlikely to permit the captive to deposit 100% of its funds back with the parent).

8.4.18 G Societies may consider arrangements whereby a third party, such as a UK composite insurer, owns a captive insurance company which "rents" underwriting capacity to a society for its own MIG business (known in the market as a "rent-a-captive"). Any society intending to follow this route should consider the basis of the cover and the availability of reinsurance cover and, as a result of these factors, how much risk it retains.

8.4.19 G The activities of society-owned MIG captives may be expanded to enable them to write other business including insurance of other risks incurred by the parent society or

another part of the society group and reinsurance of other lines of business originated by the parent society group.

8.4.20 G Where such business is written by society-owned MIG captives, sufficient capital and reserves should be maintained to enable the risk gap for MIG business to be met in full. For these new lines of business, at least the capital requirements of the local insurance supervisor should be met through fully paid share capital.

8.4.21 G To avoid "double gearing", a society's investment in these new lines of business, and loans of a capital nature to finance such business, should be excluded, in full, when calculating its solvency ratio as set out in Chapter 1 (Solvency).

8.4.22 G Capital and reserves maintained for MIG business should be legally "ring-fenced" from the capital and reserves held to meet new lines of business. Captives should therefore adopt an appropriate and effective legal structure.

## **8.5 Self-Insurance and Non-Insurance**

8.5.1 G Self-insurance is another way of containing high LTV risk. This section sets out the factors that the FSA will have regard to when assessing the adequacy of any policy for managing high LTV risk which uses this approach.

8.5.2 G With self-insurance some or all of the risk is retained by the society and either borrowers are charged a "premium" (e.g. a fee or additional interest) or the society absorbs the cost through self-charging. The FSA will consider either to be a prudent approach, provided charges to borrowers or the level of self-charging is adequate.

8.5.3 G With non-insurance some or all of the risk is retained by the society, but no charge or self-charge is made. In such cases, the society will be deemed to have no protection against the risk associated with high LTV lending and should follow the guidance in paragraph 8.3.4.

8.5.4 G Societies may combine an external MIG policy with self-insurance or non-insurance. This will arise, for example, under the co-insurance arrangements applied by many insurers, where the external MIG covers 80% of the risk but the society retains the remaining 20%. Where a society has a co-insurance arrangement or a cap on claims with their MIG insurers, it should consider what action should be taken in respect of that proportion of the risk it retains.

## **8.6 Charging for Self-Insurance**

8.6.1 G Societies which retain some or all of their MIG risk without using a captive will need a methodology for determining the amount of risk being accepted and the level of charge to borrowers (or self-charging) for carrying that additional risk.

8.6.2 G To assess the level of charge or self-charging required, societies should devise a methodology to assess the relative risk from differing loan products, borrower types and types and location of property. Such a methodology should use historical statistical information evaluated using a range of assumptions (future interest rates, property prices etc). Independent specialist advice (e.g. from a firm of actuaries) is highly desirable.

## **8.7 Excess of Loss Insurance**

8.7.1 G Excess of loss or stop loss insurance is another way of protecting against risks arising from high LTV lending. Such policies meet claims once a certain threshold loss to the society (the excess or deductible) has been reached. They usually have a defined upper limit, after which losses revert to the society, and they may involve an element of co-insurance.

## **8.8 Mortgage Book Acquisitions**

8.8.1 G Societies should also consider the risks arising from high LTV lending where they have acquired the loans through a mortgage book acquisition. Following completion of the transaction, the principles of this chapter should be applied to the portfolio of loans

acquired. Societies should also ensure that any captive acquired meets the rule and guidance in this chapter within a reasonable time of the acquisition.

## **8.9 Capital Adequacy**

8.9.1 G As set out in Chapter 1 (Solvency), the FSA will consider the lending policy and the MIG arrangements of each society when reviewing its threshold solvency ratio. The assessment will focus on the degree of risk accepted or retained by the society rather than the mechanism used to manage the risk.

8.9.2 G However, the FSA considers that the magnitude of risk retained by a society that either self-insures its entire MIG risk on-balance sheet, or places its entire MIG risk with a captive without reinsurance or takes no action to cover the uninsured portion of MIG risk under the standard external contract, is such that, other things being equal, the FSA is likely to raise that society's threshold ratio.

## **8.10 Systems**

8.10.1 G Societies should ensure that their systems are adequate to monitor and control the risks arising from high LTV lending. (Systems should, of course be adequate to monitor and control all lending, but this chapter focuses on high LTV lending). For example, where societies self-insure, they should operate adequate systems for collecting charges from borrowers (or self-charging) and should set up systems to collect data on the performance of the loan book to help them set appropriate charge levels and assess likely future losses. Where any kind of captive arrangement is used, a society's systems should collect data on the performance of the loan book to refine the underwriting, pricing and reserving/reinsurance policies of the captive.



# Interim Prudential Sourcebook for Building Societies

## 9 SYSTEMS

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# Interim Prudential Source Book for Building Societies

## 9 Systems

### 9.1 Introduction

9.1.1 G This chapter replaces PN 1996/4 issued by the Commission. It contains rules and guidance on societies' systems of business control and accounting records. It supplements, for building societies, Principle 3 and the rules and guidance on senior management arrangements and systems and controls in SYSC, in particular, rule SYSC3.1.1 ("a firm must take reasonable care to establish and maintain such systems and controls as are appropriate to its business").

### 9.2 Rules and Evidential Provisions

**9.2.1 R A society must have, and ensure that its subsidiary undertakings, if any, have, a fully-documented system of control.**

9.2.1(1) G The guidance in section 9.4 applies to the society and any subsidiary undertakings, unless the context clearly dictates otherwise. It is recognised that it may be more convenient for systems of control of the society and any subsidiary undertakings to be integrated, rather than maintained separately.

9.2.2 G Guidance on the documentation of systems of control is given in section 9.5.

**9.2.3 E (1) A society should have an internal audit function (this may be either in house or outsourced to a third party).**

**(2) Contravention of 9.2.3(1) may be relied upon as tending to establish contravention of SYSC3.1.1.**

9.2.4 G Guidance on internal audit is given in section 9.6 and in SYSC 3.2.16.

**9.2.5 E (1) A society should establish an audit committee consisting of at least three members who are also non-executive directors;**

- (2) Contravention of 9.2.5(1) may be relied on as tending to establish contravention of SYSC3.1.1.**

9.2.6 G Guidance on audit committees is given in section 9.7 and in SYSC3.2.15.

**9.2.7 R A society must maintain, and submit to the FSA, a board-approved corporate plan.**

**9.2.8 R A society making any significant change to its corporate plan must provide the FSA with a copy of the amended plan as soon as possible after it has been adopted.**

9.2.9 G Guidance on corporate planning systems is given in paragraphs 9.4.13 to 9.4.18.

### **9.3 Accounting Records and Systems**

9.3.1 G A society is required by SYSC3.2.20 to take reasonable care to make and retain adequate records (including accounting records) and should have appropriate systems and controls in place to fulfil its obligations with respect to adequacy, access, periods of retention and security of records.

9.3.2 G Every building society is also required, under section 71(1) and (2) of the 1986 Act, to keep accounting records which:-

- (1) explain the society's transactions;
- (2) disclose, with reasonable accuracy and promptness, the state of the business of the society at any time;
- (3) enable the directors properly to discharge the duties imposed on them by or under the 1986 Act (and where applicable Article 4 of EC Regulation No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards) and their functions of direction of the affairs of the society;
- (4) enable the society properly to discharge the duties imposed on it by or under the 1986 Act (and where applicable Article 4 of EC Regulation No 1606/2002



of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards).

9.3.3 G The records should contain (see section 71(3) of the 1986 Act) entries in respect of all payments and receipts together with descriptions thereof, entries of all transactions giving rise to, or likely to give rise to, assets or liabilities and a record of the assets and liabilities of the society, in particular of any class relevant to the “nature limits” in sections 6 and 7 of the 1986 Act.

9.3.4 G The main reasons why a building society should maintain adequate accounting and other records are:

- (1) to provide the directors and management of the society with adequate financial and other information to enable them to conduct its business in a prudent manner on a day-to-day basis;
- (2) to safeguard the assets of the society and the interests of investors;
- (3) to assist directors of the society to fulfil their statutory duties in relation to the preparation of annual accounts;
- (4) to provide the directors and management of the society with sufficient timely and accurate information to assist them to submit the information required or requested by the FSA.

9.3.5 G To achieve this, the society’s accounting systems should disclose, in an orderly and integrated way, with reasonable accuracy and promptness, the state of the business at any time. The records should be maintained to enable financial and business information to be extracted promptly, so that directors and management can monitor and control the performance of the business, the state of its affairs and the risks to which it is exposed. The nature of, and frequency with which, information is prepared, its level of detail, and the amount of narrative analysis and explanation, and who should receive it, is for directors and senior management to decide.

9.3.6 G More detailed guidance on accounting records and systems is set out at Annex 9A, which is derived from the FSA’s guidance in the Interim Prudential Sourcebook for

banks. References in Annex 9A to “banks”, and where appropriate “companies”, are taken to include building societies.

## **9.4 Systems of Business Control**

9.4.1 G A society should have systems to enable the directors to control the conduct of its business and to control the accounting and other records. To exercise proper control over the business, the directors should understand the underlying business activities, and how they are carried out. Directors should have procedures in place to identify and assess the risks which may arise through the conduct of that business. Control objectives should be set for each area of the business, controls established and maintained which address appropriately the identified risks to ensure the prudent conduct of the business in accordance with the society’s policies, and compliance with all relevant laws and regulations and the FSA’s rules.

9.4.2 G A society is required by SYSC3.1.1 to take reasonable care to establish and maintain such systems and controls as are appropriate to its business. In addition, SYSC3.2.6 requires a society to take reasonable care to establish and maintain effective systems and controls for compliance with regulatory requirements and standards. More detailed guidance on internal control systems is set out at Annex 9B, which is derived from the FSA’s guidance in the Interim Prudential Sourcebook for banks. References in Annex 9B to “banks” are taken to include building societies.

### **Organisational control systems**

9.4.3 G Societies are required by SYSC2.1.1 to take reasonable care to maintain a clear and appropriate apportionment of significant responsibilities among its directors and senior managers. In addition, SYSC2.1.3 requires the apportionment of the responsibilities and establishment and maintenance of systems and controls to be overseen by a senior individual. SYSC2.2.1 requires societies to keep an up-to-date record of such arrangements.

9.4.4 G Societies should have:

- (1) clearly defined organisational arrangements and a defined structure of authorities, mandates and responsibilities, including reporting lines, which distinguish between decisions to be reserved for the board and those to be delegated to board committees, or managers and employees; and
- (2) arrangements for reviewing the compliance with and effectiveness of organisational controls.

9.4.5 G The composition and operation of the board of a society, and the maintenance of a properly defined structure of board committees, are important elements of high level organisational controls (see chapter 3 Boards and Management).

9.4.6 G The directors of a society should ensure that:

- (1) the society's overall organisational arrangements are adequately defined and documented, usually through an organisation manual;
- (2) the society's decision-making processes, including authority limits and responsibilities, are properly defined and documented, usually through operating manuals; and
- (3) compliance with approved authority limits and stipulated segregation of duties is effectively monitored and controlled.

### **Management information systems**

9.4.7 G More detailed guidance on information for management is set out at paragraphs 6-8 in section 3.2.3 of Annex 9A.

9.4.8 G The board and management of a society should satisfy themselves that:

- (1) the information available is sufficient to enable the board to measure, manage and control risks identified in accordance with paragraph 9.4.1;
- (2) the information available is sufficient for a proper assessment of the potential risks for the society and the proper determination of its need for capital and liquidity;

- (3) the information available is sufficiently comprehensive to provide the board with a clear statement of the performance and financial position of the society;
- (4) management information reports are prepared for the board and management on a regular and timely basis, consistent with the dynamics of the business area reported on. Such reports should allow exposure to be monitored against limits and other parameters set by the board;
- (5) actual performance is compared with prior periods and with budgeted performance at least quarterly and that significant variations are highlighted and explained;
- (6) sufficient attention is focused on key factors affecting income and expenditure, including capital expenditure, and that appropriate performance indicators are employed;
- (7) management information is accurately prepared from the underlying accounting and other records and is presented in a clear, consistent and understandable way.

9.4.9 G The form and content of management information should be reviewed regularly. It should be appropriate and relevant to the current business of the society and to market conditions. Such information should include financial information and other matters such as current market conditions and trends, reporting on the control environment and the status of any current control issues, and the extent of achievement of quantitative and qualitative business targets. Information should clearly indicate the extent of future commitments, as well as the current position arising from treasury management operations.

9.4.10 G In forming a view on whether the management information system is sufficiently comprehensive, the board and management of a society should consider whether the information made available to them provides, for both the society and, where applicable, the group, a clear statement of:

- (1) the capital position;
- (2) the liquidity position;

- (3) the exposures arising from treasury management operations, including an analysis of off-balance sheet positions;
- (4) profits and losses, assets and liabilities, and funds flows;
- (5) the profitability of products, services and subsidiary undertakings;
- (6) the balance sheet ratios in relation to the lending and funding limits in sections 6 and 7 of the 1986 Act;
- (7) the society's actual exposure, in those areas where the board has set a limit, compared to that limit.

9.4.11 G The above matters should be compared against limits, ratios and other parameters set by the board and notified to the FSA or other regulatory authorities.

### **Information for the FSA**

9.4.12 G Information reported to the FSA should be accurate and timely. Societies must complete returns in accordance with the FSA's requirements, set out in chapter 16 of the Supervision Manual, and submit them within the specified timetable. Returns should be reviewed prior to their submission to the FSA at a sufficiently senior level. The procedures should check for consistency between different returns, between the various tables in the same return, and between the returns and information prepared for the board.

### **Planning systems**

9.4.13 G A satisfactory planning system should help a society to comply with its regulatory obligations. It is for each society to decide what is an appropriate planning horizon and to maintain and develop planning systems appropriate to its individual circumstances and the changing business environment.

9.4.14 G Rule 9.2.7 requires each society to maintain, and send to the FSA, a corporate plan. This should deal with longer-term strategic issues, should be reviewed and updated annually and should include:

- (1) views on the markets in which the society competes and the society's position in those markets;

- (2) identification of the society's strengths and weaknesses, market and other opportunities open to it, and threats to the society's business;
- (3) a clear enunciation of the society's strategic aims and action to achieve those aims;
- (4) the resource implications of the strategic aims (including information technology, senior management and staff, and financial resources);
- (5) financial projections, including sensitivity analyses.

9.4.15 G A corporate plan should not simply consist of a number of desirable aims, but should set out the process for achieving these and within what timescale. The board should ensure that there are appropriate policies and procedures in place to implement the strategic plan, as well as mechanisms to monitor achievement against the plan so that, if necessary, appropriate corrective action may be taken.

9.4.16 G The planning systems of a society should also set, review and revise short and medium-term financial and other objectives, consistent with the society's longer-term strategic aims.

9.4.17 G The planning, detailed budgeting and financial accounting systems and processes should be integrated to enable outcomes to be monitored against plan, and for the feedback of results into management decisions and into the planning process. Some of the key features of such processes are:

- (1) There should be clearly-defined short, medium and long-term planning systems, with an unambiguous allocation of responsibilities within the organisation for the development, review, approval and implementation of plans, and for subsequent monitoring of performance against them.
- (2) The elements of any plan should be supported by adequate data, obtained from internal and external sources, and by critical analysis.
- (3) A range of possible outcomes should be considered, relating to varying levels of risk and/or uncertainty, and their financial impact on profitability and capital strength assessed.

- (4) Key indicators should be identified against which actual performance will be tracked. Actual data should be prepared on a basis consistent with the plan, to enable proper comparison to be made.

9.4.18 G Comprehensive arrangements, documented in business recovery plans, should be in place to ensure continuity of business in the event of some unforeseen disaster such as a fire or bomb damage. Information technology (“IT”) is an extremely important element, and any business recovery plan should include the possibility of major hardware or software failure. Planning should cover all aspects of a society’s business that might be affected, including premises, personnel and external communications. These arrangements should be regularly reviewed and tested to ensure that they work in practice.

### **Information Technology**

9.4.19 G IT is a major feature of any society’s business. Mistakes in this area could be very costly to a society, in terms of money, staff resource and market share. The board of a society should be sufficiently knowledgeable and experienced to appreciate the issues involved and be in a position to exercise proper control over IT systems and developments.

9.4.20 G The board and management of a society should address a wide range of IT issues, some of which are set out below:

- (1) The society should have an IT strategy which is consistent with its longer-term strategic aims.
- (2) Procedures should be in place to ensure that a comprehensive evaluation is made of proposed major IT investment and that the technical and business cases for the investment are clearly demonstrated.
- (3) There should be an appropriate allocation of responsibility for IT issues and an organisation structure which is conducive to a strong IT control environment.
- (4) The security of data and systems is of paramount importance. Controls should be in place to minimise the risk of unauthorised physical and logical access, or the loss of data. Such controls should cover not only centralised mainframe processing but also remote terminals and stand-alone or linked PCs.

- (5) The board should exercise strong control over the development and implementation of new or significantly modified systems. Appropriate technical and project management skills are required and boards should consider seeking expert outside assistance.
- (6) Internal audit should have skills and experience to assess the effectiveness of IT controls. Internal audit should be involved in an advisory capacity during the development of significant new IT systems, to ensure that appropriate controls are in place.

## **9.5 Documentation of Systems**

9.5.1 G Rule 9.2.1 requires a society's system of control to be fully documented. Documents setting out the systems of control should be available to the board at all times. The documentation helps boards to assess if systems are maintained and controls are operating effectively. It also helps those reviewing the systems to ensure that the controls are those that have been authorised, that they are complete and adequate for their purpose. The use of policy statements documenting the society's policy in a particular area (e.g. lending) is an important element of high level controls.

### **Form of documentation**

9.5.2 G The board and management of a society should determine the form of documentation to be adopted. Considerations should including the following:

- (1) It should be comprehensive. It should cover all material aspects of the operations and business of the society.
- (2) It should be integrated. Separate elements of the system should be interrelated and cross-referred so that the system can be viewed as an integrated totality.
- (3) It should identify risks, and the controls and other arrangements established to manage those risks. The controls should be identified and their purpose defined so that their effectiveness can be evaluated and so that the relationship and interdependence with other controls can be established.



- (4) It should attribute responsibility for operating the controls. There should be named persons or posts for each control operation, alternatives in case of absence, and continuity of standards of control during absence.
- (5) It should state how operation of the control is to be evidenced. Evidence would normally require signatures or initials; records and registers; retention of control documents; staff attendance records.
- (6) It should establish a comprehensive and unambiguous control discipline. The instructions should be clear and precise, avoiding expressions in relation to control functions such as “normally” and “if possible”.
- (7) It should be suitable for practical, day to day use. The separate specifications of controls should have a practical role in the review and improvement of systems, for example, through the inspection function.
- (8) It should be up to date. There should be an accurate description of the system that has been established and is operating. When changes are made to the systems the appropriate systems of control need to be both established and documented by the time the changes become operative.
- (9) It should require confirmation of compliance. Managers in branches and other areas of a society’s business are key control points within the overall control system. They should periodically be required to confirm to the board, to the best of their knowledge and belief, compliance with the controls within the system which has been established.

9.5.3 G The content and level of detail required in documentation prepared for directors and senior management may be different from that required in documentation prepared for the use of more junior staff. In the latter case the main purpose of system documentation is typically to guide staff through the clerical and IT procedures. Such material may be detailed and contain only limited coverage of the control procedures applying to the work of that staff member. The board and senior management require a summarised version, with a wider scope and with a greater emphasis on controls. Whatever form of documentation is adopted it should facilitate an understanding of the society’s systems, procedures and controls, at the level appropriate to the user.

9.5.4 G Societies should make explicit the accounting and other controls which are applicable to their systems, in a separate section of a procedures manual or in a separate document devoted to controls.

9.5.5. G Documentation should not be restricted to “lower-level” clerical and authorisation controls applied in transaction processing, but should also cover “high level” supervisory controls and accordingly should deal with:

- (1) powers to be exercised only by the board, and powers delegated to others;
- (2) the purpose, composition and reporting lines of committees of directors and senior management to whom powers or responsibilities are delegated;
- (3) the specific roles, responsibilities and reporting lines of board members, including the Chairman, executive and non-executive directors;
- (4) the timing, form and purpose of meetings of the directors and the mechanism whereby agreed board strategies, policies and decisions are recorded and their implementation monitored.

## **IT controls**

9.5.6 G The documentation of IT controls should be integrated within the overall documentation of a society’s system of business control. Operating manuals provided by a IT supplier can form a useful part of a society’s procedures documentation but it is less likely that such manuals will be in a form which enables them to comprise part of the control documentation. The criteria set out in paragraph 9.5.2 apply equally to the controls surrounding IT systems.

9.5.7 G There will be a number of key controls performed within the IT and computer programs and a society should ensure that it documents all such controls if reliance is being placed on them.

## **9.6 Internal Audit**

### **Purpose of internal audit**

9.6.1 G The purpose of internal audit is to:

- (1) provide regular appraisal for management and the board as to the overall effectiveness of the control systems, including all proposed changes, and to recommend improvements where considered desirable or necessary;
- (2) determine whether the systems and controls established by management and the board have operated as laid down (in the society's control documentation) and comply with policies, procedures, laws, regulations and any other relevant requirements;
- (3) assess whether financial and operating information supplied to management and the board is accurate, pertinent, timely and complete.

9.6.2 G Societies should ensure that their internal audit function adequately covers, in addition to detailed operational activities, the following areas:

- (1) Controls to verify the accuracy and completeness of monitoring returns and other information provided to the FSA.
- (2) Controls to ensure compliance with all regulatory requirements.
- (3) Broader management controls, such as the controls over business planning, systems for monitoring and reporting on financial performance and other key business indicators.
- (4) Controls over new areas of business and other initiatives, whether carried out within the society or through subsidiaries or other associated undertakings.
- (5) "High level" controls, including those referred to in section 9.4.

9.6.3 G The board and management of a society should satisfy themselves that the following considerations have been satisfactorily addressed within the context of the scale, range, complexity and pace of development of the society's business and accounting systems:

- (1) To maintain its objectivity, the internal audit function should be independent of the functions it inspects.
- (2) The internal audit function should have sufficient manpower resources available to it so that it can achieve its agreed objectives.

- (3) Qualifications, experience and training of the individuals performing the internal audit function should be adequate in relation to the objectives.
- (4) The status and reporting relationship of the head of the internal audit function should be sufficient to maintain the independence and objectivity of the function. The head of internal audit should have the right of direct access at any time to the highest level of management and the board, including in particular the chairman of the audit committee and the chairman of the society.

9.6.4 G Audit committees have a key role to play in controlling the work of the internal audit function and receiving its reports.

### **Key elements of an internal audit function**

9.6.5 G The key elements of a system of internal audit include:

- (1) terms of reference: these should be specified with precision and should include, amongst other matters, scope and objectives of the internal audit function, and reporting requirements. They should be approved by management and the board. Internal auditors will require a wide-ranging access to records and documents, including material prepared for and by the board. They will also need to be empowered to obtain information and explanations from staff at all levels, including directors. The terms of reference should, accordingly, be framed so as to provide such access.
- (2) risk analysis: risks identified and the controls put in place by management to address those risks should be considered in each area of the society's business. In this context risk will be much wider than just the risk of pecuniary loss, or error or mis-statement in the accounting records. Reputational risk and wider operational and business risks should also be considered. The adequacy of the controls should be assessed. Weaknesses in control should be drawn to the attention of the audit committee or the board as specified in the terms of reference. Full consideration should be given to the high level controls in place within the society.

- (3) audit plan: an audit plan should be developed, covering all aspects of the society's business. The audit plan should identify the scope and frequency of work to be carried out in each area. Audit effort should be focused on those areas identified in the risk analysis as higher risk. However, over a set time-frame, all areas should be covered. The plan should be reviewed and approved by the audit committee before work commences.
- (4) detailed programmes: these should set out the specific tests to be performed in each area of the audit plan.
- (5) working papers: adequate working papers should be maintained to record the audit planning and execution, principal findings and follow-up action. They should evidence the individual who performed the programmed work, how it was controlled and supervised, and record the conclusions reached, with cross-referencing to the reports made and action taken.
- (6) system of reporting: the results of the work performed should be reported to the audit committee, or the board, in accordance with the terms of reference. Such reporting should be carried out on a regular, at least quarterly, and timely basis; obviously serious matters should be raised immediately. The reports should briefly describe the area(s) covered, significant matters arising, recommendations and overall conclusions. Procedures should be established to ensure that recommendations have been implemented or non-implemented validly justified.

9.6.6 G The key elements required for a system of inspection are not affected if internal audit services are outsourced, in whole or in part, to an auditing firm. For smaller societies, in particular, this can be a cost-effective way of obtaining the required level of resource, including appropriate technical skills. However, boards of societies which pursue this route should take into account the guidance in chapter 11 on Outsourcing and consider the following issues:

- (1) It is particularly important that clear and comprehensive terms of reference are laid down. These should specify the anticipated total resources to be provided by the audit firm, including total number of man-weeks and staff grades and/or specialisms. The terms of reference should also make clear how, and under

what circumstances, the audit firm would be involved in assignments which may not have been specifically contemplated when the annual internal audit plan was drawn up.

- (2) Boards should satisfy themselves that the timing and frequency of visits by the audit firm is appropriate for the level of assurance which the board requires, and will also enable the audit firm to be fully up to date regarding business, and control, developments.
- (3) Where there is outsourcing of only one particular element of internal audit – for example, computer audit, or audit of the treasury function - such assignments should be fully integrated into the overall internal audit plan.

### **Reporting and review**

9.6.7 G The board should satisfy itself that the internal audit function is being properly carried out. To enable it to review the overall effectiveness of the inspection function it should consider on an annual basis, or more regularly, the following aspects:

- (1) Adequacy of resources, including number, experience and skills of staff within the internal audit function. There may be circumstances, in situations where specific skills are believed to be deficient, when the board considers it appropriate to obtain these skills from an external source. Societies in these circumstances might consider looking to their external auditors. However there is clearly potential for a conflict of interest to arise, regardless of whether the work would be carried out by persons not directly involved in the audit. External auditors should not be involved in this way, except under exceptional circumstances. Societies should discuss such a proposal with the FSA.
- (2) Adequacy and scope of planning and work performed, including the allocation of audit effort to each area of the society's business.
- (3) Frequency, quality and timeliness of reporting on matters arising from the work of the internal audit function.
- (4) Resolution of points and recommendations raised, and reasons for any rejection of major points.

- (5) Review of overall effectiveness of the internal audit function.

## **9.7 Board Review and Oversight**

### **Audit committees**

9.7.1 G Ultimate responsibility for the effective operation of a society's systems of control rests with the society's board of directors. As with any board committee, the audit committee should have clear and full written terms of reference, that make clear its role, responsibilities and reporting lines.

9.7.2 G A society's board should establish an audit committee of non-executive directors consisting of at least 3 members. Executive directors should not be members of the committee. If the society's chairman is an audit committee member, he or she should not chair the committee. The internal auditor should report directly to the committee and it is usual for the chief executive, and other executives as appropriate, to attend by invitation at least part of the committee meetings. The external auditors should have direct access to the committee, with or without executives present, and should attend some, if not all, meetings, particularly those where matters such as the year end accounts, or systems, are being discussed. The matters with which an audit committee might be involved include:

- (1) the adequacy of the society's systems of business control and, in particular, its arrangements for evaluating risks in relation to its existing and future business and related capital requirements;
- (2) the effectiveness of the society's internal audit function, including an assessment of the scope of work performed by internal audit, the nature and timing of internal audit reports and the adequacy of internal audit resources;
- (3) the preparation and supervision of internal audit's plan and programme;
- (4) the receiving of reports from the internal auditor and reporting to the board on the audit plan together with recommendations for improvements;

- (5) the review of the adequacy of management information and other reports made available to the board;
- (6) the review of the annual accounts prior to their approval by the board;
- (7) assessment of the external audit function.



## G

**3.2 Accounting and other records****3.2.1 Introduction**

3 The scope and nature of the accounting and other records which a bank should have for its business to be conducted in a prudent manner should be commensurate with its needs and particular circumstances. They should have regard to the factors identified in SYSC3.1.2 and to the manner in which the business is structured, organised and managed, and to the nature, and complexity of its transactions and commitments.

4 The accounting and other records should be located where they will best assist management to conduct the business of the bank.

If the accounting and other records are kept overseas (for example at a UK branch's overseas head office) or by another entity (for example, where processing is outsourced), there should be arrangements which allow local management of the bank to have immediate and unrestricted access to them. In addition, reporting accountants should be allowed access.

**3.2.2 General**

5 The FSA does not believe it is appropriate to prepare a comprehensive list of the accounting and other records which a bank should maintain. However, they should:-

- (a) capture and record on a timely basis and in an orderly fashion, every transaction and commitment which the bank enters into, with sufficient information to explain:
  - (i) its nature and purpose;
  - (ii) any asset or liability, actual or contingent, which respectively arises or may arise from it; and
  - (iii) any income or expenditure, current or deferred, which arises from it;
- (b) provide details, as appropriate, for each transaction and commitment, showing:-
  - (i) the parties, including, in the case of a loan, advance or other credit exposure, whether (and if so to whom) it is sub-participated;
  - (ii) the amount and currency;
  - (iii) the contract, rollover, value and settlement or repayment dates;

- (iv) the contracted interest rates of an interest rate transaction or commitment;
  - (v) the contracted exchange rate of a foreign exchange transaction or commitment;
  - (vi) the contracted commission or fee payable or receivable, together with any other related payment or receipt;
  - (vii) the nature and current estimated value of any security for a loan or other exposure; the physical location and documentary evidence of such security; and
  - (viii) in the case of any borrowing, whether it is subordinated, and if secured, the nature and book value of any asset upon which it is secured;
- (c) be maintained in such a manner that financial and business information can be extracted promptly to enable management to:-
- (i) identify, measure, monitor and control the quality of the bank's assets and safeguard them, including those held as custodian;
  - (ii) identify, measure, monitor and control its exposures by related counterparties across all products;
  - (iii) identify, measure, monitor and control its exposures to liquidity risk, and foreign exchange and other market risks across all products;
  - (iv) monitor the performance of all aspects of its business on an up-to-date basis; and
  - (v) make timely and informed decisions;
- (d) contain details of exposure limits authorised by management which are appropriate to the type, nature and volume of business undertaken;
- (a) These limits should, where relevant, include counterparty, industry sector, country, settlement, liquidity, interest rate mismatch and securities position limits as well as limits on the level of intra-day and overnight trading positions in foreign exchange, futures, options, future (or forward) rate agreements (FRAs) and swaps.
- (e) provide information which can be summarised in such a way as to enable actual exposures to be readily, accurately and regularly measured against these limits;
- (f) contain details of the factors considered, the analysis undertaken and the authorisation or rejection by management of a loan, advance or other credit exposure; and
- (g) provide, on a memorandum basis, details of every transaction entered into in the name of or on behalf of another party on an agency or fiduciary (trustee) basis

where it is agreed that the bank itself is not legally or contractually bound by the transaction.

### **3.2.3 Information for management**

- 6 Every bank should prepare information for directors and management so that they can monitor, assess and control the performance of its business, the state of its affairs and the risk to which it is exposed.
- (a) This information should be prepared on an individual company and, where appropriate, on a consolidated basis.
  - (b) The frequency with which information is prepared, its level of detail and the amount of narrative analysis and explanation will depend upon the level of management to which it is addressed. Some types of information will be needed on a more frequent basis than others and it may be appropriate for some to be presented on a basis of breaches from agreed limits by way of exception reports.
- 7 It is the responsibility of directors and management to decide what information is required and to decide who should receive it. Appropriate management information should be provided to:-
- (a) persons responsible for exercising managerial functions or for maintaining accounting and other records;
  - (b) executives who, either alone or jointly, are responsible under the immediate authority of the directors for the conduct of the business of the bank; and
  - (c) the directors of the bank.
- 8 This information should be prepared:-
- (a) to show the state of affairs of the bank;
  - (b) to show the operational results of the business both on a cumulative basis and by discrete period, and to give a comparison with budgets and previous periods;
  - (c) to provide an analysis of assets and liabilities showing how they have been valued;
  - (d) to provide an analysis of its off-balance sheet positions showing how they have been valued;
  - (e) to provide an analysis of income and expenditure showing how it relates to different categories of asset and liability and off-balance sheet positions; and
  - (f) to show the bank's exposure to each type of risk, compared to the relevant limits set by management.

## G

**3.3 Internal systems and controls****3.3.1 Introduction**

9 The scope and nature of adequate control systems should take account of the matters covered in SYSC3.1.2 and:

- (a) the amount of control by senior management over day-to-day operations;
- (b) the degree of centralisation and the extent of reliance on information technology.

10 A system of internal control should be designed and operated to provide reasonable assurance that:

- (a) all the bank's revenues accrue to its benefit;
- (b) all expenditure is properly authorised and disbursed;
- (c) all assets are adequately safeguarded;
- (d) all liabilities are recorded;
- (e) all statutory requirements relating to the provision of accounts are complied with and all prudential reporting conditions are adhered to.

**3.3.2 Control environment**

11 The strength of the control environment is important for banks, as a weak control environment can undermine an otherwise adequate control system.

- (a) A working definition of 'control environment' is provided in Statement of Auditing Standards ('SAS') 300, issued by the Auditing Practices Board:

'Control environment' means the overall attitude, awareness and actions of directors and management regarding internal controls and their importance in the entity. The control environment encompasses the management style, and corporate culture and values shared by all employees'.

12 Factors relevant to the control environment include:

- (a) the importance which is attached to controls by management;
- (b) the way in which staff are assessed and rewarded (including remuneration and bonus schemes as well as promotion policies);
- (c) controls training, and the methods for reviewing control, including internal audit.

### **3.3.3 High level controls**

13 High level controls are the controls which are primarily exercised at director and senior manager level, as distinct from the detailed controls, the operation of which is delegated to others. High level controls typically include:

- (a) the setting of strategy and plans. The strategic plan should be documented and consider the external factors that might impact on the business in the near future, for example macro economic factors and competition. The strategic plan should be reviewed annually and is a key document for the production of the annual business plan that will set out how the bank will achieve its goals for the coming year. Some banks may also consider it appropriate to establish trigger points on key indicators to identify adverse trends in the business that would cause the Board to revisit its strategy or business plan. For banks that are part of a larger group, the strategic plan and annual business plan may be produced on an integrated, group-wide basis;
- (b) approval of risk policies;
- (c) establishment and review of the organisational structure;
- (d) the system for delegation;
- (e) review of high level management information;
- (f) maintaining the framework for monitoring and/or periodic review of risk management and detailed control systems and for the implementation of action points following such a review.

The FSA's requirements for adequate internal control systems will apply to high level as well as to detailed control systems.

### **3.3.4 The control system: General**

14 The FSA does not believe it is appropriate to prepare a comprehensive list of internal control procedures which would then be applicable to any bank, nor is it possible to prepare a detailed list of particular procedures which should be undertaken, where appropriate, by all banks. Nonetheless, internal control systems should provide reasonable assurance that:-

- (a) the business is planned and conducted in an orderly and prudent manner in adherence to established policies;
- (b) transactions and commitments are entered into in accordance with management's general or specific authority;
- (c) management is able to safeguard the assets and control the liabilities of the business;

- (d) there are measures to minimise the risk of loss from irregularities, fraud and error, and promptly and readily to identify them when they occur;
- (e) the accounting and other records of the business provide complete, accurate and timely information;
- (f) management is able to monitor on a regular and timely basis, among other things, the adequacy of the bank's capital, liquidity, profitability and the quality of its assets;
- (g) management is able to identify, regularly assess and, where appropriate, quantify the risk of loss in the conduct of the business so that:-
  - (i) the risks can be monitored and controlled on a regular and timely basis; and
  - (ii) appropriate provisions can be made for bad and doubtful debts, and for any other exposures both on and off balance sheet;
- (h) management is able to comply with the FSA's reporting rules ( that is to complete returns fully and accurately and in accordance with the FSA's reporting instructions, and to submit them on a timely basis ); and
- (i) the bank is able to comply with the other notification requirements under the Act.

15 In seeking to secure reasonable assurance that their internal control objectives are achieved, management needs to exercise judgement in determining the scope and nature of the control procedures to be adopted.

- (a) They should also have regard to the cost of establishing and maintaining a control procedure in relation to the benefits, financial or otherwise, that it is expected to provide.

16 It is a responsibility of directors and management to review, monitor and test its systems of internal control on a regular basis in order to assure their effectiveness on a day-to-day basis and their continuing relevance to the business.

- (a) In many banks an internal audit function assists management by providing an independent review of such systems.
- (b) Such a review should be designed to monitor the effectiveness and operation of the systems and to test compliance with daily procedures and controls (see below).

### **3.3.5 Control objectives**

17 The scope and nature of the specific control objectives which should be adopted for the business to be conducted in a prudent manner should be commensurate with a bank's needs and particular circumstances, and should have regard to the

manner in which the business is structured, organised and managed, to its size and the nature, volume and complexity of its transactions and commitments.

18

It is not appropriate for the FSA to provide an exhaustive and prescriptive list of detailed control requirements which should apply to all banks. However, the FSA considers that each bank should address the following control objectives:-

- (a) Organisational structure: Banks should have documented the high level controls in their organisation which:
  - (i) define allocated responsibilities;
  - (ii) identify lines of reporting for all aspects of the enterprise's operations, including the key controls and giving outline job descriptions for key personnel.
    - (a) The delegation of authority and responsibility should be clearly specified.
- (b) Risk management: A bank should document its risk management framework setting out how the risks in the business are identified, measured, monitored and controlled. At a high level this might be documented in a matrix, setting out the key risks in the business e.g. credit, interest rate etc, key control procedures, the person responsible for monitoring the risk, and the type and frequency of management information to monitor each risk (see below).
- (c) Monitoring procedures: A bank should have procedures in place to ensure that relevant and accurate management information covering the financial state and performance of the bank and the risk exposures which the bank has entered into is provided to appropriate levels of management on a regular and timely basis. Procedures should also be in place which are designed to provide reasonable assurance of compliance with the bank's policies and practices, including any limits on delegated authority referred to above, and with statutory, supervisory and regulatory requirements.
- (d) Segregation of duties: A prime means of control is the separation of those responsibilities or duties which would, if combined, enable one individual to record and process a complete transaction. Segregation of duties reduces the risk of intentional manipulation or error and increases the element of checking.
  - (a) Functions which should be separated include those of authorisation, execution, valuation, reconciliation, custody and recording.
  - (b) In the case of a computer-based accounting system, systems development and daily operations should be separated.
  - (c) For smaller banks, segregation of duties can be difficult due to limited number of staff. In such circumstances, the Board should satisfy itself that the bank is not running undue risk and that there are compensating controls in place e.g. frequent review of the area by internal audit and/or executive directors.
- (e) Authorisation and approval: All transactions should require authorisation or approval by an appropriate person and the levels of responsibility should be recorded as prescribed above.

- (f) Completeness and accuracy: Banks should have controls to ensure that all transactions to be recorded and processed have been authorised, are correctly recorded and are accurately processed.
- (a) Such controls include:
    - (i) checking the arithmetical accuracy of the records,
    - (ii) checking valuations,
    - (iii) the maintenance and checking of totals,
    - (iv) reconciliations,
    - (v) control accounts and trial balances, and
    - (vi) accounting for documents.
- (g) Safeguarding assets: A bank should have controls designed to ensure that access to assets or information is limited to authorised personnel. This includes both direct access and indirect access via documentation to the underlying assets.
- (a) These controls are of particular importance in the case of valuable, portable or exchangeable assets and assets held as custodian.
- (h) Personnel: There should be procedures to ensure that personnel have capabilities commensurate with their responsibilities. The proper functioning of any system depends on the competence and integrity of those operating it.
- (a) The qualifications, recruitment and training as well as the innate personal characteristics of the personnel involved are important features to be considered in setting up any control system.

### **3.3.6 *Controls in an Information Technology Environment***

19 The information held in electronic form within a bank's information systems is a valuable asset that needs to be protected against unauthorised access and disclosure. It is the responsibility of management to understand the extent to which a bank relies upon electronic information, to assess the value of that information and to establish an appropriate system of controls.

- (a) The control objectives described above apply equally to operations undertaken in both manual and electronic environments, although there are additional risks associated with electronic environments.
- (b) The FSA recognises that this will usually be achieved by a combination of manual and automated controls, the balance of which will vary between banks, reflecting the need for each to address its particular risks in a manner which is cost effective.

20 The types of risk most often associated with the use of information technology in financial systems may be classified as follows:

- (a) fraud and theft:



- (a) Access to information and systems can create opportunities for the manipulation of data in order to create or conceal significant financial loss. Additionally, information can be stolen, even without its physical removal or awareness of the fact, which may lead to loss of competitive advantage. Such unauthorised activity can be committed by persons with or without legitimate access rights.

(b) Errors:

- (a) Although they most frequently occur during the manual inputting of data and the development or amendment of software, errors can be introduced at every stage in the life cycle of an information system.

(c) Interruption:

- (a) The components of electronic systems are vulnerable to interruption and failure; without adequate contingency arrangements this can lead to serious operational difficulty and/or financial loss.

(d) misinformation.

- (a) Problems may emerge in systems that have been poorly specified or inaccurately developed. These might become immediately evident, but can also pass undetected for a period during which they could undermine the veracity of supposedly sound information. This is a particular risk in systems where audit trails are poor and the processing of individual transactions difficult to follow.

21 Management should be aware of its responsibility to promote and maintain a climate of security awareness and vigilance throughout the organisation. In particular, it should give consideration to:

- (a) IT security education and training, designed to make all relevant staff aware of the need for, and their role in supporting, good IT security practice and the importance of protecting company assets;
- (b) IT security policy, standards, procedures and responsibilities, designed to ensure that arrangements are adequate and appropriate.

### **3.3.7 Money laundering deterrence**

22 It is a requirement of the Money Laundering Regulations 1993 that authorised banks have policies and procedures in place to guard against their business and the financial system being used for the purpose of money laundering. The *FSA*, when considering whether a breach of its *rules* on systems and controls against *money laundering* has occurred, will have regard to whether a *firm* has followed relevant provisions in the guidance for the *UK* financial sector issued by the Joint Money Laundering Steering Group.

- (a) See also *SYSC* 3.2 for the *FSA's rules* on systems and controls against *money laundering*.

### **3.3.8 Outsourcing**

23 Authorised banks are required to adequately record and control their business. Where a bank has outsourced an aspect of its operations to another part of the

group, or to an external supplier, it should ensure that its records and controls adequately cover that business.

- 24 Banks should put in place procedures for monitoring and controlling the outsourced operations, and for ensuring that the information requirements of the authorised bank's management with respect to the outsourced operations are satisfied (see chapter OS).

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**3.2 Accounting and other records****3.2.1 Introduction**

3 The scope and nature of the accounting and other records which a bank should have for its business to be conducted in a prudent manner should be commensurate with its needs and particular circumstances. They should have regard to the factors identified in SYSC3.1.2 and to the manner in which the business is structured, organised and managed, and to the nature, and complexity of its transactions and commitments.

4 The accounting and other records should be located where they will best assist management to conduct the business of the bank.

If the accounting and other records are kept overseas (for example at a UK branch's overseas head office) or by another entity (for example, where processing is outsourced), there should be arrangements which allow local management of the bank to have immediate and unrestricted access to them. In addition, reporting accountants should be allowed access.

**3.2.2 General**

5 The FSA does not believe it is appropriate to prepare a comprehensive list of the accounting and other records which a bank should maintain. However, they should:-

- (a) capture and record on a timely basis and in an orderly fashion, every transaction and commitment which the bank enters into, with sufficient information to explain:
  - (i) its nature and purpose;
  - (ii) any asset or liability, actual or contingent, which respectively arises or may arise from it; and
  - (iii) any income or expenditure, current or deferred, which arises from it;
- (b) provide details, as appropriate, for each transaction and commitment, showing:-
  - (i) the parties, including, in the case of a loan, advance or other credit exposure, whether (and if so to whom) it is sub-participated;
  - (ii) the amount and currency;
  - (iii) the contract, rollover, value and settlement or repayment dates;

- (iv) the contracted interest rates of an interest rate transaction or commitment;
  - (v) the contracted exchange rate of a foreign exchange transaction or commitment;
  - (vi) the contracted commission or fee payable or receivable, together with any other related payment or receipt;
  - (vii) the nature and current estimated value of any security for a loan or other exposure; the physical location and documentary evidence of such security; and
  - (viii) in the case of any borrowing, whether it is subordinated, and if secured, the nature and book value of any asset upon which it is secured;
- (c) be maintained in such a manner that financial and business information can be extracted promptly to enable management to:-
- (i) identify, measure, monitor and control the quality of the bank's assets and safeguard them, including those held as custodian;
  - (ii) identify, measure, monitor and control its exposures by related counterparties across all products;
  - (iii) identify, measure, monitor and control its exposures to liquidity risk, and foreign exchange and other market risks across all products;
  - (iv) monitor the performance of all aspects of its business on an up-to-date basis; and
  - (v) make timely and informed decisions;
- (d) contain details of exposure limits authorised by management which are appropriate to the type, nature and volume of business undertaken;
- (a) These limits should, where relevant, include counterparty, industry sector, country, settlement, liquidity, interest rate mismatch and securities position limits as well as limits on the level of intra-day and overnight trading positions in foreign exchange, futures, options, future (or forward) rate agreements (FRAs) and swaps.
- (e) provide information which can be summarised in such a way as to enable actual exposures to be readily, accurately and regularly measured against these limits;
- (f) contain details of the factors considered, the analysis undertaken and the authorisation or rejection by management of a loan, advance or other credit exposure; and

- (g) provide, on a memorandum basis, details of every transaction entered into in the name of or on behalf of another party on an agency or fiduciary (trustee) basis where it is agreed that the bank itself is not legally or contractually bound by the transaction.

### 3.2.3 *Information for management*

- 6 Every bank should prepare information for directors and management so that they can monitor, assess and control the performance of its business, the state of its affairs and the risk to which it is exposed.
  - (a) This information should be prepared on an individual company and, where appropriate, on a consolidated basis.
  - (b) The frequency with which information is prepared, its level of detail and the amount of narrative analysis and explanation will depend upon the level of management to which it is addressed. Some types of information will be needed on a more frequent basis than others and it may be appropriate for some to be presented on a basis of breaches from agreed limits by way of exception reports.
- 7 It is the responsibility of directors and management to decide what information is required and to decide who should receive it. Appropriate management information should be provided to:-
  - (a) persons responsible for exercising managerial functions or for maintaining accounting and other records;
  - (b) executives who, either alone or jointly, are responsible under the immediate authority of the directors for the conduct of the business of the bank; and
  - (c) the directors of the bank.
- 8 This information should be prepared:-
  - (a) to show the state of affairs of the bank;
  - (b) to show the operational results of the business both on a cumulative basis and by discrete period, and to give a comparison with budgets and previous periods;
  - (c) to provide an analysis of assets and liabilities showing how they have been valued;
  - (d) to provide an analysis of its off-balance sheet positions showing how they have been valued;
  - (e) to provide an analysis of income and expenditure showing how it relates to different categories of asset and liability and off-balance sheet positions; and
  - (f) to show the bank's exposure to each type of risk, compared to the relevant limits set by management.

## G

**3.3 Internal control systems****3.3.1 Introduction**

9 The scope and nature of adequate control systems should take account of the matters covered in SYSC3.1.2 and:

- (a) the amount of control by senior management over day-to-day operations;
- (b) the degree of centralisation and the extent of reliance on information technology.

10 A system of internal control should be designed and operated to provide reasonable assurance that:

- (a) all the bank's revenues accrue to its benefit;
- (b) all expenditure is properly authorised and disbursed;
- (c) all assets are adequately safeguarded;
- (d) all liabilities are recorded;
- (e) all statutory requirements relating to the provision of accounts are complied with and all prudential reporting conditions are adhered to.

**3.3.2 Control environment**

11 The strength of the control environment is important for banks, as a weak control environment can undermine an otherwise adequate control system.

- (a) A working definition of 'control environment' is provided in Statement of Auditing Standards ('SAS') 300, issued by the Auditing Practices Board:

'Control environment' means the overall attitude, awareness and actions of directors and management regarding internal controls and their importance in the entity. The control environment encompasses the management style, and corporate culture and values shared by all employees'.

12 Factors relevant to the control environment include:

- (a) the importance which is attached to controls by management;
- (b) the way in which staff are assessed and rewarded (including remuneration and bonus schemes as well as promotion policies);

- (c) controls training, and the methods for reviewing control, including internal audit.

### 3.3.3 ***High level controls***

13 High level controls are the controls which are primarily exercised at director and senior manager level, as distinct from the detailed controls, the operation of which is delegated to others. High level controls typically include:

- (a) the setting of strategy and plans. The strategic plan should be documented and consider the external factors that might impact on the business in the near future, for example macro economic factors and competition. The strategic plan should be reviewed annually and is a key document for the production of the annual business plan that will set out how the bank will achieve its goals for the coming year. Some banks may also consider it appropriate to establish trigger points on key indicators to identify adverse trends in the business that would cause the Board to revisit its strategy or business plan. For banks that are part of a larger group, the strategic plan and annual business plan may be produced on an integrated, group-wide basis;
- (b) approval of risk policies;
- (c) establishment and review of the organisational structure;
- (d) the system for delegation;
- (e) review of high level management information;
- (f) maintaining the framework for monitoring and/or periodic review of risk management and detailed control systems and for the implementation of action points following such a review.

The FSA's requirements for adequate internal control systems will apply to high level as well as to detailed control systems.

### 3.3.4 ***The control system: General***

14 The FSA does not believe it is appropriate to prepare a comprehensive list of internal control procedures which would then be applicable to any bank, nor is it possible to prepare a detailed list of particular procedures which should be undertaken, where appropriate, by all banks. Nonetheless, internal control systems should provide reasonable assurance that:-

- (a) the business is planned and conducted in an orderly and prudent manner in adherence to established policies;
- (b) transactions and commitments are entered into in accordance with management's general or specific authority;

- (c) management is able to safeguard the assets and control the liabilities of the business;
- (d) there are measures to minimise the risk of loss from irregularities, fraud and error, and promptly and readily to identify them when they occur;
- (e) the accounting and other records of the business provide complete, accurate and timely information;
- (f) management is able to monitor on a regular and timely basis, among other things, the adequacy of the bank's capital, liquidity, profitability and the quality of its assets;
- (g) management is able to identify, regularly assess and, where appropriate, quantify the risk of loss in the conduct of the business so that:-
  - (i) the risks can be monitored and controlled on a regular and timely basis; and
  - (ii) appropriate provisions can be made for bad and doubtful debts, and for any other exposures both on and off balance sheet;
- (h) management is able to comply with the FSA's reporting rules ( that is to complete returns fully and accurately and in accordance with the FSA's reporting instructions, and to submit them on a timely basis ); and
- (i) the bank is able to comply with the other notification requirements under the Act.

15 In seeking to secure reasonable assurance that their internal control objectives are achieved, management needs to exercise judgement in determining the scope and nature of the control procedures to be adopted.

- (a) They should also have regard to the cost of establishing and maintaining a control procedure in relation to the benefits, financial or otherwise, that it is expected to provide.

16 It is a responsibility of directors and management to review, monitor and test its systems of internal control on a regular basis in order to assure their effectiveness on a day-to-day basis and their continuing relevance to the business.

- (a) In many banks an internal audit function assists management by providing an independent review of such systems.
- (b) Such a review should be designed to monitor the effectiveness and operation of the systems and to test compliance with daily procedures and controls (see below).



### 3.3.5 *Control objectives*

17 The scope and nature of the specific control objectives which should be adopted for the business to be conducted in a prudent manner should be commensurate with a bank's needs and particular circumstances, and should have regard to the manner in which the business is structured, organised and managed, to its size and the nature, volume and complexity of its transactions and commitments.

18 It is not appropriate for the FSA to provide an exhaustive and prescriptive list of detailed control requirements which should apply to all banks. However, the FSA considers that each bank should address the following control objectives:-

- (a) Organisational structure: Banks should have documented the high level controls in their organisation which:
  - (i) define allocated responsibilities;
  - (ii) identify lines of reporting for all aspects of the enterprise's operations, including the key controls and giving outline job descriptions for key personnel.
    - (a) The delegation of authority and responsibility should be clearly specified.
- (b) Risk management: A bank should document its risk management framework setting out how the risks in the business are identified, measured, monitored and controlled. At a high level this might be documented in a matrix, setting out the key risks in the business e.g. credit, interest rate etc, key control procedures, the person responsible for monitoring the risk, and the type and frequency of management information to monitor each risk (see below).
- (c) Monitoring procedures: A bank should have procedures in place to ensure that relevant and accurate management information covering the financial state and performance of the bank and the risk exposures which the bank has entered into is provided to appropriate levels of management on a regular and timely basis. Procedures should also be in place which are designed to provide reasonable assurance of compliance with the bank's policies and practices, including any limits on delegated authority referred to above, and with statutory, supervisory and regulatory requirements.
- (d) Segregation of duties: A prime means of control is the separation of those responsibilities or duties which would, if combined, enable one individual to record and process a complete transaction. Segregation of duties reduces the risk of intentional manipulation or error and increases the element of checking.
  - (a) Functions which should be separated include those of authorisation, execution, valuation, reconciliation, custody and recording.
  - (b) In the case of a computer-based accounting system, systems development and daily operations should be separated.

- (c) For smaller banks, segregation of duties can be difficult due to limited number of staff. In such circumstances, the Board should satisfy itself that the bank is not running undue risk and that there are compensating controls in place e.g. frequent review of the area by internal audit and/or executive directors.
- (e) Authorisation and approval: All transactions should require authorisation or approval by an appropriate person and the levels of responsibility should be recorded as prescribed above.
- (f) Completeness and accuracy: Banks should have controls to ensure that all transactions to be recorded and processed have been authorised, are correctly recorded and are accurately processed.
  - (a) Such controls include:
    - (i) checking the arithmetical accuracy of the records,
    - (ii) checking valuations,
    - (iii) the maintenance and checking of totals,
    - (iv) reconciliations,
    - (v) control accounts and trial balances, and
    - (vi) accounting for documents.
- (g) Safeguarding assets: A bank should have controls designed to ensure that access to assets or information is limited to authorised personnel. This includes both direct access and indirect access via documentation to the underlying assets.
  - (a) These controls are of particular importance in the case of valuable, portable or exchangeable assets and assets held as custodian.
- (h) Personnel: There should be procedures to ensure that personnel have capabilities commensurate with their responsibilities. The proper functioning of any system depends on the competence and integrity of those operating it.
  - (a) The qualifications, recruitment and training as well as the innate personal characteristics of the personnel involved are important features to be considered in setting up any control system.

### 3.3.6 *Controls in an Information Technology Environment*

19 The information held in electronic form within a bank's information systems is a valuable asset that needs to be protected against unauthorised access and disclosure. It is the responsibility of management to understand the extent to which a bank relies upon electronic information, to assess the value of that information and to establish an appropriate system of controls.

- (a) The control objectives described above apply equally to operations undertaken in both manual and electronic environments, although there are additional risks associated with electronic environments.

- (b) The FSA recognises that this will usually be achieved by a combination of manual and automated controls, the balance of which will vary between banks, reflecting the need for each to address its particular risks in a manner which is cost effective.

20 The types of risk most often associated with the use of information technology in financial systems may be classified as follows:

(a) fraud and theft:

- (a) Access to information and systems can create opportunities for the manipulation of data in order to create or conceal significant financial loss. Additionally, information can be stolen, even without its physical removal or awareness of the fact, which may lead to loss of competitive advantage. Such unauthorised activity can be committed by persons with or without legitimate access rights.

(b) Errors:

- (a) Although they most frequently occur during the manual inputting of data and the development or amendment of software, errors can be introduced at every stage in the life cycle of an information system.

(c) Interruption:

- (a) The components of electronic systems are vulnerable to interruption and failure; without adequate contingency arrangements this can lead to serious operational difficulty and/or financial loss.

(d) misinformation.

- (a) Problems may emerge in systems that have been poorly specified or inaccurately developed. These might become immediately evident, but can also pass undetected for a period during which they could undermine the veracity of supposedly sound information. This is a particular risk in systems where audit trails are poor and the processing of individual transactions difficult to follow.

21 Management should be aware of its responsibility to promote and maintain a climate of security awareness and vigilance throughout the organisation. In particular, it should give consideration to:

- (a) IT security education and training, designed to make all relevant staff aware of the need for, and their role in supporting, good IT security practice and the importance of protecting company assets;
- (b) IT security policy, standards, procedures and responsibilities, designed to ensure that arrangements are adequate and appropriate.

### 3.3.7 *Money laundering deterrence*

22 It is a requirement of the Money Laundering Regulations 1993 that authorised banks have policies and procedures in place to guard against their business and the financial system being used for the purpose of money laundering. The Joint Money Laundering Steering Group Guidance Notes ('Money Laundering Guidance Notes for the Financial Sector' revised and consolidated by the Joint

Money Laundering Steering Group in June 1997) provide a practical interpretation of the Regulations. The FSA expects banks to adopt policies and procedures in line with those Guidance Notes.

(a) See also the sourcebook on money laundering.

### **3.3.8**      ***Outsourcing***

23            Authorised banks are required to adequately record and control their business. Where a bank has outsourced an aspect of its operations to another part of the group, or to an external supplier, it should ensure that its records and controls adequately cover that business.

24            Banks should put in place procedures for monitoring and controlling the outsourced operations, and for ensuring that the information requirements of the authorised bank's management with respect to the outsourced operations are satisfied (see chapter OS).

# Interim Prudential Sourcebook for Building Societies

## 10 Securitisation

### 10.1 Introduction

10.1.1 G This chapter contains new guidance for building societies on securitisation. It replaces the consultation draft Prudential Note issued by the Commission in June 1994.

10.1.2 G This chapter consists of the guidance for banks on securitisation (chapter SE of the Interim PSB for banks) as amended by additional guidance specific to building societies set out in paragraph 10.1.3 and in section 10.3 of this chapter.

10.1.3 G Save as mentioned in paragraph 10.1.3(2), all of the guidance in chapter SE of the IPSB for banks applies to building societies, with the following amendments:

- (1) All references to “banks” should be taken to include building societies.
- (2) Section 1.4 (Grandfathering) of chapter SE does not apply to building societies.
- (3) In paragraph 5 in section 4.3 of chapter SE, the reference to “a bank’s minimum (or “Individual”) capital ratio” should be read as “ a building society’s threshold solvency ratio”.
- (4) In paragraph 7 in section 4.4 of chapter SE, the liquidity implications of securitisation transactions will be assessed for societies by reference to chapter 5 (Liquidity) of this IPSB.

## **10.2 Areas of the bank guidance which are particularly relevant to societies**

10.2.1 G Section 3 of chapter SE outlines the various roles that a bank may play in a securitisation transaction. The following paragraphs direct societies to the parts of the bank guidance that are likely to be most relevant to them.

- (1) Societies planning to securitise mortgages currently on their own balance sheets will act as an “originator”, as described in section 3.2.1 of chapter SE.
- (2) Societies will also act as “servicing agents”, as set out in section 3.3.2, where they continue to administer the mortgages after securitisation.
- (3) Societies may undertake some or all of the secondary roles described in section 3.3.3.

## **10.3 Additional guidance for building societies**

10.3.1 G This section sets out additional guidance on securitisation for building societies over and above that set out in chapter SE of the IPSB for banks. These additions arise as a result of the particular constitutional structure of building societies and the provisions of the 1986 Act. The FSA will expect societies, when planning to securitise, to consider these issues and to adopt a policy to deal with them.

### **Principal Purpose and Nature Limits**

10.3.2 G Section 5(1) of the 1986 Act provides that “*a society may be established ... if its purpose or principal purpose is that of making loans which are secured on residential property and are funded substantially by its members*”. The 1986 Act also gives the FSA certain powers of control in respect of a failure to comply with these provisions. A society will therefore need to ensure that any programme of securitisation does not threaten its continued compliance with its principal purpose.

10.3.3 G The principal purpose is a continuing purpose: it is not just viewed at a single point in time. Whether a society is fulfilling its principal purpose depends on what business it is doing on a continuing basis. For example if, for an extended period of time, a society diverted all its new mortgage business to a special purpose vehicle as part of a securitisation programme, it would arguably not be meeting its principal purpose.

10.3.4 G Sections 6 and 7 of the 1986 Act describe, respectively, the “lending” and “funding” limits, together known as the “nature limits”, which are quantitative criteria which help to determine whether an individual society is complying with its principal purpose. Societies should ensure that any programme of securitisation does not threaten compliance with the nature limits. Sections 6(3) and 7(3) of the 1986 Act respectively make clear that only items included in total assets or total liabilities in a society’s accounts count towards the nature limits.

#### **Provisions of section 9A of the 1986 Act**

10.3.5 G Paragraph 6 (i) in section 6.3 of chapter SE sets out some additional guidance for banks which play a primary role in securitisation transactions in respect of undertaking swaps. In addition to the guidance in that paragraph, building societies should also ensure that any swaps they undertake comply with section 9A of the 1986 Act.

#### **Membership of the society**

10.3.6 G As mutual institutions, societies have a special responsibility to their customers which, in the context of securitisation, the FSA considers should include maximum openness with affected borrowers. The relationship between a society and its borrowers is qualitatively different to that between a bank and its borrowers because society borrowers are members of the society. Because of this, the FSA will expect societies, when planning to securitise, to consider the issue of membership and to adopt a Board policy to deal with it, which should include a strategy for handling the affected borrowing members.

10.3.7 G The membership issue will not arise if a society intending to undertake a securitisation transaction originates mortgages directly into a vehicle, so that the borrower does not become a member of the society in the first place. In these circumstances, the FSA considers that societies should make clear to borrowers, when they take out the loan, that they do not have membership rights.

10.3.8 G Societies should bear in mind that if they securitise mortgages by means of an equitable transfer, paragraph 5(2) of Schedule 2 to the 1986 Act means that the relevant borrowers will still be members of the society.

## **10.4 Transitional provisions**

10.4.1 G Any securitisation transaction undertaken by a society before 20 June 2000, which conformed to the guidance on securitisation issued by the Commission, is grandfathered. Accordingly, such a transaction may be treated for capital purposes as conforming with the guidance set out in this chapter, without the need to restructure the transaction. A society should, however, satisfy itself that any new pool of assets securitised through a grandfathered structure conforms with the guidance in this chapter.



## SECURITISATION AND ASSET TRANSFERS

### 1 INTRODUCTION

#### 1.1 Application

1 This chapter applies to a UK banks acting in a *primary role* in respect of a transfer of a single asset, pool of assets or securitised portfolio. Where a bank does not meet the terms of this policy, it should regard the assets as remaining on the solo and consolidated balance sheet.

See s3.2

- a) Further details on *primary roles* are set out below.
- b) The FSA's policy does not apply to banks incorporated outside the United Kingdom, even if the special purpose vehicle (SPV) is UK-incorporated.

2 Where a UK bank acts in a *secondary role* in respect of a transfer of a single asset, pool of assets or securitised portfolio, this policy only applies in the following circumstances:

- (a) Where the bank also acts in a primary role. If the bank fails to follow this policy, the FSA will regard the assets as being on the solo and consolidated balance sheet; or
- (b) Where the performer of the primary role is a member of the consolidated group. If the bank fails to follow this policy, the FSA will regard the assets as being on the consolidated balance sheet.

See s3.3

- a) Further details on *secondary roles* are set out below.

See ch CS

- b) The details regarding *consolidated groups* are explained in chapter CS.

3 Where a member of the consolidated group acts in a secondary role in respect of a transfer of a single asset, pool of assets or securitised portfolio, this policy will only apply when the UK bank acts in a primary role. Failure to follow the policy would result in the assets being on the consolidated balance sheet.

4 Where the role policy is followed, the capital consequences are explained below.

## **1.2 Legal Sources**

5 For relevant legal sources see the Legal Sources section of the Capital Overview chapter.

## **1.3 [deleted]**

6 [deleted]

## **1.4 Grandfathering**

7 All securitisation transactions completed prior to the 30<sup>th</sup> December 1999 will be grandfathered.

8 A bank should satisfy itself that a new pool of assets securitised through a grandfathered structure complies with this policy.

## **1.5 How this chapter is organised**

9 Section 2 outlines the principles and objectives that lie behind the FSA's approach to securitisation and asset transfers. Section 3 then explains the various roles that a bank may take within a securitisation. Section 4 highlights the wider implications of the risks to banks that result from securitisation and loan transfers.

Sections 5, 6, 7 & 8 explain the FSA's general policy applicable to a bank acting in a primary role. Section 5 details the methods of transferring risk effectively and the FSA's policy in each case. Section 6 outlines the FSA's policy for all basic asset transfers or securitisations other than on effective transfers. Section 7 details the policy specifically applying to revolving credit securitisations. Section 8 deals with other specialist schemes.

- Sections 9, 10 & 11 outline the policy applying to banks acting in specific secondary roles. Section 9 outlines the policy on the provision of credit enhancement. Section 10 outlines the policy on the provision of liquidity facilities. Section 11 outlines the policy on dealing and underwriting of asset backed securities.



## 2 SECURITISATION, ASSET TRANSFERS AND THE FSA'S APPROACH

### 2.1 Background

#### 2.1.1 General

1 An *asset transfer* occurs where an asset owned by a bank is *sold* to another legal entity. In doing so, a bank may remove the asset from its supervisory balance sheet, where the conditions of this chapter are met.

See s5

- a) *Sold* means the legal and economic methods of transfer discussed in more detail below.

2 *Securitisation* is generally a process by which assets are sold to a *bankruptcy remote special purpose vehicle* (SPV) in return for an immediate cash payment. The cash payment is raised by the SPV issuing debt securities, usually in the form of tradable notes or commercial paper. A bank performing such a transaction may remove the assets from its supervisory balance sheet, where the conditions of this chapter are met.

- a) In a securitisation, the assets are usually transferred to a vehicle existing specifically for the purpose of securitisation called a *special purpose vehicle* (SPV).
- b) A *bankruptcy remote* SPV is an entity that is considered by the rating agencies to be unlikely to be subject to voluntary or involuntary bankruptcy proceedings.
- c) Although securitisable assets may take other forms, they are generally those with associated streams of principal and interest e.g. mortgages, credit cards and corporate loans.

3 Although this policy is primarily concerned with the sale of loans, the policy also applies to the transfer of other forms of assets.

#### 2.1.2 Rationale for Securitisation

4 A bank may undertake a securitisation for a number of reasons. These include:

- portfolio management;
- reducing the need for capital to support assets on the balance sheet;
- risk management;
- enhancing equity return by allowing the redeployment of capital;

- restructuring the balance sheet for reasons connected with large exposures or sectoral concentrations;
- issuing securities as a means of funding with benefits for both cost and diversification of sources; and
- to provide funding of assets when the originator cannot obtain funding on its own part, for example to fund an acquisition.

### 2.1.3 *The risks involved*

- 5 In the process of transfer, the functions normally carried out by a lending bank are unbundled. Normally, the various risks in a bank's banking book other than credit risk do not warrant special treatment, as the capital needed to cover credit risk helps to protect a bank against these other risks as well. This is no longer the case, however, where the credit risk lies with a third party and a bank solely carries the risks associated with asset administration or promotion.
- 6 Banks should be aware that although this policy is primarily concerned with capital adequacy, operational and reputational risk may also be incurred. For example, in the transfer of a single asset, the originating bank may have difficulty in avoiding close association with the asset; for a pool of assets, the level of association depends upon the structure used and the number of roles performed. The FSA believes that the risks from close association, which may take a variety of forms with a securitisation scheme, can assume material proportions.
- 7 The solution for the FSA has been to implement the policy of "clean break". A bank, once it has securitised assets, should not have any further involvement with those assets except in accordance with the policy in this chapter. This should be the case both explicitly and implicitly i.e. any reputational linkage between the assets of the originator/sponsor should be broken so far as is possible.

## 2.2 Objectives

- 7 The framework of the FSA's rules is designed to achieve the following objectives, in that:
- (a) asset sales and packaging achieve their intended effect of passing rights and obligations from the seller to the buyer. Ideally, a completely clean break should be achieved;
  - (b) all the parties to the transaction fully understand the responsibilities and risks they have assumed or retained; and
  - (c) any material risks to buyers or sellers are properly treated in the FSA's supervision of banks.
- 8 The FSA believes that these objectives are best achieved by ensuring that a transfer achieves the following:
- (a) the immediate legal separation of the seller from the assets and their new owner (or the effective economic separation in the case of a transfer by sub-participation);
  - (b) as far as possible, the complete economic separation of the seller from the assets and their new owner;
  - (c) presentational or "moral" separation of the seller from the assets and their new owner; and
  - (d) the identification of the retained risks for capital or other coverage purposes.

### **3 PRIMARY & SECONDARY ROLES**

#### **3.1 General**

1 This section outlines the various roles that fall within the scope of this policy.

#### **3.2 Primary roles**

##### **3.2.1 Bank as originator**

See s3.2.2(b) 2 A bank acts as an *originator* when it transfers from its balance sheet a single asset, an asset package or assets that are not investment grade third party financial instruments.

- a) The terms *seller* and *originator* are used interchangeably to mean the bank that is seeking to move assets off its own balance sheet. Note that the terms *seller* and *buyer*, for the party taking on the risk, are used throughout this chapter although in a strict legal sense they may be inaccurate where transfer is by way of sub-participation.

3 Where a bank lends to an SPV in order for that SPV to grant a loan to a borrower as though it were the bank, the bank will be regarded as an originator.

- a) This method of lending is known as *remote origination*.
- b) The bank is regarded as the originator as the SPV is creating an asset that is branded by the bank. The bank will incur reputational risk through the association with the product.

##### **3.2.2 Bank as sponsor or repackager**

4 A bank acts as a *sponsor* or *repackager* when:

(a) As a sponsor, it repackages *third party* assets *directly* into a *conduit scheme* that funds the purchase by an issue of securities.

- See s1.1
- a) *Third Party* means parties other than the members of the bank's wider accounting group.
  - b) *Directly* means that the assets have never appeared on the bank's balance sheet.
  - c) In a *conduit scheme*, the term sponsor is used to describe the bank promoting the securitisation scheme. A sponsor may be connected to the scheme in ways that may open it to "moral" pressures in the same way as an originator.

- d) Where there is more than one originator in the securitisation the SPV is known as a *multi-seller vehicle*.
  - e) The various sellers usually continue to service the assets, carrying out the functions of collection, administration and the pursuit of arrears.
- (b) As a repackager, it sells *investment grade third party financial instruments* via its balance sheet to an SPV that then rebundles them and resells them to investors.
- a) In a *repackaging scheme*, the repackager is *not* the original lender and is therefore subject to fewer limitations than an originator.
  - b) Where the assets are influenced in credit quality by reference to the repackaging bank, the bank will be regarded as an originator.
- See ch TI 47G
- c) For a definition of *investment grade* see the Interest Rate position risk chapter. Where the securities to be repackaged are not rated, the bank should be able to demonstrate that the assets are of a comparable quality.
- See ch CB s3.2.2
- d) For the purposes of this paragraph, *financial instruments* are as defined in Section B of the Annex to the ISD.

5 Where a bank repackages assets that are not investment grade third party financial instruments via its balance sheet the bank will be treated as an originator and should comply with the policy relating to that role except where:

- (a) the bank acts as sponsor and originates up to 10% of the total assets into the scheme; or
- (b) the bank acts as repackager and repackages up to 10% of the total assets in the scheme that are either sub-investment grade securities or securities where it has acted as originator.

Banks should apply the originator treatment for assets falling within this exception, albeit without jeopardising the overall treatment for the scheme.

- a) The rule will be applied at the level of the conduit irrespective of any prior SPVs.



### 3.3 Secondary Roles

#### 3.3.1 *General*

6 A bank acting in a primary role may also carry out one or more of the secondary roles associated with a securitisation or asset transfer. The number and scope of roles carried out by a bank under a securitised structure affect its treatment under the FSA's policy.

7 If a bank is carrying out only one role, it may be acceptable for it to have greater latitude in that role than if it was carrying out several roles, as the FSA considers the totality of a bank's involvement when assessing the completeness of the clean break and any residual risks.

#### 3.3.2 *Servicing agents*

8 A bank acts in the secondary role of *servicing agent* when it administers or services the securitised assets.

- a) The terms *servicer*, *servicing agent* and *administrator* are used interchangeably to describe a bank which carries out an administrative function with regard to a securitisation scheme.

9 Where a bank acts as servicing agent, it should satisfy itself that it does not have a reputational obligation to support any losses incurred by the scheme. If a bank is unable to do so, it should comply with the policy applying to an originator.

- a) A bank acting as servicing agent can run explicit operational and reputational risks as its identification with the assets can mean that its commercial reputation is committed. The extent of the association depends upon the extent of involvement and the sophistication of the underlying borrowers. The FSA is concerned that a bank in this position may give in to pressure to support losses incurred by the investors/buyers to protect its name.

10 Where a bank acts as serving agent, the bank should be able to demonstrate to investors that it has no reputational obligations to support losses by a clear and unambiguous statement in the offering circular in respect of any implied support.

#### 3.3.3 *Other secondary roles*

11 A bank acts in a secondary role when it carries out any of the following functions:

- See s9 (a) the provider of *credit enhancement*;
- a) A *credit enhancement* is provided to an SPV to cover the losses associated with the pool of assets. The level of the enhancement is reflected in the rating given to the notes by a rating agency.
- See s10 (b) the provider of *liquidity facilities*;
- a) *Liquidity facilities* enable SPVs to assure investors of timely payments. These include smoothing timing differences in the payment of interest and principal on pooled assets and ensuring payments to investors in the event of market disruptions.
- See s11 (c) the *underwriter* and *dealer* in securities issued by the SPV;
- a) *Underwriting* is the arrangement under which a bank agrees to buy, before issue, a specified quantity of securities in a new issue on a given date and at a given price if no other purchaser has come forward.
- b) *Dealing* is acting as principal in both the sale and purchase of notes, in the secondary market of an issued security.
- See s10.4.3 (d) the provider of *bridging loans* to the SPV;
- a) A *bridging loan* is a loan made to an SPV, before the issuance of the notes, to cover a mismatch in time between the date of purchase of the underlying assets and the date of issue of the securities.
- See s6.2.2 (i) (e) the counterparty in swap transactions.

## 4 IMPLICATIONS OF SCHEMES FOR A BANK'S GENERAL RISKS

### 4.1 Introduction

1 The following sections of this chapter cover banks acting in a primary and secondary role.

2 No consideration of a securitisation or asset transfer can be concerned solely with the technical rules regarding its structure. It also has wider implications for a bank's risks.

3 The extent of the risks for a bank involved in a securitisation or asset transfer vary according to the comparative size of the bank and the assets involved, as well as the complexity of the structure of transfer.

### 4.2 Systems & Controls

4 The FSA needs to be satisfied that a bank acting in a primary role has adequate systems and controls in place to deal with all aspects of the securitisation taking place.

a) Some of the systems implications may be significant. The arrangements for controlling the securitisation should be carefully assessed and monitored, and be subject to internal audit.

b) Where appropriate, the FSA may use section 166 reports as part of the monitoring of these systems.

### 4.3 Operational risks

See ch CO

5 The FSA takes into account any significant operational risks not related to balance sheet items when setting a bank's minimum (or "Individual") capital ratio. In exceptional cases it may wish to apply an explicit capital requirement against this sort of risk.

### 4.4 Liquidity

6 Where assets may eventually return to the bank's balance sheet, there are particular issues for banks' management of their liquidity.

7 Before the FSA allows assets to be treated as off balance sheet, it needs to be satisfied that the bank can deal with the liquidity implications. These should be handled within a bank's normal liquidity management and assessed using the standard maturity mismatch approach or, in those cases where it is relevant, the sterling stock liquidity approach.

See s7 a) The liquidity treatment of revolving-credit securitisations is dealt with in more detail below.

See s10.4.2 (d) 8 The FSA may require sponsors or repackagers that report on a mismatch basis to meet mismatch guidelines out to six months. Similarly the FSA may require sponsors or repackagers reporting on a sterling stock basis to submit additional information (on a mismatch basis) covering the bank's liquidity out to six months.

See ch LM 9 A bank may be required to arrange committed facilities to be drawn down to the extent necessary to fund assets returning to its balance sheet. The requirements governing these committed facilities will generally be consistent with the FSA's liquidity approach.

a) Likewise the FSA follows its normal approach on the question of the weighting of such committed facilities by the lending bank for capital adequacy purposes.

b) Since such commitments need to be available in circumstances where a replacement securitisation does not prove possible, they should not include a "material adverse change" condition in relation to the bank.

#### 4.5 Capital planning

10 Where assets may eventually return to the bank's balance sheet - such as in a liquidity asset repurchase agreement - there are particular issues for banks' management of its capital. Returning assets could affect the capital adequacy of the bank.

See s10.4.2 (e) 11 Where assets could return to the balance sheet the FSA may request a bank to submit a plan to take account of the possible return of the assets to the balance sheet.

a) A plan should detail how the bank intends *either* to sell the assets, sell other assets or to raise the requisite capital.

#### 4.6 Remaining asset base

12 The process of securitising a significant portion of a bank's assets may lead to a change in the profile of the assets on its supervisory balance sheet, in terms of both quality and spread. These implications are considered when assessing any securitisation scheme and may need to be discussed with the bank.

13 The FSA may impose limits on the extent to which assets may be securitised in terms of total volume and/or the types of assets securitised in comparison to the total asset base.

- a) The FSA may regard assets removed from a bank's balance sheet through securitisation, even where the bank complies with the policy in this chapter, as carrying some residual risk to the originator.

## 5 BASIS OF THE POLICY: METHODS OF TRANSFER

### 5.1 Introduction

1 The FSA considers that the method of transfer of an asset can have an important bearing on the risks assumed by buyer and seller since different methods achieve the desired 'clean break' to varying extents.

2 Each of the four methods set out below may be used to make an effective transfer of a loan off the supervisory balance sheet. The considerations raised in each case apply in all forms of securitisation or asset transfer; the policies set out in section 6 and elsewhere are additional to the policy for identifying adequate forms of transfer.

Sections 5.2 to 5.4 give the FSA's position on transfer methods for on-balance sheet items; section 5.6 for assets which are undrawn.

3 Methods of transfer, other than the four described below may be valid, especially with reference to transfers carried out in other jurisdictions. If a bank proposes to rely upon any other method, it should be supported by legal opinion and the prior approval of the FSA should be obtained.

### 5.2 Novation

4 A transfer of an asset through *novation* is regarded as a clean transfer and the asset may be therefore excluded from the selling bank's capital ratio and added to the buying bank's.

a) In a *novation*, the existing agreement between the originator and the borrower is cancelled and a new agreement between the investor and borrower is substituted. This effectively transfers all the seller's rights and obligations to the buyer.

b) In the FSA's view, the cleanest transfer of risk is achieved by novation.

### 5.3 Assignment

5 A legal or equitable *assignment*, if properly structured, can also achieve an effective transfer of the seller's rights - but not his obligations - and the remedies available to him to enforce those rights.

a) An *assignment* transfers from seller to buyer all rights to principal and interest. A loan agreement may impose restrictions on assignability and these bind the buyer. Thus if assignment is prohibited without the consent of the borrower, the borrower's consent should be obtained. In any case, there may be difficulties in assigning the benefit of rights other than the right to principal and interest. The buyer's rights may be impaired by any rights of set-off that exist between the borrower and the seller.

- b) The seller retains any outstanding obligations (for example, to advance further funds).

6 A transfer through an *assignment duly notified* to the borrower is regarded as a clean transfer, provided that the buyer has taken reasonable precautions to ensure that his rights under the transfer are not impaired by an intervening right; for example, a right of set-off between seller and borrower.

- a) At a minimum there should be a warranty from the seller that no such right of set-off exists.

7 A *silent assignment* (i.e. where the borrower is not notified) is usually regarded as a clean transfer. This is subject to the following:

- (a) the volume of assets to individual borrowers sold on a silent assignment basis should be subject to appropriate internal controls;
- (b) the seller should keep under careful review the risks that follow on from this position as it remains the lender of record and therefore will be the focal point for pressure from the borrower.
  - a) The additional risks for the seller as lender of record are that he remains subject to requests to reschedule or renegotiate or advance further funds.
  - b) The buyer also faces additional risks because the absence of notice to the borrower removes some legal protection he would otherwise have had. These need to be kept under careful review.

If it is not satisfied on these points, the FSA may disregard a transfer of an asset through a silent assignment in calculating the capital ratio of the seller.

#### **5.4 Declaration of trust**

8 A declaration of trust is regarded as a clean transfer of the assets that is equivalent to a silent assignment, subject to the following:

- (a) The policy on silent assignments detailed above is fulfilled in relation to the trust.
- (b) The bank receives a legal opinion confirming that the trust is effective to transfer the beneficial interest.

If it is not satisfied on these points, the FSA may disregard a transfer of an asset through a declaration of trust in calculating the capital ratio of the seller.

## 5.5 Sub-participation

- 9 Where an asset is funded in whole or in part via a *sub-participation*, the FSA recognises the transfer of credit risk by excluding it (or the relevant part) from the original lender's capital ratio, and including it in the sub-participant's as a claim on the underlying borrower.
- a) Sub-participation does not transfer any of the seller's rights, remedies or obligations against the borrower to the buyer, but is an entirely separate, back-to-back, non-recourse funding arrangement, under which the buyer places funds with the seller in exchange for acquiring a covenant from the latter under which he passes on to the buyer payments under the underlying asset which the borrower makes to him, but the asset itself is not transferred.
  - b) Sub-participation is accepted as meeting the FSA's criteria for effective transfer as, although not transferring in a legal sense the rights of the original lender, an asset sub-participation aims to have the same economic effect.
  - c) The sub-participant may, but is not required to, obtain a charge over the underlying assets. Such a charge would, among other things, allow the sub-participant to report on the basis of the capital charge on the underlying assets.
  - d) The sub-participant also faces additional risks since it assumes an exposure to the borrower, but is also at risk to the seller, because it relies on the seller to pass through funds received from the borrower.

## 5.6 Undrawn commitments

- 10 Where banks transfer an *undrawn commitment* to lend (or part thereof), the commitment (or part thereof) is excluded from the selling bank's capital ratio only when:
- (a) the transfer is by novation; or
  - (b) the transfer is by an assignment accompanied by a release by the borrower of the seller from its obligations, an assumption by the buyer of the seller's obligations and a formal acknowledgement from the borrower of a transfer of obligations from the seller to the buyer.
    - a) An acknowledged assignment is regarded as amounting to, in substance, a novation and therefore effectively transfers this obligation.

- 11 A transfer by means of silent assignment, declaration of trust or sub-participation does not lead to the exclusion of the commitment from the selling bank's capital ratio. Instead the commitment is regarded as being to the buyer rather than to the potential borrower.



- a) This treatment is adopted because an undrawn commitment is an obligation on the part of a lender, whilst an assignment is a transfer of rights only. As explained further below, the seller will face a credit risk in the event of the failure of the buyer.
- b) Note that undrawn advised facilities are not extinguished through sub-participation.

See chs BC s4 &  
LE

12 The buyer's assumption of a commitment (or part) is included in its capital ratio as a claim on the borrower, irrespective of the method of transfer used.

- a) In the case of an effective transfer of the obligation, this is clearly the necessary corollary, as the risk is no longer being taken into account against the seller.
- b) A form of transfer which does not transfer an undrawn commitment, i.e. under silent assignment or sub-participation, gives the appearance of a double counting of the credit risk since it is taken into account for both the seller and the buyer. This is because there are two, legally separate transactions, even if the intention in entering into them is to achieve a combined effect. There are, therefore, two credit risks.

## **6 BASIS OF THE POLICY: LIMITING THE ASSOCIATION WITH THE ASSETS**

### **6.1 Scope**

1 This section covers the general policy applying to banks acting in a primary role. It covers single assets, parts of assets and the packaging, securitisation and sale of asset pools as well as the transfer of risk under sub-participation agreements. 0

See s7 & 8

a) This chapter includes guidance applying to specialist schemes for particular asset types, additional to that set out in this section.

See s5

b) This section should be read in conjunction with the sections covering effective forms of transfer; the policy in this section should be met in addition to that in section 5.

2 There are a number of general policies applying to both single asset and asset packages, set out in s6.2, and further general policies for asset package schemes only, set out in s6.3.

3 References to assets in the singular are for convenience only, unless specifically stated.

### **6.2 Policy relating to all types of assets**

4 The following conditions for the transfer of a single asset, part of an asset or package of assets should be met:

(a) The transfer should not contravene the terms and conditions of the underlying asset agreement and all the necessary consents have been obtained;

(b) The performer of the primary role has no residual economic interest in the principal amount of the asset (or that part which has been transferred) and the buyer has no formal recourse to the seller for losses;

a) When a secured asset is transferred and further advances are made by the originator, if these additional advances are to be secured there should be a separate formal agreement with the borrower. A side letter is insufficient for these purposes.

(c) The performer of the primary role has no legal or moral obligation to purchase or repurchase the asset (or fund the repayment of a sub-participation), or any part of it, at any time;

See s6.4

- a) The performer of the primary role may not retain an option to repurchase the assets, except where the loan portfolio has reduced to less than 10% of its maximum value and the option extends only to fully performing assets.
  - b) The inclusion of a 'step up' will only be permitted for mortgage securitisations and will be considered on a case by case basis pending a fuller review of the policy. Where a bank can demonstrate that the economic characteristics for the assets that it proposes to securitise are the same as for mortgages, the inclusion of a step up may be considered.
  - c) The details regarding the repurchase or purchase of assets are explained below.
  - d) An exception to the conditions in this paragraph is where the obligation arises from warranties given in respect of the asset at the time of its transfer, provided that these are not in respect of the future credit-worthiness of the borrower.
    - i) The FSA would not regard this condition as met if warranties were provided by the originator on matters outside its control.
    - ii) Environmental warranties should restrict liability to legislation in force at the time of sale, not at any time in the future otherwise they may be regarded as constituting a warranty on matters outside the originator's control.
- (d) The performer of the primary role can demonstrate, to the satisfaction of the FSA, that it has given notice to the buyer that it is under no legal obligation to repurchase the asset (or fund the repayment of a sub-participation), nor support any losses suffered by the buyer, and that the buyer has acknowledged the absence of obligation;
- a) Penalty interest imposed at the administrator's option does not constitute a loss caused by borrower default and may therefore be met by the performer of the primary role.
  - b) An SPV has an ongoing credit exposure to the performer of the primary role, because it is dependent on it passing on payments it receives in respect of the securitised assets. A bank may provide a guarantee to the SPV in respect of such an obligation by its subsidiary (if all or part of the assets are originated by the subsidiary) if the effect is only to bring the credit rating of the subsidiary up to that of the parent bank. The commitment by the parent may go no further than commitments the subsidiary could have given itself within the limitations of the FSA's policy.

- (e) The documented terms of the transfer are such that, if the asset is rescheduled or renegotiated, the buyer and not the performer of the primary role would be subject to the rescheduled or renegotiated terms; and
- (f) Where payments are routed through it, the performer of the primary role is under no obligation to remit funds to the buyer unless and until they are received from the borrower.
  - a) Payments voluntarily made by the performer of the primary role to the buyer in anticipation of payments from the borrower should be made on terms under which they can be recovered from the buyer if the borrower fails to perform.

### **6.3 Additional policy relating to asset packages**

- 5 The process of packaging assets together and selling them as a block or pool can compound risks that are often negligible when a single asset is transferred. The commercial reputation of the performer of the primary role is committed because of its close association with the scheme; such a commitment may jeopardise the existence of a clean break and there may be pressure to support any losses of investors.
- 6 When performing a primary role for a package of assets, a bank should meet the following additional conditions, in order to ensure that its role is not seen as being more than acting as an agent, whether or not it retains the servicing role:
  - (a) The FSA expects the performer of the primary role to have evidence available in its records that its legal advisers are satisfied that the terms of the scheme protect it from any liability to investors in the scheme, other than liability for breach of express contractual performance obligations as servicing agent or originator or for breach of warranty made with respect to the assets in conformity with the policy in this chapter, or liability for any other matter wholly within the control of the originator.
  - (b) The FSA expects the performer of the primary role to have evidence available in its records that the terms of the scheme satisfy the conditions for non-consolidation of an SPE, derecognition or linked presentation set out in FRS5.
  - (c) The FSA expects the performer of the primary role to confirm in writing to the FSA that it has evidence available in its records that its auditors and legal advisers are satisfied, so far

- as it is within their professional competence, that the terms of the scheme comply with the FSA's policy.
- a) Regardless of the bank having obtained opinions from professional advisors and its auditors under the sub-paragraph above, the responsibility for ensuring that the scheme meets these provisions rests with the bank.
  - b) The FSA may request sight of the opinions of the auditors and legal advisers.
  - c) The evidence in the bank's records may be included in a section 166 report.
- (d) The performer of the primary role should be able to demonstrate that it has taken all reasonable precautions to ensure that it is not obliged, nor will feel impelled, to support any losses suffered by the scheme or investors in it.
- a) This may be met by any offering circular (or other analogous documentation) containing a highly visible, unequivocal statement that the performer of the primary role does not stand behind the issue or the vehicle and will not make good any losses in the portfolio.
  - b) Where an existing funding is part of a proposed securitisation scheme, the FSA may consider that the statement need not be made retrospectively, although it should be inserted in subsequent funding issues.
  - c) The provision of insurance cover by a bank or a subsidiary of the bank against loss, e.g. mortgage indemnity insurance, will be considered on a case by case basis.
- (e) The performer of the primary role may not own any *share capital* or other form of proprietary interest in or control over, either directly or indirectly, any company used as a vehicle for the scheme.
- a) Where the bank acts in a primary role, this also applies to members of the consolidated group.
  - b) *Share capital* includes for this purpose all classes of ordinary and preference share capital.
- (f) The Board of a company used as vehicle for a scheme should be independent of the performer of the primary role, although may have one director representing it.

- a) Where the bank acts in a primary role, this also applies to members of the consolidated group.
- (g) [deleted]
- (h) The performer of the primary role should not bear any of the recurring expenses of the scheme.

See s9

- a) Credit enhancements are considered below.
- b) The failure of the performer of the primary role to charge appropriate fees or other compensation may amount to funding. The agreement should specify fees and, if costs are not covered, should be subject to the approval of the FSA as being at an acceptable level.
- c) If a bank wishes to securitise a mortgage book which includes staff mortgages which are subsidised, such a subsidy will not count as funding the vehicle if paid to the employee; it may do if paid directly to the buyer. The different treatment arises due to the likely events upon default.
- (i) The performer of a primary role may not enter into swap agreements with the SPV that intentionally bear losses.
  - a) However, the bank may enter into interest or exchange rate swap at market prices with the vehicle, either directly or through a third party.
  - b) There should be provision for unintended temporary losses arising from normal administrative procedures, for example delays in changing mortgage rates, to be recovered by the servicing agent as soon as possible;
- (j) The performer of a primary role may not fund a vehicle or scheme (except within the terms of condition (h) above) and in particular may not provide temporary finance to cover cash shortfalls arising from delayed payments or non-performance of loans which it administers.
  - a) This section does not apply to sponsors or repackagers.

### 6.3.1 *Asset replenishment*

7 An originating bank may structure a securitisation scheme to allow for further tranches of assets to be placed into the scheme. It should be able to demonstrate to the FSA that at the time of subsequent transfer:

- (a) the asset quality of the pool is not materially altered by the addition;
- (b) any change to the quality of the assets remaining with the originating bank is either not material or is acceptable to the FSA;
- (c) (for revolving credit securitisation only) there is no change in the liquidity implications of the securitisation resulting from the addition; or
- (d) there are no unacceptable changes to the “moral” risks to the originator signalled by the addition.
  - a) The test of material alteration of the quality of asset pool is to be applied to the pool at the time of the proposed addition, not to the quality of the pool at the original securitisation.
  - b) A bank may discuss and receive non objection from the FSA for asset replenishment either at the time of each replenishment or once only to establish a framework to apply for several replenishments.

## **6.4 Repurchasing the assets**

### **6.4.1 *Repurchasing by an originator***

8 An originator should not repurchase the asset securitised from the SPV unless one of the following circumstances apply:

See 6.2.(c)

- (a) The repurchase is for a breach of warranty;
- (b) The repurchase is of fully performing or defaulted assets when the loan portfolio has sunk to less than 10% of the maximum face value of the assets;
  - a) The total size of the pool for these purposes is equal to the maximum total face value of the assets during the life of scheme, prior to the calculation.
  - b) Defaulted assets may be bought back for nominal consideration.
  - c) Repurchases for further advances or product switches from a mortgage pool will be agreed on a case by case basis pending a fuller review of the policy.

Any repurchase should be performed at market prices with no preference of any kind being shown in the terms and is subject to the bank’s normal credit approval and review process;

- 9 A bank may restructure or refinance a securitisation only if the assets remain, at all times, off the balance sheet.
- a) A bank should notify the FSA when wishing to restructure or refinance a securitisation. The restructuring or refinancing will be considered on a case by case basis.

#### 6.4.2 *Repurchasing by a sponsor or repackager*

- 10 A sponsor may purchase or a repackager may repurchase or purchase the assets from a scheme. At the time of (re)purchase the following conditions should apply:
- (a) The assets are either investment grade or defaulted, in the case of financial instruments, or fully performing or defaulted, for non-financial instruments;
- See 6.2.(c)
- a) If the repurchase occurs due to a breach of warranty, the policy in this section need not be followed.
- b) Defaulted assets may be bought back for nominal consideration.
- (b) The repurchase is performed at market prices with no preference of any kind being shown in the terms and is subject to the bank's normal credit approval and review process.



## 7 SPECIAL STRUCTURES: REVOLVING CREDITS

### 7.1 Introduction

1 Compared with other types of securitisation, schemes to securitise *revolving credits* introduce the possibility of increased legal and moral risk. This arises from the complexity of the arrangements, the shared interest of the originating bank and investors, and the eventual reversion in full to the originating bank of the pool of accounts. Additionally, the speed at which assets return to the balance sheet of the originating bank may cause liquidity problems.

2 Although most securitisations to which this policy applies are of credit cards, it is not limited to any particular type of assets but applies whenever the structure has the characteristics described in the above paragraph.

3 If carefully constructed, however, such schemes can result in the originating bank successfully transferring the risk on the share of the pool assets to the investors. This section outlines the conditions that should be met in respect of revolving credit securitisations in order for the assets to be given off-balance sheet treatment for supervisory purposes.

The policy in this section is additional to the general policy set out in section 6 and the conditions for effective transfer in section 5.

- a) The term *revolving credits* refers to loan facilities which permit borrowers to vary the drawn amount within an agreed limit. Repayment may be at the borrower's discretion, subject in some cases to a minimum amount per payment period, or by fixed schedule.
- b) *Securitisation* of such receivables is especially complex because of the nature of the assets as fluctuating and of indefinite maturity.
- c) Typically, schemes insulate investors in the notes from the effects of fluctuating balances by assigning shares in the receivables that are the subject of the securitisation both to the investors (the *investor interest*) and to the originating bank (the *seller interest*). The amount of the investor interest in the outstanding balances normally stays fixed at the amount of their funding (until the notes start to amortise) whereas the amount assigned to the selling bank goes up or down as borrowers make net drawings or repayments.
- d) Schemes are given a fixed maturity by dividing their life into a revolving (or interest-only) period and an amortisation period.
  - i) During the *revolving period*, the investors receive their share of interest payments, but their share of principal repayments by borrowers is reinvested in the pool.

- ii) During the *amortisation period*, the investors' share of principal repayments is used to redeem the securities, with the result that at the end of the scheme the full interest in the outstanding balances has reverted to the originating bank.

## 7.2 Principles

4 In setting the conditions for off balance sheet treatment of the share of the balances funded by investors, the FSA considers it a fundamental principle that the arrangements for the securitisation should ensure the full sharing of interest, principal, expenses, losses and recoveries on a clear and consistent basis.

- a) This principle implies, among other things, the need for full loss-sharing on the stock of receivables in the pool throughout the revolving period of the securitisation, since the investors' share of the receivables is removed in full from the originating bank's balance sheet for the whole of that period.

5 There is no specific limit on the total volume of outstanding revolving credits that a bank may remove from its balance sheet using securitisations. It is therefore important to ensure:

- (a) that adequate standards apply to the structure of securitisation schemes; and
- (b) that the implications of securitisation for the bank's risks generally are adequately handled.

## 7.3 Features and treatments

### 7.3.1 Pooling

6 Schemes typically involve the transfer of a pool of receivables into a trust.

- a) The trust directs the flows on the accounts to the originating bank and to a special purpose vehicle (SPV) according to the proportion of the funding that they are providing.
- b) The SPV in turn directs the flows to the investors who hold the securities.
- c) Schemes usually contain provisions concerning the selection of the original pool of receivables from the assets on the originating bank's balance sheet and the subsequent replenishment, as necessary, of the pool of accounts.

7 These arrangements form the basis of an acceptable structure to allow the share of the balances funded by the SPV to be removed from the originating bank's balance sheet for supervisory purposes.

- 8 A bank may take back the full financing of a pool at the end of the scheme if there is no reason to assume that its performance will have deteriorated in the meantime.
- a) For a scheme to be acceptable, therefore, the FSA needs to be convinced that it contains no features - for example for the substitution of higher-quality accounts into the scheme - as a result of which the performance of the pool systematically favours the investor interest.
  - b) Adequate seasoning of the accounts transferred into the pool - so that they are likely to display the characteristics of fully operational accounts - is usually required; together with the random selection of the assets transferred into the pool, this should normally ensure that investors are not systematically advantaged.
  - c) In addition, the scheme's documentation should ensure that servicing practices are applied consistently to securitised and unsecuritised loans.

### 7.3.2 *Aggregated and disaggregated*

- 9 Schemes may incorporate one of two main approaches concerning the payments received by the SPV in respect of the pool of accounts transferred:
- Under the *aggregated* approach, the payments received during a period are aggregated and in distributing them shares are applied to that aggregate, treating the receivables as a homogeneous pool.
    - a) The pool of assets is looked upon as though it were one and receipts/advances apportioned between originator and investor.
  - Under the *disaggregated* approach, the amounts paid to investors and the originating bank are linked to particular receivables that they have financed.
    - b) Each advance/receipt is allocated to either the originator or the investor.

Schemes using either approach may be eligible for off balance sheet treatment by the FSA.

### 7.3.3 *Scheduled amortisation*

- 10 Under the *scheduled amortisation* of the securities, the outstanding balance of receivables reverts to the originating bank after a scheduled date fixed in the terms of the securitisation, in a controlled manner.

The FSA considers that the following conditions should be met by the provision for scheduled amortisation in a scheme:

- (a) There is a need to ensure full loss-sharing on the stock of receivables throughout the revolving period of a securitisation, which has implications for the rate at which schemes may be amortised at the end of that period.
  - a) If an SPV is able to a large extent to derive repayment flows from borrowers who turn over their balances quickly, and relatively little reliance on borrowers who pay only the minimum amount each month, it might be able to make a very rapid exit from the scheme.
  - b) If the borrowers who paid their debts slowly had different risk characteristics from those repaying and renewing credit at a fast rate, this might allow the investors to avoid their full share of losses on the pool at the end of the revolving period.
  - c) The pace of repayment during any set amortisation period should not in normal circumstances be more rapid than would be allowed by straight-line amortisation over the period.
- (b) Amortisations providing for a *clean-up call* - by which an originating bank has the option to buy back the remaining securitised assets - are considered to be acceptable so long as the clean-up can occur only when 10% or less of the receivables at the start of amortisation remain outstanding.
- (c) If the scheme is based on the disaggregated approach, this is an acceptable structure (as long as any assumption that it includes about the length of the amortisation period is reasonable).
  - a) The investor interest is not eliminated until each borrower in whose debts the SPV shares has made sufficient principal payments to cover the balances outstanding at the end of the revolving period - or these have been recognised as in default.
- (d) If the scheme is based on the aggregated approach, this is more complex but may still be acceptable. There is a need to allay the concern that the SPV may be able to exit from the scheme while a substantial proportion of the total amount outstanding at the start of the scheduled amortisation period remains outstanding.
  - a) This may be the result of a scheme in which, after the start of the amortisation period, investors are repaid from a fixed share of the repayments arising from the aggregate gross flows on the accounts, including repayments of new borrowings incurred during the amortisation period.
- (e) For aggregated structures, the originating bank should be able to demonstrate (either on a theoretical basis or on the basis of historical statistics) to the FSA that, by the end of the scheduled amortisation

period, borrowers in the pool should have made sufficient payments to ensure that in aggregate at least 90% of the total debt outstanding at the beginning of the amortisation period will have been repaid or recognised as in default.

- a) Payments are taken to include both principal and interest.

#### 7.3.4 *Early amortisation*

11 *Early amortisation* of the securities provides for the repayment of the investor interest to be brought forward on the occurrence of certain circumstances defined in the terms of the securitisation. Such an occurrence is called a *trigger event*.

12 Various early amortisation triggers have been included in past securitisations, in the United Kingdom and elsewhere. They may be divided into two main kinds: *economic* and *non-economic* triggers.

- (a) *Economic* triggers activate early amortisation because of a deterioration in the performance of the pool of receivables: for example, a fall below a certain level in the yield of the pool net of provisions, interest and other expenses. The FSA considers that *economic* triggers may, therefore, be included only if:
  - (i) there is full sharing of interest, principal, expenses, losses and recoveries on the balances outstanding at the start of the amortisation period, using either the disaggregated approach or the aggregated approach applying the same conditions as outlined in paragraph 10 above; and
  - (ii) that at the point that early amortisation is triggered losses on the pool will have reached a level where the bank will feel able, if necessary and without putting its reputation at risk, to reduce its new lending broadly in line with the amortisation of the investor interest. The bank should be able to demonstrate to the FSA that this is the case.
- a) In some cases, such triggers allow investors to reduce their participation once they begin to experience losses and commit the originating bank to taking back the full financing in these circumstances. Because the FSA is seeking to ensure full loss-sharing, it considers that certain conditions should be met on the inclusion of *economic* triggers if the assets securitised are to be given off balance sheet treatment. The conditions are intended to prevent the inclusion of such triggers providing, in effect, implicit credit support. The aim is to ensure that investors share in losses for as long as these remain unusually high or until the originating bank decides, and feels able, to run down its portfolio in line with the amortisation of the investor interest.

- (b) *Non-economic* early amortisation triggers relate to changes, other than in the performance of the securitised assets, which have significant implications for the securitisation.
- a) Past examples include tax-event and legal-change triggers, triggers relating to the originating bank's material non-performance in its role as servicing agent to the SPV, and triggers relating to the insolvency of the originating bank or SPV.
  - b) In the FSA's view, the presence of these particular types of trigger does not amount to credit support. It therefore considers that such early amortisation triggers may be included in acceptable schemes, and in these limited cases a form of *rapid amortisation* - by which the investor interest may be repaid as fast as is allowed by its share of the inflow of principal payments - may be included.
  - c) The FSA needs to be convinced of the case for allowing any other forms of *non-economic* early amortisation trigger.

## **7.4 Implications of schemes for a bank's general risks**

### **7.4.1 Context**

13 This subsection explains the particular concerns relating to banks involved in revolving credit securitisations. It should be read in conjunction with Section 4 which discusses the implications for securitisations generally; the policy in this section is in addition to that set out in Section 4.

### **7.4.2 Systems**

14 Systems needs are more complex than in other securitisations, because of the active nature of the assets, the consequent need for the identification of loans and payments, and the monitoring of the portfolio's performance.

### **7.4.3 Liquidity**

15 The eventual return in full of the revolving-credit balances to the bank's balance sheet - as a result of either their scheduled or early amortisation - means that such securitisations raise particular issues for originating banks' management of their liquidity.

- a) These liquidity implications should be handled within a bank's normal liquidity management and assessed as under Section 4.4.
- b) In the case of securitisations of credit-card (and similar) receivables, this approach is combined with the FSA's normal liquidity approach for credit cards.

- c) Before the FSA is able to assess whether it is appropriate to treat such assets as off balance sheet, it needs to be satisfied that the bank can deal with these liquidity implications.
- 16 Each scheme should be included in a bank's liquidity management assuming, in normal circumstances, that during its amortisation the bank may be required to find replacement funding for the full amounts previously provided by the investor interest.
- a) This is because it may not be possible to arrange a replacement securitisation, and an across the board withdrawal or reduction of borrowers' facilities would put its reputation at risk.
- b) In each case, the FSA will consider whether an extra margin based on the likely maximum net growth in lending should be added to the funding requirement, and will, if necessary, set this margin in consultation with the bank including whether to include in the funding requirement an estimate based on the likely maximum net growth in lending.
- 17 For scheduled amortisations, before off balance sheet treatment is adopted, a bank should outline how it expects to manage its liquidity. A bank should satisfy the FSA that its liquidity arrangements could cope with the additional need for funding and, where appropriate, that it would build up additional liquid assets for the periods covering amortisation payments.
- a) This should include, at the appropriate maturities, the cash outflows resulting from the scheduled repayments to investors plus any additional growth margin decided on.
- b) The FSA examines banks' proposals to ensure that schemes do not unwind at times and in amounts that would pose difficulties for the bank concerned.
- 18 For early amortisation triggers in a securitisation scheme there are additional complications, since they render uncertain the timing of the potential need for replacement funding.
- (a) For a bank originating a scheme incorporating an early amortisation trigger or triggers, and having it treated as off balance sheet the bank should be able to demonstrate to the FSA that it has adequate funding plans in place to cope with their implications.
- (b) Where schemes include early amortisation triggers, the FSA wherever possible agrees with the originating bank 'warning indicators' that early amortisation might be triggered.
- a) For example, if the scheme allows early amortisation to be triggered after three successive months of negative net yield on the portfolio, a warning indicator might be one month of negative net yield. Following a signal from one of these

warning indicators, the maturity of the scheme will be advanced in the bank's liquidity reporting; in this example, its presumed maturity immediately after the warning indicator would be two months.

- b) For those banks operating using the stock liquidity approach, the FSA where appropriate will seek to agree with the bank the additional liquidity that should be maintained in the event of a signal from a warning indicator.
- (c) Where a scheme includes an early amortisation trigger that does not permit any warning indicator, the originating bank should likewise explain how it would cope with the liquidity implications of its being triggered.

19 There is additional liquidity risk in the case of originators of more than one securitisation with the same early amortisation trigger(s) (whether 'economic' or 'non-economic').

- a) Because the potential liquidity demand on such banks is multiplied if the early amortisation triggers in each can be triggered at the same time, in such cases the FSA needs further reassurance as to the liquidity implications before being able to agree the appropriate off balance sheet treatment of subsequent issues.

20 In order for a bank to satisfy the FSA that it can deal with the liquidity implications of the amortisation of schemes, it may need to arrange committed facilities to be drawn down to the extent necessary to fund receivables returning to its balance sheet.

- a) The policy governing these committed facilities generally is that used elsewhere in the FSA's liquidity approach. Likewise the FSA follows its normal approach on the question of the weighting of such committed facilities for capital adequacy purposes. Since such commitments need to be available in circumstances where a replacement securitisation does not prove possible, they should not include a material adverse change condition in relation to the bank.

#### **7.4.4 Capital**

21 For a bank carrying out revolving-credit securitisations amounting to a high percentage of its solo capital base, the FSA monitors and where appropriate discusses with its management the potential capital implications of its involvement in the securitisation market. Consideration here takes account of the size and development of that market.

- a) This is a particular issue where the presence of common early amortisation triggers makes it possible that a significant volume of assets could revert to the bank at the same time, thereby threatening to cause problems both for the bank's liquidity and its capital requirements.



## **8 OTHER SPECIAL STRUCTURES**

### **8.1 Transfers of receivables arising from the finance of equipment or consumer goods**

#### **8.1.1 Introduction**

See s2

- 1 The FSA's principal policy objective is to ensure that in any securitisation, all parties fully understand the responsibilities and risks which they assume or retain, and that any material risks to buyers or sellers are properly treated in the supervision of banks.
- 2 The financing of the purchase of equipment or consumer goods (including hire-purchase) can involve particular risks, which it is difficult legally to transfer to a buyer of the receivables, which may adversely affect this objective.
- 3 The policy in this section is additional to the general policy set out in section 5 and 6.

#### **8.1.2 Concerns**

- 4 The following concerns are particular to a securitisation of this type of loan:
  - (a) This type of lending can involve lenders in continuing liabilities for the "merchantability" of goods or equipment.
  - (b) If defective goods were to cause personal injury, very substantial costs could arise.
  - (c) In addition to liabilities for the quality of equipment, institutions involved in the finance of equipment hire or leasing may have contractual obligations towards the borrower - for instance to arrange for the servicing or taxation of vehicles.
  - (d) It is difficult legally to transfer these obligations, unless the transfer is done through novation.

#### **8.1.3 The FSA's policy**

- 5 The FSA views the following as the necessary steps to address these concerns:
  - (a) The FSA believes that for assets to be viewed as off-balance sheet, sellers should either receive an indemnity from the buyer to cover any liability, or otherwise take steps to minimise the risk of loss (such as taking out insurance to cover the risk).

- a) Lenders against whom claims are made as a result of their liability for the quality of goods or equipment usually have recourse to the manufacturer which, provided the manufacturer has appropriate liability insurance, may limit the risk to the lender. In addition, the FSA has been given to understand that the loss experience of lenders under such claims is historically very small. Nevertheless, the FSA does not view the risk retained by the seller as unimportant.
- (b) In situations where the seller is left with responsibilities of the kind outlined in paragraph 4 above, the FSA has some concern over the position of the buyer (if the buyer is a bank). The FSA reminds buying banks that risks of this nature need careful evaluation. Buyers should satisfy themselves of the seller's competence to fulfil its obligations towards the borrower in a timely manner.
  - a) There is a clear possibility that the borrower will exercise a right to reduce or withhold payments on the loan to reflect his costs - for instance, the cost of repairing the vehicle - if the original lender fails to meet his obligations under the loan agreement.

## 8.2 Securitisation of a reverse repo

See s6

6 Where the benefits of a reverse repo are transferred, the transaction is considered to be the securitisation of a single loan. The originator therefore should comply with the policy above for standard schemes.

- a) A reverse repo is where a bank has bought (or borrowed) trading book securities from a counterparty subject to buyback (or a return clause);

7 Whether the securitised loan is considered to be secured or unsecured depends on the structure of the transaction.

- a) A sub-participation is deemed to be unsecured.
- b) Where the transactions are through a trust structure (the trust having legal title) it will usually be secured.

See s7

8 Where the transaction is through a trust structure and the originator retains an interest in the reverse repo, the concerns raised in respect of sharing of interest, principal and losses for revolving schemes should also be addressed by the bank.

## **9 SECONDARY ROLES: CREDIT ENHANCEMENTS**

### **9.1 Background**

See s6.3 (h)

1 The policy on credit enhancements is part of the wider policy on securitisation published by the FSA, and therefore feature in a previous section. Because of their importance and the variety of possible constructions, this section expands upon the basic rules.

### **9.2 Overview**

2 A credit enhancement is an arrangement provided for the SPV that, in form or substance, covers the losses and risks associated with the pool of assets. The level of the enhancement is reflected in the rating given to the notes by a rating agency.

- a) Where a bank demonstrates a pattern of providing (implicit) support, it will be deemed to have provided credit enhancement.
- b) An enhancement can be an integral part of the structure used to manage funds or securitise assets (i.e. driven by cash flow) or may be provided from outside the structure (i.e. provided by the originator or another third party).
- c) Ratings agencies require banks to provide credit enhancement in order to make the paper issued in securitisations more attractive to investors.

3 A bank acting in a primary role may provide credit enhancement to support an SPV (and its investors). The capital charges against the credit risk that should be made are detailed below.

### **9.3 Structure of credit enhancements**

4 A credit enhancement may be structured in a number of forms, examples include:

- (a) A subordinated loan or note facility issued by a bank equal to a maximum amount of credit support being provided.
- (b) Over-collateralisation, where the face value of the assets is greater than the securities issued. The securitisation will amortise more quickly and a buffer is created against losses. On maturity, any residual assets revert to the originator.
  - a) The credit enhancement, for calculating capital requirements, is the over-collateralisation.

- (c) Spread accounts. The interest rate on the assets is usually higher than the coupon on the securities issued, with the difference being used to cover costs and provide for losses. Utilising all or part of this for credit enhancement purposes means leaving it in the SPV rather than returning it to the originator.
  - a) If the funds are to be returned to the originator, the FSA considers that the SPV should not have recourse to the monies thereafter.
  - b) The conditions detailed in 9.4 do not apply to credit enhancement in the form of a spread account retained by the SPV.

See ch TI 47G 5

Securities issued that are deemed to be investment grade by relevant rating agencies, as defined, are deemed not to constitute credit enhancement if there is already sufficient credit enhancement within the terms of this section.

See 9.6.1

- a) The limitations on the ability to hold such securities are detailed below.

See s11

- b) The limitations on the ability to trade such securities are detailed below.

#### **9.4 Detailed policy**

6

Any bank providing credit enhancement should ensure that:

- (a) the facility is limited in amount and duration;
- (b) there is no recourse to the bank beyond the fixed contractual obligations provided for in the facility;
- (c) the SPV and/or investors in a bond issue have the clear right to select an alternative party to provide the facility;
- (d) the facility is documented separately from any other facility provided by the bank;
- (e) the transaction should be undertaken at the initiation of the scheme;
  - a) However, in the event of a scheme having subsequent tranches of assets being placed in to the SPV, within the terms set out above, the credit enhancement can increase at that time, if detailed in the offering circular. The new credit enhancement should not be used to provide, in a disguised way, enhancement for earlier tranches of assets and schemes seeking to be structured in this way should be discussed in advance with the FSA.

- (f) the details of the facility should be disclosed in any offering circular or other appropriate documentation; and
- (g) payment of any fee or other income for the facility is not further subordinated, or subject to deferral or waiver, beyond what is already explicitly provided for in the applicable order of priority and other payment entitlement provisions.

See s9.6 & 9.7      7      If the above conditions are met, the relevant capital treatment that should be applied is detailed below.

## **9.5 Definitions of first loss & second loss credit enhancement**

### **9.5.1 General**

8      The distinction between the types, *first loss* and *second loss*, is drawn to allow for an understanding of the underlying structure, and for the other implications resulting from this.

### **9.5.2 Definition of first loss credit enhancement**

9      A *first loss facility* represents the first level of financial support to a SPV.

- a) A first loss facility bears, in effect, all of or the bulk of the risk associated with the assets held by a SPV, as part of the process in bringing the paper issued by the SPV to investment grade. Hence the high capital cost.
- b) A payment by a bank to provide cover against losses incurred by an SPV (e.g. to fund a reserve account) or the sale of assets to an SPV for below their book value in the bank's books (where not written down or off against profits) is regarded as a *first-loss facility*.
- c) Capital is not required for *spread accounts* where the funds are held in the SPV.
- d) Additional capital is not required for *over collateralisation* beyond the assets that are effectively written off in providing the margin of assets.

### **9.5.3 Definition of second loss credit enhancement**

10      A *second-loss facility* represents a credit enhancement providing a second (or subsequent) tier of protection to an SPV against potential loss. The share of risk of a second loss facility depends on the coverage provided by any first loss facility. In order to limit the possibility of the second loss facility carrying a disproportionate

level of risk, a credit enhancement facility is deemed a second loss facility only if:

- (a) it enjoys the benefit of protection from a substantial first loss facility; and
- (b) it can only be drawn after the first loss facility has been exhausted.
  - a) For the purposes of this section, a first-loss facility will be considered substantial where it covers some multiple of historic losses or worst case losses estimated by simulation or other techniques.
  - b) A bank providing a second loss facility needs to assess the adequacy of the first loss facility on an arm's length basis in accordance with its normal credit policies. A review of first loss facilities might refer to such factors as:
    - i) the class and quality of the assets held in the SPV;
    - ii) the history of default rates on the assets;
    - iii) the output of any statistical models used by banks to assess expected default rates on the assets; the types of activity permitted the SPV (i.e. whether the risk underlying the credit enhancement facilities extends beyond the asset held);
    - iv) the quality of the parties providing the first loss facility; and
    - v) the opinions or rating letters provided by reputable third parties, such as rating agencies, regarding the adequacy of the first loss protection.
  - c) Where a second loss facility provided by a bank would substitute for a first loss facility provided by another party, in the event of that party failing to meet its obligations, the bank should treat the facility it provides as equivalent to a first loss facility.

## **9.6 Credit enhancements supplied by an originator**

### **9.6.1 *Restrictions upon an originator***

11 An originator should only make a one-off contribution to enhance the credit-worthiness of a vehicle. Any transactions should be funded at the initiation of the scheme and disclosed in the offering circular.

- a) The agent or originator may lend on a long-term subordinated basis to the vehicle only if the loan is made at the outset of the scheme and is repayable only following winding up of the scheme.

See s11

12 An originator may not hold any of the securities issued by the SPV unless it has received a waiver to deal, as detailed below.

- a) Any holdings in excess of the agreed dealing limits will be deducted from capital.

### 9.6.2 *Treatment for first loss*

13 The originating bank may make a choice of either deducting the amount of the credit enhancement from capital or including the assets within their risk weighted asset ratio under normal rules as if there had been no securitisation. The choice should be made at the outset and maintained for the duration of the credit enhancement. Where the credit enhancement is permanently reduced through the remittance of funds to the originator, and without recourse to the originator thereafter, the amount deducted from capital can be reduced accordingly.

### 9.6.3 *Treatment for second loss*

14 An originator providing a second loss facility (in an acceptable form) should deduct the amount of the facility from capital. Where the credit enhancement is permanently reduced through the remittance of funds to the originator, and without recourse to the originator thereafter, the amount deducted from capital can be reduced accordingly.

## 9.7 **Credit enhancements supplied by a sponsor or repackager**

### 9.7.1 *General*

15 Due to the complexity of conduit and repackaging schemes, the definitions of first and second loss facilities may be difficult to apply. In such circumstances, the FSA should be consulted.

- a) For the purposes of this section, the holding of sub-investment grade paper will be deemed to constitute credit enhancement unless there is already sufficient enhancement within the scheme.

### 9.7.2 *Treatment for first loss*

16 First loss credit enhancement facilities provided by a sponsor or repackager should be deducted from capital. Where the credit enhancement is permanently reduced through the remittance of

funds to the sponsor or repackager, and without recourse to the sponsor or repackager thereafter, the amount deducted from capital can be reduced accordingly.

### 9.7.3 *Treatment for second loss*

17 A bank acting as sponsor or repackager which provides a second loss facility, as defined above, may weight the facility as normal, provided that the extent of the bank's involvement is fully and properly explained in any offering circular for the scheme, or is otherwise notified to investors, and it is made unequivocally clear to investors:

- (a) that the bank's responsibilities do not go beyond that which is provided for in the second loss facility in question (as explained in the offering circular); and
- (b) the bank will not support losses beyond the requirements of the second loss facility or generally stand behind the scheme.





## **10 SECONDARY ROLES: LIQUIDITY FACILITIES**

### **10.1 General**

1 *Liquidity facilities* enable SPVs to assure investors of timely payments. These include smoothing timing differences in the payment of interest and principal on pooled assets and ensuring payments to investors in the event of market disruptions. Such facilities can be particularly important where SPVs hold long term assets funded by the issuance of short-term securities.

- a) Ratings agencies require banks to provide liquidity facilities in order to make the paper issued in securitisations more attractive to investors.
- b) The Commercial Paper (CP) markets display some degree of volatility. For example, in the United States, this may cause the \$CP rates to diverge from \$LIBOR from time to time, particularly over the year-end, quarter ends and US tax payment days. SPVs are sometimes therefore set up in such a way that they are not tied to an obligation to fund assets for a full quarter on specific days each quarter so as to avoid such difficult days. A liquidity facility may be key to the flexibility an SPV needs in such circumstances.

### **10.2 Detailed Policy**

2 To guard against the possibility of a facility functioning as a form of credit enhancement, a liquidity facility when provided should satisfy the following conditions:

- (a) the facility is provided on an arm's length basis and is subject to the bank's normal credit review and approval processes;
- (b) the facility may be reduced or terminated should a specified event relating to a deterioration in asset quality occur, e.g. the facility should not be available to be utilised if the assets of the SPV have deteriorated in quality to the extent there is no longer a sufficient level of credit enhancement to cover the amount of any new or existing drawdowns under the facility.
- (c) the facility should be conducted on market terms and conditions;
- (d) the facility is limited in amount and duration;
- (e) there is no recourse to the bank beyond the fixed contractual obligations provided for in the facility;
- (f) the SPV and/or the note trustee representing the investors have the clear right to select an alternative party to provide the facility;

- (g) the facility is documented separately from any other facility provided by the bank;
- (h) payment of any fee or other income for the facility is not further subordinated, or subject to deferral or waiver, beyond what is already explicitly provided for in the applicable order of priority and other payment entitlement provisions;
- (i) the facility may not be drawn for the purposes of credit support;
- (j) the documentation clearly defines the circumstances under which the facility may be drawn and prohibits drawing in any other circumstances;
- (k) the facility will provide for repayment of advances within a reasonable time period;
- (l) funding is provided to (or via) the SPV and not directly to investors;
- (m) proceeds of drawings under the facility cannot be used to provide permanent revolving funding, or be for the express purpose of purchasing underlying assets held by an SPV (although it is permissible for a liquidity facility to be structured as an arrangement in which underlying assets held by the SPV are purchased by the liquidity provider, provided that the assets in question are investment grade);
- (n) funding cannot be used to cover losses recorded by the SPV; and
- (o) drawings under the facility are not subordinated to the interests of investors, except that drawings may be subordinated to other liquidity facilities if a tiered liquidity facilities are used in a scheme. Such subordination should be clearly set out in the offering circular or other appropriate documentation.

3 Failure to satisfy these conditions will cause the facility to be deemed to be serving the economic purpose of a credit enhancement facility and therefore be treated in the same way as a credit enhancement for capital purposes.

- a) The facility may be deemed to be a first or a second loss facility, as appropriate.

### **10.3 Restrictions on originators**

See s6.3

4 An originator should not provide a liquidity facility as it is deemed to be funding. If it does, it is deemed not to have achieved a clean break with

the assets, which will then be considered by the FSA as being on its balance sheet.

- a) The provision of a liquidity facility to cover very short-term timing differences may be considered acceptable. However, there should be no obligation on the bank to make the payment, the vehicle should have sufficient funding to meet any clawback claims and the structure should be covered in the scheme's documentation.
- b) Although originators may not provide a liquidity facility, the workings of the securitisation vehicle may still require one which may, therefore, be provided by a third party bank.

## **10.4 Restrictions upon sponsors and repackagers**

### **10.4.1 General**

See ch BC s4

- 5** A sponsor or repackager may provide a liquidity facility to a scheme. The facility will be calculated as 100% weighted asset drawn and 0% or 50% undrawn (in the normal way), provided that the extent of the bank's involvement is fully and properly explained in any offering circular for the scheme, or is otherwise notified to investors, and it is made unequivocally clear to investors:
- (a) that the bank's responsibilities do not go beyond that which is provided for in the liquidity facility in question (as explained in the offering circular); and
  - (b) the bank will not support losses beyond the requirements of the liquidity facility or generally stand behind the scheme.
- 6** If these conditions are not met, the bank should treat the scheme as a fully consolidated subsidiary for capital adequacy purposes.
- a) If a bank acting as sponsor is seeking to use the concessionary treatment of section 3.2.2 paragraph 5, (as a partial originator in a multi-seller vehicle, providing a part of the liquidity facility) and fails the tests in this section, then any assets it originates will be considered as remaining on its balance sheet.

### **10.4.2 Large Exposures**

- 7** Conduits can grow to considerable sizes and consequently a liquidity facility provided by a sponsor or repackager to such a conduit could potentially exceed the bank's large exposures capital base. A bank should only disaggregate facilities where the following general conditions are fulfilled:
- (a) The facilities are provided to separate legal entities;

- See Ch LE s5.2
- (b) The legal entities are not closely related counterparties for large exposure purposes;
- a) The details regarding large exposures are explained in chapter LE.
- See s4.2
- (c) The bank has systems and controls in place to monitor the assets within the conduit;
- a) The need to aggregate the underlying assets involves the use of complex systems and controls. A bank should be able to satisfy the FSA that it is able to control the securitisation properly primarily at notification and through the section 166 process.
- See s4.4
- (d) There are internal systems in place, that have undergone stress testing on mismatch limits, to monitor and/or manage the bank's liquidity out to at least six months; and
- a) It is possible for CP conduits to grow to a significant size. Should there be a disruption to the CP market that requires the drawing of a facility, sizeable funds will be needed to meet the demand. The drawing of these funds may accelerate as each CP fund matures. The sponsor should be able to monitor its liquidity to ensure that it is able to cope with such an effect.
- b) Conduits should manage their CP maturities so that they do not have significant amounts of CP maturing during any one day or week. If the liquidity lines' renewal dates are not concentrated the bank may be less exposed to market disruption as drawing will take place over a longer period of time.
- See s4.5
- (e) The sponsor's capital planning takes account of possible drawings under the facilities i.e. that they are either able to sell the assets, sell other assets or raise the requisite capital. A sponsor should pre-notify the FSA as to how it will provide capital in the event of possible drawings.
- a) If a CP disruption occurs it may result in the sponsor making a large loan or taking a large quantity of assets onto the balance sheet over a short period of time. A sponsor should plan how it will provide capital in the event that this occurs.

8

The FSA considers that it is appropriate for a bank to disaggregate facilities where the following specific conditions are fulfilled:

- (a) For an asset repurchase facility, the exposure to the obligor for each underlying asset held by each special purpose vehicle is aggregated for large exposures purposes with the bank's own exposures to that obligor; or

- (b) For a liquidity backstop facility, a bank takes reasonable steps to aggregate, for large exposure purposes, exposures to the obligor of the underlying assets, that represents a significant proportion of the pool, with the bank's own exposure to that obligor.
  - a) A bank should also take into account any originator, sectoral, country or regional concentrations when providing liquidity to an SPV.
  - b) A bank should not only aggregate the exposure to the obligors of the underlying assets across the SPVs but also any exposures to closely related counterparties across the SPVs.

See ch LE s9.2.7

### **10.4.3 Bridging Loans**

9 *A bridging loan* is a loan made to a vehicle, prior to the issuance of the notes, to cover a mismatch in time between the date of purchase of the underlying assets and the date of issue of the securities.

See s3.2.1

- a) A sponsor or repackager should not use the practice in this section to establish a remote origination scheme.

10 The FSA considers that it is acceptable for a sponsor or repackager to provide a bridging loan to an SPV subject to usual capital and large exposures requirements where the following conditions are met:

- (a) The loan is provided at market prices with no preference of any kind being shown in the terms and conditions;
- (b) The sponsor or repackager has the senior secured status; and
- (c) The term of the loan is limited to three months or less.
  - a) The maturity of the underlying assets should extend considerably beyond this period.

11 A sponsor or repackager providing a bridging loan for greater than three months should treat the assets as on the balance sheet until the transaction is completed.

See s3.2.1

- a) Assets that are regarded as being on balance sheet for the purposes of this section will be regarded as originated when securitised.

## **11 SECONDARY ROLES: DEALING & UNDERWRITING**

### **11.1 Dealing & underwriting by an originator**

1 An originator may underwrite the securities issued by the SPV. The assets will not be regarded as being off balance sheet until 90% of the total issue has been sold to a third party.

- a) The FSA may vary the minimum level of assets that have to be sold to a third party before off balance sheet treatment is considered appropriate.

See s9.6.1

2 Once the assets have been removed from the balance sheet, any holdings in excess of agreed dealing limits should be deducted from capital. The bank should fully comply with the policy on holding the assets, as detailed above, within one month.

3 An originator should not deal in the securities issued by the SPV unless it has discussed its intention with the FSA. The FSA considers that a bank's deals should be limited. Appropriate limits are likely to represent only a small fraction of the total securities issued.

- a) Limit structures should generally be subject to limits specific to individual tiers of securities issued. Limits are likely to be more constraining for trading in securities other than the most senior debt.

See s6.2

- b) It is an accepted role of an originating bank to promote an orderly market in the securities issued by the SPV, but not to the extent that that originator is or appears to be able to support the issue, which would be in contravention of the policy above.

See s9 and Ch  
TI 47G

- c) The ability to deal in securities is limited to securities deemed to be of investment grade by a relevant rating agency as defined. Securities below investment grade fall within the definition of as credit enhancement as described below.

- d) The policy is not intended to restrict the ability of an SPV to buy back securities it has issued at or below par.

### **11.2 Dealing & underwriting by a sponsor or repackager**

See ch TU

4 A sponsor or repackager may act as underwriter for the securities issued by the SPV subject to the policy in chapter TU.

See s9

- a) At the end of the underwriting concession period any holdings of sub-investment grade paper will be deemed to constitute credit enhancement unless there is already sufficient enhancement within the scheme.

- b) Securities issued that are deemed to be investment grade by relevant rating agencies are deemed not to constitute credit enhancement, provided that there is already sufficient credit enhancement.

5 A sponsor or repackager may act as dealer in the secondary market in the securities issued by the SPV, provided that there is always at least two other third party dealers.

- a) This may be waived where a scheme is small and having multiple dealers is not practicable. However, given that in such schemes, there may more reason for concerns as to liquidity, the sponsor should be able to demonstrate that it is creating an orderly market and not supporting the issue. Banks wishing to follow this approach should obtain the prior approval of the FSA.



# Interim Prudential Sourcebook for Building Societies

## 11 Outsourcing

### 11.1 Introduction

11.1.1 G This chapter contains new guidance for building societies on outsourcing.

11.1.2 G The rest of this chapter consists of the guidance for banks on outsourcing (taken from chapter OS of the IPSB for banks). This guidance applies in its entirety to building societies with the following amendments and exceptions:

- (1) all references to “banks” should be read as including building societies;
- (2) paragraphs 3(b)(a)(i) and 4 in section 1.1 do not apply to building societies (societies are not currently subject to the RATE process);
- (3) the date referred to in paragraph 8 in section 1.2 is changed from 30 June 1999 to 1 September 2000.

## OUTSOURCING

### 1 INTRODUCTION

#### 1.1 Legal sources

1 Principle 3 of the Principles for Businesses states that a firm must organise and control its affairs effectively which includes having adequate systems and controls (see also the high-level rule in SYSC 3.1.1R). The Threshold Conditions ('Suitability') also includes the need to ensure that a firm conducts its affairs 'soundly and prudently'. Relevant to the meeting of these requirements is a bank's outsourcing arrangements. In considering any outsourcing proposal, a bank should consider whether the outsourcing meets the material outsourcing definition below. Where the proposal meets these criteria, the bank should take into account the system and control implications, including adequate anti-money laundering systems, and the degree to which management control of the task will be relinquished to the supplier. The FSA considers that a bank's management is accountable for the adequacy of systems and controls for the outsourced activity.

See Supervision  
Manual, chapter  
2

2 The FSA has powers under section 165 of the Act to require a bank to provide documents to the FSA which it reasonably requires in connection with the exercise of its functions under the Act. Nevertheless additional steps need to be taken to protect the FSA's access to information in relation to outsourced activities.

3 Material outsourcing is the use of third parties to provide services to a bank which are of such importance to the bank that:

- (a) a weakness or failure in any of the activities outsourced would cast into serious doubt the bank's continuing compliance with the Principles for Business and Threshold Conditions; and
- (b) the outsourcing is by business units which are *significant units*.
  - a) A *significant unit* is one which is covered by the FSA's risk assessment.
    - i) The first step in the FSA's RATE approach is to agree with banks exactly which units are significant: this process is described in paragraphs 26 to 30 (UK banks) and 31 to 33 (overseas banks) of the FSA's June 1998 paper "Risk based approach to supervision of banks".
  - b) The purchase of a standardised service from, for example, Bloombergs or Reuters and the provision of custody arrangements fall outside of the definition of material outsourcing.

- 4 This definition is solely for the purpose of determining the scope of the policy on outsourcing. It is not intended to restrict discussion with the FSA, nor is it intended to limit the issues that the FSA considers as part of the RATE process. A bank should apply its normal tests in deciding which issues should be raised with the FSA.
- 5 If in doubt as to whether a function would be considered material the bank should discuss the definition of material outsourcing with the FSA.
- 6 Although the principles in Section 4 apply to both intra- and extra-group outsourcing, the FSA applies them flexibly where the outsourcing is intra-group or to another regulated entity, particularly where the outsourced activity is a regulated core business function carried out by the supplier for its own purposes, e.g. cheque clearing.

## **1.2 Application**

- 7 The policy set out in this chapter applies to all banks except EEA banks.
- 8 A bank which had outsourcing arrangements in place on 30 June 1999 or which was close to completing outsourcing arrangements on or after this date, is exempt from the application of this policy until the existing contracts become due for renewal. At that time the FSA expects a bank to discuss with it how the bank intends to apply this policy to the renewal of its existing arrangements.

## **1.3 How this chapter is organised**

- 9 Section 2 sets out the basic scope and range of the FSA's approach to outsourcing proposals. Section 3 summarises the main features of the policy.
- 10 Section 4 details the minimum criteria a bank should adopt when it intends to outsource. These range from its due standard of care, to its relationship with the FSA and to its customers.
- 11 Section 5 sets out some points for further consideration regarding the structure of a bank's relationship with the supplier of the outsourced function. It stresses particularly the standards the bank should expect a supplier to meet and how the bank should monitor the relationship. This section does not represent additional minimum criteria, but a bank still needs to have considered the issues raised; the FSA may ask the outsourcing bank what procedures have been put in place to address relevant concerns.
- 12 Section 6 is an appendix setting out the FSA's general approach to *central booking*. It also explains when the FSA regards central booking as a form of material outsourcing for the purposes of sections 2 to 5.

- a) *Central booking* is where the business is carried out in one location or legal entity within a group and booked in the accounting records of another. In some cases, the risks arising from such business may be managed in a third location.

## **2 THE FSA'S APPROACH TO OUTSOURCING**

- 1 Banks frequently decide to outsource aspects of their operations, either to other group companies or to independent third parties. This is sometimes done on grounds of cost, sometimes because the other party can deliver a better service than can be provided in-house, and sometimes a combination of both.
- 2 The FSA recognises that outsourcing can bring significant benefits to banks and their customers. However, the FSA is concerned that when an important function is performed outside a bank, the bank may lose or have reduced control of the outsourced activity. Furthermore, the FSA's ability to exercise its supervisory powers to gather information or to require changes in the way that the outsourced function is carried out may be affected adversely. In addition, there may be some circumstances in which the FSA will need to assess the suitability of the service provider and its key staff. This policy is designed to address these concerns without impeding unduly banks' ability to use outsourcing to further their business objectives.
- 3 The FSA recognises that some of this policy will not be appropriate to intra-group outsourcing. Where a particular principle applies only to outsourcing either solely within or alternatively outside the consolidated group this has been clearly stated. Where there is no such statement it should be assumed that the policy applies to both intra- and extra-group outsourcing.

### **3 THE MAIN FEATURES OF THE POLICY**

This section summarises the main features of the policy applying in relation to outsourcing banks. It should be read in conjunction with section 4 below.

#### **3.1 Informing the FSA**

- See s4.1 1 A bank should make the FSA aware, through its normal supervisory channels, of its intention to outsource a task which, materially, either impacts on its systems and controls or affects its risk profile. This should take place in reasonable time to allow the FSA to consider the proposal and to raise any concerns.
- 2 During the course of the outsourcing agreement a bank should make the FSA aware of any material problems encountered with the outsourcing supplier.

#### **3.2 Material outsourcing proposals**

- See s4 3 The FSA expects a bank to be able to analyse the impact outsourcing a particular function will have on its overall risk profile and the bank's internal systems and controls.
- See s4.5 4 A bank should ensure that the FSA has access to any information relevant to the outsourced activity reasonably required by the FSA in connection with the exercise of its functions under the Act.
- See s4.6 5 A bank should ensure that its internal and external auditors have access to any relevant information they require to fulfil their responsibilities.

#### **3.3 The FSA's consideration of banks' outsourcing proposals**

- See s4.1 6 The FSA will consider a bank's outsourcing proposal and raise any concerns that it has. The FSA is aware of commercial pressures involved in outsourcing contracts and will agree with the bank a suitable timescale for response.

## **4 PRINCIPLES OF OUTSOURCING**

### **4.1 General**

1 A bank should make the FSA aware of a material outsourcing proposal in reasonable time to allow the FSA to consider the potential impact of the proposal on the bank and to raise any concerns. The FSA is aware of commercial pressures involved in outsourcing contracts and will agree with the bank a suitable timescale for response. Once a bank has notified the FSA of a material outsourcing proposal, the FSA will determine the level of its ongoing scrutiny of the process and ask the bank to provide further information accordingly.

See ch GN s3

2 Regardless of whether the outsourcing supplier is inside or outside the group, the FSA holds the bank's management responsible for ensuring that the outsourced function is carried out to a proper standard and that the integrity of the bank's systems and controls is maintained. The FSA would expect a member of the bank's senior management to take responsibility for each material outsourced function; this person should be an approved person (see 3.3.24G).

3 In some limited circumstances it is possible that a person employed by a supplier may be subject to the approved persons requirements under the Act. Further details are given in the Supervision Manual.

- a) The scope and principles of the approved persons requirements are set out in Part V of the Act, the High Level Standards for Business and the Supervision Manual.
- b) Applicants apply to the FSA to become approved persons using Form A in chapter 10 of the Supervision Manual.

### **4.2 Principles governing a bank's relationship with its supplier**

See s5.2

4 A bank should monitor and manage on an ongoing basis its relationship with the supplier so as to seek to ensure the integrity of its systems and controls is maintained.

5 The supplier should be a competent, financially sound firm with good relevant knowledge and expertise. The bank should be able to demonstrate that it has taken proper steps to verify this and that it also has procedures for assessing the supplier's performance on a continuous basis. Additionally, the bank should be able to satisfy the FSA that the supplier is committed for the term of the contract to devoting sufficient, competent resources to providing the service.

- a) Where the supplier is a member of the same group as the bank, the latter is likely to have a greater pre-existing level of knowledge about the former. The level of assessment may therefore be reduced.

6 The agreement between the bank and the supplier should provide that the bank is informed of any developments which may have a material adverse impact on the supplier's ability to meet its obligations. This includes, for example, relevant material control weaknesses identified by the supplier's internal or external auditors. The supplier's auditors do not have a responsibility to report any concerns to the FSA. Nonetheless, the bank should ensure that there is a clear reporting line between the supplier and itself so that any material problems relating to the outsourced activity can be communicated and to enable it (or the FSA) to make any further enquiries of its own into such problems.

- a) Where the supplier operates abroad, the Data Protection Act 1998 sets out legal requirements governing the transfer of data across borders.

7 For outsourcing outside the group there should be a right to terminate the contract in the event that the supplier undergoes a change of ownership or the supplier becomes insolvent or goes into liquidation or receivership.

### **4.3 Principles covering service level agreements ('SLAs')**

See s5.4

8 An *SLA* is a negotiated agreement on the standards of service between the supplier and the end-user (the bank). A bank should always have a written SLA in place with its supplier, where the outsourcing is outside the group. The SLA should also provide for periodic reviews and appropriate remedies should problems arise. Such reviews should allow for the relationship to be amended via the SLA or contract as appropriate, on the basis of performance against specified targets.

- (a) Banks may be asked to submit SLAs to their supervisors.

9 Where the outsourcing is intra-group a SLA may not always be appropriate. This is particularly the case where a service is supplied on a group wide basis. In such circumstances the supplier may wish to provide a statement of the standard of service to be provided to the whole group. This statement may be supported by a wide range of other existing relationship management systems. Where these provide a sufficient performance measurement structure a SLA may not be required.

### **4.4 Principles affecting contingency planning**

See s5.5

10 A bank should have and regularly review contingency plans to enable it to set up new arrangements as quickly as possible, with minimum disruption to business, if the contract is suddenly terminated or the supplier fails. The level of detail in such plans may vary. For example, if there are large



numbers of possible alternative suppliers the outsourcer may simply be able to use one of the alternative supplier(s). However, this may still be a complex and time consuming process and a bank should consider how it would deal with the hand-over process. If, on the other hand, the only option is for the bank to resume the activity itself the plan should be far more detailed.

- a) As the contract with an intra-group supplier is highly unlikely to be terminated through the actions of the supplier, the only significant risk is that the service will be interrupted by another unrelated event. Such events should be covered by the supplier's business continuity plan and therefore a separate contingency plan for the bank may not be appropriate.

#### **4.5 Principles governing supervisors' access to information**

11 The contract between the bank and the supplier should ensure that the bank can provide the FSA with any information relating to the outsourced activity that the FSA may require in order to carry out effective supervision, whether the outsourcing is within or without the group, for example, through section 166 reports by a person with relevant professional skill.

12 Where the supplier is based outside the UK, the bank should assess the extent to which the local regulator/regulations may restrict access to information about the outsourced activity.

13 The FSA should be informed if any other regulator raises serious concerns with the bank's proposal to outsource.

#### **4.6 The auditor's role**

14 A bank should have processes in place to identify and deal with any weaknesses in the supplier's procedures which could have a material adverse impact on the service provided to the bank. This could include access for the bank's internal and external auditors, independent reports on the supplier and/or monitoring of detailed performance statistics.

15 In line with the FSA's approach to other areas of banking supervision, where internal or external audit raises material problems the bank should alert its supervisor. The bank should also ensure that it has the management capacity to assess and respond to any such concerns so raised.

#### **4.7 Outsourcing internal audit**

16 All cases of outsourcing internal audit will be considered material.

- 17 A bank should not outsource its internal audit function to either its skilled persons or its external auditors. A bank should have an internal audit function independent from external audit as this segregation of responsibilities would be compromised if the same firm fulfilled both functions.
- See ch AR s3 18 However, the FSA considers that it may be appropriate for certain internal audit services to be provided by the external auditors/skilled persons where the following conditions are met:
- (a) the work is carried out under the overall supervision and management of the bank's own internal audit staff;
  - (b) ultimate responsibility for the adequacy and effectiveness of internal audit lies with the Head of Internal Audit.
  - (c) the Head of Internal Audit is a senior and experienced individual who is an employee of the bank, or the group of which the bank is a part.
  - (d) the FSA is satisfied that the Head of Internal Audit has satisfactory reporting lines. These lines would typically involve unfettered access to the audit committee or at a minimum a non-executive director.
- 19 A bank wishing to use its external auditor/skilled person to perform any part of internal audit's function should notify the FSA of its intention to do so. It need not, however, notify where individual employees of a bank's external auditors/skilled persons are seconded to work within the internal audit function.
- 20 Where internal audit is outsourced to another firm which is not otherwise involved in the auditing or accounting function of the bank, the independence issue does not arise. Therefore, outsourcing proposals meeting this criterion are assessed in the same way as any other function.

#### **4.8 Principles covering sub-contracting**

- 21 The contract should state that if the outsourcing supplier decides to sub-contract further the original outsourcing supplier continues to be contractually liable and the level of service and systems and controls will not deteriorate.
- a) *Sub-contracting* is where the supplier of an outsourced function further contracts out that function to a third party unrelated to the bank or supplier.

## **5 FURTHER AREAS FOR CONSIDERATION**

Banks should have considered the issues raised in this section as the FSA may ask what procedures have been put in place to address these concerns.

### **5.1 General**

- 1 Any voluntary Codes of Conduct adopted by the bank that would have a direct impact on customers could also be observed by the supplier. This step may help to prevent a deterioration in the service received by its customers.

### **5.2 A bank's relationship with its supplier**

#### *5.2.1 General*

See s4.2

- 2 The bank may wish to be aware of the material risks to which the supplier is exposed in relation to the service provided to the bank by the supplier and the corresponding control procedures in place. There might also be provision for relevant management information so that problems, such as a deterioration in service, are brought to the attention of the appropriate individuals in the bank at an early stage. The bank may wish to take steps to seek to ensure that it is clear who is accountable at the appropriate level in respect of such problems. One such mechanism may be through establishing clear lines of escalation both within the supplier and the bank.
- 3 It would be prudent for a bank's management to provide adequate resources at appropriately senior levels to ensure that the relationship with the supplier is properly managed and monitored against performance targets.
- 4 Where the outsourcing supplier is in direct contact with the bank's customers, the bank may wish to establish how its customer relations policies will be reflected by the supplier, for example, answering complaints within a certain time period. Such policies could be measured and factored into any consideration of the supplier's performance. This is important to a bank since any material deterioration in customer relations may adversely affect its reputation. This matter has greater significance if the supplier is external to the group since the supplier might have a different culture.

#### *5.2.2 Termination of contract with the supplier*

See s4.2

- 5 A bank may wish to make provision in the contract to ensure that it does not lose any work or records which are material to the bank's business and has been carried out by the supplier, should the contract be terminated. In

any case it would be sensible for termination clauses to provide adequate notice for the bank to put in place alternative arrangements.

### **5.3 Confidentiality**

6 Confidentiality may not be a significant issue if the outsourcing is within a bank's group. However, the bank may wish to consider whether the confidentiality constraints below need to be fulfilled.

7 Where a supplier deals with a bank's competitors distinct procedures (such as Chinese Walls) may be advantageous in seeking to ensure that there is no breach of client confidentiality. Where the supplier operates abroad, the Data Protection Act sets out legal requirements governing the transfer of data across borders.

### **5.4 Service level agreements ('SLAs')**

See s4.3

8 In order to ensure that there is no confusion over respective duties banks may wish to clearly define what is to be outsourced in their SLA. Additionally the SLA may incorporate the capacity for change (including technological change) or expansion, set out clearly who is responsible for ensuring that work is completed and incorporate details of the reports that the bank might wish to receive from the supplier and their frequency.

9 Where a supplier provides a service for several banks or the bank has peak periods of service, the bank might wish to seek to ensure that a minimum level of resources will be continuously devoted to provide an agreed level of service.

10 For extra-group outsourcing, the contract may provide the option for regular re-tendering. However, for both intra- and extra-group outsourcing, it may be prudent for the relationship to be reviewed, where and when appropriate, but at least annually to take account of all relevant business and environmental changes and the review may also include a financial strength assessment of the supplier.

11 An agreed standard of service between the supplier and the bank might be particularly relevant in the case of extra-group outsourcing. A bank may wish to consider whether the standard of service operated by the supplier needs to be as high as that operated within the bank. Performance targets might be included within the SLA, along with provision for escalation and termination where the targets are not met.

### **5.5 Contingency planning**

See s4.4

- 12 Daily operations and systems problems, such as temporary disruption/suspension of the service, could be included within a plan although this could be covered in the supplier's own contingency arrangements.
- 13 A bank might wish to ask the supplier for information about its own contingency plans, in order to assess the level of comfort it can draw from these plans and consider the implications for its own contingency planning. Where sufficient comfort cannot be drawn the bank may wish to make alternative contingency arrangements either in-house or through an alternative supplier as appropriate.

## 6 APPENDIX – CENTRAL BOOKING

*Central booking* is where the business is carried out in one location or legal entity within a group and booked in the accounting records of another location or legal entity. This general description covers a range of different scenarios, as explained in the remainder of this section: in all cases, the overriding objective is that, however a bank chooses to organise its activities, it must continue to comply with the Principles for Businesses and Threshold Conditions for Authorisation and with its other legal and supervisory obligations, including those relating to the provision of information to the FSA. The FSA expects banks to discuss significant new central booking proposals with their supervisors, in the same way as for any other significant change in its organisational arrangements.

### 6.1 Central booking between different locations of the bank

1 Banks often record transactions in a different physical location to that in which the business is undertaken. This will never fall within the definition of material outsourcing (because a bank cannot, by definition, outsource to itself). A bank should nevertheless satisfy itself that, wherever the various functions associated with its business are physically carried out, the bank complies with its legal and regulatory obligations including (but not limited to):

- (a) the maintenance of adequate accounting and other records and internal control systems;
- (b) the adequacy of provisions, liquidity and capital (where relevant); and
- (c) the provision of information to the FSA (including periodic reporting such as prudential returns and the notifications on large exposures, controllers and close links, and ad hoc requests for information).

### 6.2 Central booking between different legal entities

2 A bank should consider both the legal form and the commercial substance of its arrangements with the other entity in order to establish the true nature of the relationship and therefore the procedures which are appropriate to enable the bank to comply with its obligations. The key consideration is the risks to which the bank is exposed as a result of the transactions undertaken and/or its arrangements with the other party.

3 Material outsourcing issues only arises where the bank records, and bears the risk of, business which is initiated by another legal entity in the group acting in the bank's name (so that clients/counterparties believe that they are dealing with the bank's own staff).

- a) In contrast, where another legal entity in the group acts as broker/introducer for example, it provides a discrete service in its own name to both the bank and customers/counterparties.

Financial Services Authority

*Final Rules – Building Societies*  
*Volume 2 of 2*

**Part of:**

The Interim Prudential  
Sourcebook for  
Building Societies

July 2001



**Interim Prudential Sourcebook for Building Societies**  
**Constitutional Guidance**

**1 APPLICATIONS FOR THE RIGHT TO OBTAIN ACCESS TO  
THE REGISTERS OF MEMBERS OF BUILDING SOCIETIES**

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## **1.1 Introduction**

- 1.1.1 This chapter gives guidance to building societies, and to those members of building societies considering making an application to the FSA about the exercise of the right to obtain access to the registers of members of building societies. This right is governed by the provisions of paragraph 15 of Schedule 2 to the 1986 Act. Since the functions under paragraph 15 of Schedule 2 to the 1986 Act have not been amended by the Act, there is no material change in this guidance compared with the procedure and practice previously adopted by the Commission. Societies should be aware, however, that the Electronic Communications Order 2003 modifies various provisions of the 1986 Act to enable the use of electronic communications between societies, their members and other persons, subject to their consent. In particular, the Order provides for the inclusion of a member's electronic address in the register of members in addition to a postal address. The remaining text of this chapter has not been amended to take account of the Order, but the FSA will in general be prepared to use electronic communication if requested by the society or the applicant and some procedures may have to be adapted accordingly.
- 1.1.2 This guidance is not a definitive interpretation of the 1986 Act. That is a matter for the courts.

## **1.2 Registers of Members**

- 1.2.1 Each society is under a statutory obligation to maintain a register of its members (although the form in which it is maintained is at the discretion of the society). The register must show each member's name and address and whether that person is a shareholding member or a borrowing member. The register must be kept at the society's principal office or such other place or places as the society's directors think fit.
- 1.2.2 Companies are under a statutory obligation to make their share registers available for inspection by the general public. There is no equivalent obligation on building societies with respect to the registers of their members. A society is not required to

allow access to its register other than in the circumstances provided for in paragraph 15 of Schedule 2 to the 1986 Act. Except to the limited extent that access is permitted under that paragraph, a society's register of members is confidential (and subject to data protection legislation).

- 1.2.3 There are two principal reasons for the confidentiality of the registers of members of building societies. First, it is to protect the privacy of members, whether individually or generally, so the fact that a person is either a shareholder in or a borrower from a particular society (or both) is not subject to indiscriminate disclosure. Second, it is to protect the commercial interests of societies given that it could be to their competitive disadvantage if the identities of their shareholding and borrowing members, who are their customers, were readily available to competitor organisations (the identity of whose customers is not so available).
- 1.2.4 However, building societies are mutual associations of members. As such, it is in principle reasonable for members to be able to pursue a direct interest in the business and management of "their" society and to get in touch with each other on matters of mutual concern.
- 1.2.5 Within the framework set out in paragraph 15 of Schedule 2 to the 1986 Act, it is the responsibility of the FSA to balance the rights of individual members generally to privacy, and of societies to commercial confidentiality, with the reasonable right of particular individual members to get in touch with each other on matters relating to the affairs of their society. The confidentiality of the information held on the register can be set aside only where the applicant can make out the case within the exceptional circumstances described in paragraph 15 of Schedule 2. In the opinion of the FSA, the exception is to be considered as much a privilege as a right.

### **1.3 Statutory Framework**

- 1.3.1 Paragraph 15 of Schedule 2 to the 1986 Act governs when and how access to the register of members of a building society may be obtained. Subject to the exception provided for in paragraph 15(1) of Schedule 2, access may only be granted on a direction by the FSA. Paragraph 15(2) of Schedule 2 provides that a member may, if

qualified to do so, make a written application to the FSA to exercise the right to obtain members' names and addresses from the register of the society of which he or she is also a member, for the purposes of communicating with those other members of the society on a subject relating to its affairs. The text of the relevant legislation is at Annex A.

1.3.2 Paragraph 15(1) of Schedule 2 provides for an exception to the requirement to make an application to the FSA. Where the FSA has cancelled a society's permission to accept deposits and the society has not had its permission reinstated by the FSA, a member of that society has the right to obtain the names and addresses of its members from the register without application to the FSA. In this case, the applicant is not required to have been a member for any specified period but the minimum shareholding or minimum mortgage debt requirements described in paragraph 1.3.3 may still apply.

1.3.3 A member is qualified for the purposes of obtaining access under paragraph 15(1) or (2) of Schedule 2 if, under the rules of the society, he or she may join in a members' requisition for a special meeting or in nominating a person for election as a director. This means that the applicant must be an investing or borrowing member of the society. If the society's rules prescribe a minimum investment or mortgage debt the member must hold shares or have a mortgage debt of at least that amount. The minimum cannot exceed £100 in either case (which figure the Treasury may change by Order). In cases covered by paragraph 15(2) of Schedule 2, the society may also require the applicant to have been a member for such period as may be specified in its rules. In most cases this is two years (the maximum permitted by the 1986 Act).

1.3.4 An application under paragraph 15(2) of Schedule 2 is subject to the payment of a reasonable fee, currently £25, to the FSA. Where an application is made, the FSA may direct the society to give the member access to the register provided the FSA is satisfied that:

- (1) the applicant requires the right for the purposes of communicating with members of the society "*on a subject relating to its affairs*"; and

- (2) the applicant has not, since making the application, voluntarily ceased to be a member of the society.
- 1.3.5 The FSA must also have regard to “*the interests of the members as a whole*” and “*to all the other circumstances*”.
- 1.3.6 If access is granted it may only be used to obtain the names and addresses of members for the purposes of communicating with them on a subject relating to its affairs (see also paragraphs 1.5.10 to 1.5.12).
- 1.3.7 Before giving a direction, the FSA is required to give particulars of the application to the building society concerned and to give it the opportunity to make representations. If either the applicant or the society so requests, the FSA must give both the opportunity of being heard by it.
- 1.3.8 A direction given by the FSA may be subject to such limitation or conditions as the FSA may think fit.
- 1.3.9 If the FSA directs that the applicant shall have the right to obtain access to the register, the applicant may apply in writing to the society, describing the subject on which it is proposed to communicate with other members of the society. The society is required to give the applicant all necessary information as to where the register is kept and reasonable facilities (including office accommodation) for inspecting it and taking copies of any names and addresses.
- 1.3.10 The applicant only has the right to take names and addresses from the register. A society may make the information from the register available to an applicant in such a way that only those names and addresses are disclosed.
- 1.3.11 Information obtained by the applicant from the register of the society concerned and relating to a member of that society may not be disclosed to any other persons without the consent of that member whose name and address has been taken from the register. Nor may it be disclosed for purposes not connected with the purposes given at the

time the FSA made its direction. Contravention of these requirements is a criminal offence.

1.3.12 Paragraph 6 of Schedule 14 to the 1986 Act provides that any dispute as to the rights of a member under paragraph 15 of Schedule 2 shall be referred to the FSA and treated as a reference to arbitration; and its award shall have the same effect as that of an arbitrator in a reference under paragraph 4(1) of Schedule 14.

## **1.4 Making an Application**

1.4.1 Applications must be made to the FSA in writing in the form of Annex B to this chapter.

1.4.2 Each application must be accompanied by the prescribed fee, which is currently £25 (cheques should be made payable to the Financial Services Authority). This fee is not refundable in any circumstances.

1.4.3 Should an applicant wish to obtain access to the registers of more than one society (the applicant must, of course, be a qualified member of each of them), there must be a separate application, for each of which a separate fee must be paid.

1.4.4 The FSA will acknowledge all applications within 5 working days of receipt.

1.4.5 To assist the FSA in its consideration of an application, and the society in making any representations on it, the application should set out clearly and concisely the issues about which the applicant wishes to communicate with other members and the purposes in doing so. In addition to this statement, the FSA requires at the time of the initial application a draft of the communication that would be sent should the FSA direct the society to give the applicant access to the register.

1.4.6 Without prejudice to its consideration of an application in any particular case, applicants should note the following general guidelines when preparing an application:

- (1) the FSA will expect the member making the application to have read carefully the relevant provisions of the 1986 Act and this chapter;
- (2) it is important to be specific about the purpose of the application, how it relates to the affairs of the society and why and how access to the register of members is necessary to achieve the applicant's objective;
- (3) an applicant should think carefully about the purpose and content of the proposed communication before making the application so as to minimise the need for substantive changes to it at a later date;
- (4) an application may be supported by such information or documents as the applicant may wish, but these will be considered to form part of the application, will be seen by the society and be open to comment by it;
- (5) where an applicant submits two or more applications (together or in quick succession) it should be made clear as to why access to the register of members of each of the societies is necessary and how the purpose of each application relates to the affairs of that society;
- (6) should an applicant be successful he or she will incur expenditure in taking names and addresses from the register and then producing and mailing the communication and the applicant should take this into account before submitting an application.

## **1.5 Considering an Application**

1.5.1 The FSA will consider, first, whether the application contains all the relevant information. It may ask the applicant to provide further information or clarify what has already been given.

1.5.2 If, in the opinion of the FSA, the application is defamatory, frivolous or vexatious, the FSA may decide that it would be inappropriate to consider it further. The applicant will be informed of such decision as soon as practicable. In such cases the FSA may

give the applicant an opportunity (normally only once) to revise the application to take the FSA's opinion into account. If a revised application is received by the FSA within 10 working days of the FSA's notice that the previous application was unacceptable (or such other period as the FSA may, in the circumstances, consider reasonable), a further fee will not be payable.

- 1.5.3 If the FSA is satisfied that the application provides all the relevant information and is, on the basis of that information, a valid application for the purposes of paragraph 15 of Schedule 2, the FSA will send the application, together with any supporting information or documents provided by the applicant, to the society. The society will be asked to confirm that the applicant was qualified to make the application at the time it was made and, if so, invited to make written representations on it to the FSA. The FSA will also ask the society whether it wishes to make oral representations at a hearing held by the FSA. The FSA will normally expect a society to submit its representations, or to confirm that none are to be made, within 15 working days of receipt of the copy of the application.
- 1.5.4 Once the FSA has received the society's written representations, together with any supporting information or documents, a copy will be sent to the applicant with an invitation to make written comments on them to the FSA. The FSA will also ask whether the applicant wishes to make oral representations, irrespective of whether the society has indicated that it would wish to do so. The FSA will normally expect an applicant to provide written comments or to confirm that none are to be made within 15 working days of receipt of the invitation.
- 1.5.5 Once the FSA has received the applicant's written comments, a copy of them will be sent to the society. This will normally be for information only. However, in any case where, in the opinion of the FSA, the applicant has introduced new matters which can properly be dealt with as part of the existing application, the society will be given the opportunity to make further representations. If the applicant has introduced new matters which, in the opinion of the FSA, cannot properly be dealt with as part of the existing application, the FSA may ask the applicant to make a new application or it may disregard the new matters for the purposes of the application under consideration. In the latter case the FSA will inform the applicant accordingly.



1.5.6 The FSA may seek further information or other documents from either the applicant or the society at any time.

1.5.7 Paragraph 15(2) of Schedule 2 sets out the criteria to which the FSA should have regard in considering an application:

(1) the purpose of the proposed communication must be on “*a subject relating to its (the society’s) affairs*”;

(2) the FSA should have “*regard to the interests of the members as a whole*”;

(3) the FSA should have “*regard ... to all the other circumstances*”.

1.5.8 Paragraph 15(3) of Schedule 2 provides that the FSA may give a direction “*subject to such limitations or conditions as the Authority may think fit*”.

1.5.9 The FSA will consider each application on its merits. The purpose of the guidance in paragraphs 1.5.10 to 1.5.20 is to give a broad indication of the FSA’s approach and the criteria to which it will have regard.

**“*a subject relating to its (the society’s) affairs*”**

1.5.10 The 1986 Act does not define “*affairs*”. As a general proposition, the FSA considers that “*affairs*” will primarily relate to matters connected with the society’s finances, its business activities and the manner in which it carries on those activities, and not just to the applicant’s personal affairs. Bearing in mind the considerations discussed in paragraph 1.2.3, the matters about which the member wishes to communicate with other members, will, in the opinion of the FSA, normally need to be of a substantial nature and must relate to the particular society concerned. The FSA will expect the applicant to demonstrate not only why he or she is personally concerned about, or affected by, these matters (rather than simply being concerned or affected in some more general way) but also why it is necessary that this concern is communicated direct to other members.

1.5.11 Paragraph 15 of Schedule 2 requires each application to be considered separately by the FSA so that it cannot consider applications with the same, or similar purpose, or related to the same, or similar issue, as if they were a “class application”. So, for example, an application from a member wishing to obtain the required support of other members to stand for election to the board of directors of a society will be considered individually and on its merits, notwithstanding any previous decision the FSA may have taken on an application with the same, or similar, purpose.

1.5.12 The FSA will wish to be satisfied that the wording of the communication is consistent with the stated purpose of the application. It may invite the society to comment on the communication but the society cannot itself stipulate what its terms should be.

***“the interests of the members as a whole”***

1.5.13 The FSA will balance the wider interests of the membership as a whole with those of any one individual member or group of members. The FSA will require the applicant to demonstrate that the communication raises matters which are likely to be of interest to the society’s members generally or at least a substantial section of them. The FSA will take into consideration any evidence of support from other members of the society, should the applicant claim that this has already been given.

1.5.14 Whilst the right to make an application is open to all qualified members of the society, the FSA is of the opinion that, as a general proposition, access to the register is not an appropriate vehicle for the pursuit of a private grievance between a member and the society or the pursuit of a more general campaign affecting the building societies sector as a whole. The Act provides for a reference to the Financial Services Ombudsman for the investigation of a customer complaint and the 1986 Act provides for a reference to the High Court (in Scotland, the Court of Session) for the resolution of a membership dispute.

1.5.15 The 1986 Act does not require that a person who is given access to the register must write to all the members. To do so would mean that the right of access was of little practical value. In the opinion of the FSA, it is acceptable for the applicant to write,

for example, to a random selection of members or to those living in a particular geographical area. However, the FSA may require the communication to indicate whether or not it has been sent to all the members or only a proportion of them (and, if so, on what basis that proportion was selected).

***“all the other circumstances”***

- 1.5.16 The circumstances that may be appropriate for the FSA to take into account can only be identified in the particular case at the particular time. As a general proposition, the FSA will take into account any relevant information in respect of the applicant’s relationship with the society. This could include, for example, previous applications for access to the register. The FSA will also take into account whether the applicant has raised the issue about which he or she is concerned at the society’s annual general meeting or whether he or she would be able to do so at a future meeting. The FSA will at the same time take into account any evidence that the society has attempted to frustrate the member’s legitimate right to speak on the issue at the annual general meeting or seems likely to do so on a future occasion.
- 1.5.17 The FSA will also take into account the likely effect on building societies generally should the applicant be given access to the register of members of a particular society and write to the other members as proposed. It will consider whether, should it direct that an applicant be given access to the register of one society, this could have any adverse impact on other societies, for example, a possible risk to confidence. The FSA will also expect the applicant to explain why it is not possible to obtain support in some other way and so why it is necessary to have the privilege of accessing the register of members. The FSA will expect an applicant to show an awareness of these wider considerations and will wish to be assured that they will be appropriately reflected in both the tone and the content of the communication.
- 1.5.18 An applicant will be expected to disclose to the FSA whether he or she is acting in a purely personal capacity or on behalf of, or in concert with, any other person or institution, or whether he or she has an interest in the society beyond the fact of being a member of it. Where the applicant has not made such a disclosure, but the FSA has reason to believe that he or she may be acting for or in concert with another party, the

FSA will make enquiries to establish the facts and will invite the applicant to comment on its findings. Each application to inspect the register of members is considered on its merits. Where an application is made by a member whom the FSA considers to be in effect acting on behalf of a third party commercial institution, it will in particular have regard to: (a) the nature of the member's own interest in the application and the third party institution's objectives; (b) the interest of members as a whole in preserving privacy and the society's right to commercial confidentiality in its membership list; (c) any interaction between the application and the detailed and mandatory procedures under the 1986 Act governing mergers of building societies or as the case may be transfers of business to commercial companies; and (d) other means open to the member and the third party institution to communicate with members on the relevant subject. The interests of the members as a whole should not be confused with the personal interests of one or more individual members.

***“such limitations or conditions as the Authority may think fit”***

1.5.19 The 1986 Act imposes a specific restriction on any person who has taken information from the register of members. That is, the information may not be further disclosed (by that person or anyone to whom the information has been disclosed in accordance with the direction given by the FSA) except with the consent of the member to which it relates or for the purposes for which the 1986 Act provides. This is an essential safeguard against the abuse of the privilege of being given access to the register of members and contravention of the restriction is a criminal offence.

1.5.20 The FSA will consider what limitations or conditions it should properly attach to a direction in each particular case. However, and without prejudice to the exercise of its discretion, the FSA will normally consider limitations or conditions in the following areas:

- (1) whether the information taken from the register may be further disclosed and, if so, those to whom it may be disclosed and, in particular, if the FSA decides to direct access to the register of members in the circumstances outlined in paragraph 1.5.18, it will impose such conditions as may be necessary to ensure that the third party institution does not directly or indirectly gain access to the

information in the register or use the proposed communication by the applicant with other members to damage the society;

- (2) that the communication must be in writing and addressed separately to each of the members to whom it is sent;
- (3) that the material terms of the communication sent must be those seen by the FSA at the time it reached its decision on the application;
- (4) that the communication is accurate, is not offensive, is not misleading (including any inference that the communication is being made by, or on behalf of, the society), is not likely to bring about a loss of confidence in the society (or in societies generally) or otherwise harm its current or future business;
- (5) that the communication must be sent within a specified time;
- (6) that the applicant is given a specified period during which the relevant information is to be made available.

## **1.6 Oral hearings**

1.6.1 Should either the society or the applicant ask for an opportunity of being heard by the FSA, then it will invite both parties to attend a hearing. If neither party so requests, the FSA will normally decide the application on the basis of the written evidence available to it, including the application, the society's comments (paragraph 1.5.3) and the applicant's written comments (paragraphs 1.5.4 and 1.5.5) together with the results of any enquiries the FSA itself may have made.

1.6.2 If there is an oral hearing this will normally be taken by one or more persons authorised by the FSA to act on its behalf.

1.6.3 The FSA will normally give the applicant and the society not less than 10 working days formal notice that there will be a hearing, including the place and time at which it will be held.

- 1.6.4 The hearing will normally be held in public. However, if either the applicant or the society requests that the hearing be held in private, the person(s) taking the hearing will listen to arguments from both parties before deciding whether to admit the public (which may include representatives of the media).
- 1.6.5 Whilst the proceedings will be comparatively informal, the applicant and the society may, if they wish, be legally represented. In any such case, the FSA must be notified at least 5 working days in advance of the hearing so that it may inform the other party. The applicant and the society may also be assisted by such other persons as the FSA considers reasonable in the circumstances.
- 1.6.6 The person(s) taking the hearing will introduce the proceedings and deal with any preliminary matters. The applicant and the society will then each be invited to present their cases, in that order. Each will have the opportunity to comment on the case presented by the other. The person(s) taking the hearing may ask such questions as they consider necessary, particularly to establish or elucidate matters of fact, but will not respond to questions from either of the parties. This procedure may be varied according to the circumstances of the particular case.

## **1.7 Deciding an Application**

- 1.7.1 The person taking the hearing will not normally announce a decision at the hearing or give any indication as to the FSA's likely decision.
- 1.7.2 The FSA's decision with reasons will always be given in writing. The FSA will normally expect to issue its decision within 15 working days of a hearing. A copy will be sent to the applicant and to the society.
- 1.7.3 The FSA will make its decision public. It would also normally expect to make copies of its written decision with reasons available to those interested to see it. It may decide not to do so, however, where it considers that publication could be prejudicial to the interests of shareholders or depositors in or with the society. The FSA will, if

either applicant or society objects to the publication of its written decision, give both parties the opportunity to make representations to it.

**EXTRACT FROM THE 1986 ACT**

**Schedule 2, paragraph 15**

*“Right of members to obtain particulars from the register*

*15. (1) At any time when a building society -*

*(a) has had its permission under Part IV of the Financial Services and Markets Act 2000 to accept deposits cancelled;*

*and*

*(b) has not subsequently been given such permission,*

*a member of the society shall, subject to sub-paragraph (1A) below, have the right to obtain, from the register kept under paragraph 13 above, the names and addressees of members of the society, for the purpose of communicating with them on a subject relating to the affairs of the society.*

*(1A) Sub-paragraph (1) above shall not apply unless the member in question*

*(a) is qualified under the rules of the society to join in a members’ requisition for a special meeting, or to join in nominating a person for election as a director; or*

*(b) would be so qualified if any requirements as to length of time a person must have been a shareholding or borrowing member were omitted.*



*(2) If, at any time not falling within sub-paragraph (1) above, a member of a building society who is qualified under the rules of the society to join in a members' requisition for a special meeting, or to join in nominating a person for election as a director, makes a written application to the Authority for the right to obtain names and addresses from the register, the Authority -*

*(a) if satisfied that the applicant -*

*(i) requires that right for the purpose of communicating with members of the society on a subject relating to its affairs; and*

*(ii) has not, since making the application, voluntarily ceased to be a member of the society; and*

*(b) having regard to the interests of the members as a whole and to all the other circumstances;*

*may direct that the applicant shall have the right to obtain from the register the names and addresses of the members for the purpose of communicating with them on that subject.*

*(2A) The Authority may charge a reasonable fee for considering an application under sub-paragraph (2) above.*

*(3) Any direction under sub-paragraph (2) above may be given subject to such limitations or conditions as the Authority may think fit.*

*(4) Before giving a direction under sub-paragraph (2) above, the Authority shall give particulars of the application to the building society and shall afford the society an opportunity of making representations with respect to the application; and the Authority shall, if the applicant or the society so requests, afford to the applicant and to the society an opportunity of being heard by it.*

*(5) A member entitled under this paragraph to obtain the names of members of a building society may apply in writing to the society, describing in the application the subject on which he proposes to communicate with other members of the society; and the society shall give him all necessary information as to the place or places where the register, or part of it, is kept, and reasonable facilities for inspecting the register and taking a copy of any names and addresses in the register.*

*(6) A building society shall not be obliged to disclose to a member making an application under this paragraph any particulars contained in the register other than the names of the members and their addresses, and may construct the register in such a way that it is possible to disclose the names and addresses to inspection without disclosing any such other particulars.*

*(7) No information obtained under sub-paragraph (1) or (2) above or this sub-paragraph and relating to a member of the society may be disclosed except -*

*(a) with the consent of that member; or*

*(b) in the case of information obtained under sub-paragraph (1) or (2) above, for purposes connected with the purpose mentioned in that paragraph.*

*(8) Any person who discloses information in contravention of sub-paragraph (7) above shall be liable -*

*(a) on conviction on indictment, to imprisonment for a term not exceeding two years or to a fine or both; and*

*(b) on summary conviction, to a fine not exceeding the statutory maximum.*

**APPLICATION FOR THE RIGHT TO OBTAIN ACCESS  
TO THE REGISTER OF MEMBERS OF A BUILDING SOCIETY**

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*This form is to be completed by a member of a building society who wishes to be given access to the register of members of the building society of which he or she is a member in accordance with paragraph 15 of Schedule 2 to the Building Societies Act 1986 (as amended by and under the Financial Services and Markets Act 2000) and who is qualified under that paragraph to make such an application. Before completing this form you are advised to read the guidance published by the Financial Services Authority.*

*On completion this form should be sent to the Financial Services Authority, 25 The North Colonnade, Canary Wharf, London E14 5HS. Copies of this form and the guidance may also be obtained from this address.*

---

**1. Name of the society of which you are a qualified member to whose register of members you wish to be given access:**

**2. Name and address of applicant:**

**Name**

**Address**

**Telephone**

**3. Share account details**

**Account name (s)**

**Account number (s)**

**4. Mortgage account details**

**Account name (s)**

**Account number (s)**

**NOTE**

If the name and/or the address in which you hold either or both of the above accounts are different from the name and address given for the purposes of this application, please specify that in which it/they are held.

**Name**

**Address**

5. Please specify the subject on which you wish to communicate with other members of the society and the points you would wish to make in your communication. Please also enclose a draft of your proposed communication.

6. If there is any other information or documents, in addition to your draft communication, you would wish to form part of your application, please specify.

**DECLARATION**

7. I declare that I am qualified under the rules of the society named above to make this application.

8. I understand that this application form, and any information or documents enclosed with it, may be sent to the society, which may make representations about it to the FSA.

9. I have read and understand the statutory restrictions which will restrict me from disclosing any information I take from the register if I am given access to it.

10. I enclose payment of £25 in respect of this application. I understand that this fee is not refundable.

**Signed** .....

**Date** .....

## Interim Prudential Sourcebook for Building Societies

### 2. MERGER PROCEDURES

#### G

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## DEFINITIONS

“the 1986 Act”	the Building Societies Act 1986 <sup>1</sup>
“the Authority”	the Financial Services Authority
“amalgamation agreement”	a formal agreement between societies on the terms of their amalgamation
“the board”	the board of directors of a building society
“the BSA”	the Building Societies Association
“borrower” or “borrowing member”	a person who is indebted to a society in respect of a loan fully, or where the Rules so provide, substantially secured on land
“the Central Office”	the department of the Authority carrying out the registration functions transferred from the Central Office of the Registry of Friendly Societies
“this chapter”	this chapter of the IPSB on Merger Procedures
“the Commission”	the former Building Societies Commission
“DTI”	the Department of Trade and Industry, Industrial Relations Division
“Fees Rules”	the Rules made by the Authority from time to time under paragraph 17 of Schedule 1 to the Financial Services and Markets Act 2000 prescribing the fees to be paid in connection with the discharge of its functions under the 1986 Act.
“First, Second, Third Criterion”	see “the Three Criteria”
“Instrument of Transfer”	the Instrument of Transfer of Engagements required by Section 94(6) of the 1986 Act
“the IPSB”	the Interim Prudential Sourcebook for building societies
<i>"listed"</i>	included in an <i>official list</i> .

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<sup>1</sup> As amended by and under the Building Societies Act 1997 and the Financial Services and Markets Act 2000. The 1986 Act has also been amended by other legislation.

“member”	a shareholding or borrowing member of a society
“Memorandum”	the Memorandum of a building society required by paragraph 2 of Schedule 2 to the 1986 Act
“merger”	an amalgamation or transfer of engagements
“Merger Document”	the document or booklet containing the Schedule 16 Statement
“Merger Notification Statement”	a statement sent to members in the circumstances described in section 6
“Merger Resolutions”	the shareholding members’ resolution and borrowing members’ resolution required to approve a merger where no direction under Section 42(B)(3) has been given
"official list"	(a) the list maintained by the FSA in accordance with section 74(1) of the Financial Services and Markets Act 2000 (The official list) for the purposes of Part VI of the Act (Official Listing);  (b) any corresponding list maintained by a competent authority for listing in another EEA State.
“OFT”	the Office of Fair Trading
“PIBS”	Permanent interest-bearing shares, a type of deferred share
“proxy voting form”	an instrument appointing a proxy to attend a meeting of a society and vote on the member’s behalf
“rationale”	the explanation of the reasons for a proposed merger provided to the members of a society by its board of directors
“the Rules”	the Rules of a building society
“Schedule 16 Statement” or "the Statement" the	the statutory statement required by Schedule 16 to the 1986 Act to be sent to every member entitled to notice of a meeting of society
“section”	a section of this chapter
“shareholder” or “shareholding member”	a person holding a share in a society (by investing in one or more share accounts or holding PIBS or other deferred shares).
“society”	a building society

“successor society”	a society accepting a transfer of engagements or the new society in the case of an amalgamation
“the Three Criteria”	the criteria prescribed by Section 95(4) of the 1986 Act which the Authority has to consider when deciding whether to confirm a merger <sup>2</sup>
“transferee society”	a society accepting a transfer of engagements from another society
“transferor society”	a society transferring its engagements to another society
“UKLA”	<del>the UK Listing Authority (currently the Authority).</del>

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<sup>2</sup> The Three Criteria are varied in certain circumstances - see section 6.

# MERGER PROCEDURES

## 1. INTRODUCTION

### **Purpose of the chapter**

- 1.1 This chapter replaces the Merger Procedures Guidance Note issued by the Commission in May 1999. It gives guidance on the requirements of the 1986 Act, as amended by and under the Financial Services and Markets Act 2000, under which certain functions of the Commission were transferred to the Authority. However, since the nature of the transferred functions remains substantially unaltered, there is no significant change in this guidance compared with the guidance previously issued by the Commission on the procedures to be followed by a building society proposing to merge with another building society. **This chapter is not intended to be exhaustive and is not a substitute for looking at the 1986 Act and the Mergers Regulations 1987 (SI 1987/2005) as amended by the Mergers (Amendment) Regulations 1995 (SI 1995/1874), the Merger Notification Statements Regulations 1999 (SI 1999/1215), where applicable, and a society's own Rules. Nor is it a substitute for the society seeking its own legal advice.** It gives a description of the relevant provisions of the 1986 Act, of the information which must be made available to the Authority and to societies' members, together with an outline of the procedures to be followed at general meetings, and the voting majorities required to pass the Merger Resolutions which the members are to be asked to approve. This chapter describes the role of the Authority in approving the statements to members under Schedule 16 to the 1986 Act, in its prudential supervision of mergers, and in confirmation hearings. It also gives a broad indication of the way in which the Authority may be expected to exercise its discretionary powers. **Except as described in section 6, to which section 7 of this chapter also applies, this chapter is concerned only with voluntary Mergers under Sections 93 and 94 of the 1986 Act.**
- 1.2 It is for the boards of societies to assess the case for a merger, and they must explain and recommend their decision to their members. However the Authority's staff are available to give advice on the procedures to be followed and the information required to ensure that the members can reach fully informed decisions. **Societies are strongly recommended to consult the Authority early on in the formative stages of merger**

**discussions.** Such consultation will, of course, be treated in the strictest confidence. It will also be helpful to have regard to the indicative timetable set out in paragraph 8.3.

- 1.3 Societies should consult their own legal advisers about the application of the provisions of the 1986 Act, and the general law, to the particular features of a proposed merger.
- 1.4 This chapter considers each stage of the merger procedure in chronological order. The remainder of this section gives a synopsis of the relevant requirements of the 1986 Act, which are then discussed in more detail in subsequent sections.

*Section 2, Preliminary Matters,* considers the rationale for a merger and its terms and the handling of public announcements, and gives guidance on certain prudential issues.

*Section 3, Information Provided to Members,* discusses the form and content of the statutory Schedule 16 Statement and the accompanying rationale and statements by the board of the society, and describes the form of application to be made to the Authority for approval of the Statement.

*Section 4, General Meetings and Resolutions,* discusses the resolutions and majorities required to pass them, the notice of meeting, the register of members and members' entitlement to vote, the arrangements for general meetings and the scrutineers' report. It also describes the Authority's discretionary powers.

*Section 5, Confirmation,* describes the form of application to the Authority for confirmation of a merger, and the procedures which the Authority expects to follow in considering and hearing written and oral representations and in reaching its decision.

*Section 6, Transfer of Engagements under Direction,* describes the modified procedure to be followed when a society has been directed by the Authority to transfer its engagements to another society and/or to proceed by board resolution.

*Section 7, Registration and Dissolution,* briefly discusses the process of registration of amalgamations or transfers of engagements and dissolution of the amalgamated or transferor societies.

*Section 8, Timetable*, reviews the expected timetable, including statutory notice periods, which may be expected to apply to a merger from start to finish.

## **Statutory Requirements**

- 1.5 The statutory provisions concerning mergers are in Sections 93 to 96 of, and Schedule 16 to, the 1986 Act, where three types of transaction are provided for:

**Amalgamation**, where two or more societies unite to form a new “successor” society;

**Transfer of engagements**, where a society (the transferor) transfers its membership and the whole of its undertaking to another (the transferee), which then continues as before; and

**Partial transfer of engagements**, where a society transfers only a part of its membership and business to another society (for example, some outlying branches).

The procedures for all three are much the same, and the differences are explained in the relevant sections of this chapter. The Authority’s practice as described in this chapter is derived exclusively from previous experience of transfers of engagements because, so far, there have been no amalgamations nor partial transfers under the 1986 Act. However, it is not expected that the Authority’s handling of amalgamation procedures would be significantly different from what is described here.

- 1.6 The purposes of the provisions of the 1986 Act are to ensure that the members are given all the material information they need about the terms of the merger which they are asked to approve and a proper opportunity to cast their votes. Subsequently, they are to be given the opportunity to make representations about that process before the merger is confirmed.
- 1.7 The 1986 Act makes no provision for a merger to be initiated by any other means than a proposal by a board put to the society’s members. It requires that each member who is entitled to receive notice of the general meeting at which the Merger Resolutions are to be moved must also receive a copy of the Schedule 16 Statement. A merger must be approved by a **shareholding members’ resolution** and a **borrowing members’ resolution**. There is an additional voting requirement for the approval of a partial transfer of engagements.

- 1.8 If the terms of a merger include provision for the payment of **compensation to directors or other officers** for loss of office or of income, then the proposed payments must be approved by a separate **special resolution**. A further special resolution may also be required if there is to be a distribution to members which exceeds the limits described in paragraph 4.4.
- 1.9 Sections 93 to 96 of the 1986 Act specify certain procedures for the consideration of representations by interested parties concerning **confirmation**, and the criteria which the Authority must consider before deciding whether or not to confirm a merger. The Authority may not consider matters concerning the merits of merger proposals or the fairness of the terms which the members have approved by passing the Merger Resolutions.
- 1.10 The statutory requirements of the 1986 Act are explained and discussed in more detail in subsequent sections of this chapter. In addition, societies and their advisers must have regard to the legislation mentioned below.
- 1.11 **Fair Trading Act 1973:** societies should inform the Office of Fair Trading of a proposed amalgamation or transfer of engagements where, currently, the merged society will have a market share in the UK, or in any substantial part of the UK, of at least 25%, or where the assets of the transferor society exceed £70 million. The OFT will then advise whether or not the Director General of Fair Trading proposes to recommend to the Secretary of State that the merger be referred to the Competition Commission. In some cases the OFT may wish to discuss the proposal with the societies before deciding. It is essential that any submission to the OFT is undertaken at the earliest possible opportunity since, should the Secretary of State decide to refer a merger to the Competition Commission that would be a “material fact” to be disclosed in the Schedule 16 Statement, unless it is impracticable to put the matter to members until the Competition Commission has reported. Societies may need to consider the Competition Act 1998 when planning a merger. However, the merger control structure described above is left in place by the 1998 Act, although with some amendment.
- 1.12 **Transfer of Undertakings (Protection of Employment) Regulations 1981 (SI 1981/1794):** These Regulations have the effect that the employees of a transferor society automatically become the employees of the transferee society following the merger. They require, in particular, information to be given in certain cases to employees’ representatives, long enough before the merger takes place, to enable



consultations to be held between the society and those representatives. Failure to inform or consult in this way is a ground for reference of the matter to an industrial tribunal and there are other significant provisions. Societies are advised to consult “Employment Rights on the Transfer of an Undertaking” (Employment Legislation Pack Booklet No: PL699) which explains the Regulations and is available from the DTI Order Line (Tel: 0870 1502500).

1.13 **Taxes Acts:** Societies should take advice on the timing and amount of tax liabilities.

1.14 **Electronic Communications Order 2003:** Societies should be aware that this Order modifies various relevant provisions of the 1986 Act. This enables the use of electronic communications between societies, their members and other persons on matters relating to a proposed merger, such as the Schedule 16 statement and the voting arrangements. The Order requires that societies must obtain consent before using electronic means of communication. The remaining text of this chapter has not been amended to take account of the Order. A society proposing to use electronic communications in relation to a merger will need to take its own legal advice as to how the procedures described in this chapter will have to be adapted. In that event the FSA will also adapt its own procedures appropriately.

## **2. PRELIMINARY MATTERS**

### **Rationale for a Merger**

- 2.1 It is a matter for the board to decide whether to recommend a merger to its members. The overriding duty of the board is to reach a view having regard to what is in the best interests of the society, and its members as a whole, both present and future, borrowing members and shareholding members. The board may also reasonably consider the interests of customers who are not members, of the staff, suppliers of goods and services, and of the wider community.
- 2.2 A well planned and well matched merger can benefit both the shareholding and borrowing members and the staffs of both societies by producing a combined society with the financial strength and management expertise and experience needed to compete successfully in the market place. It must be recognised, however, that in many instances it will take time for economies of scale to be achieved and a careful assessment of projected costs is essential to a realistic view of whether such economies are likely to be achievable. On the other hand, a merger between two weak and over-extended societies may produce an even weaker one. It is better to negotiate a merger from a reasonably secure position than to be obliged to seek a merger when the society has become too weak to carry on as an independent entity.
- 2.3 This chapter cannot deal exhaustively with all the factors to be taken into account by a board when deciding whether to recommend a merger to its members. Moreover, there will be factors peculiar to particular cases. However, the following paragraphs draw attention to those matters which the Authority expects boards to consider in all cases.
- 2.4 Consideration of a merger can normally be expected to emerge from the board's regular consideration of the strategic options available to the society. That is not to say that merger as a transferor society should always figure as an option in every society's corporate plan. On the other hand, every board should be alive to business trends which point to, or which, if not altered, will point to, the need to consider options for merger. In short, a merger should be foreseen and planned. Alternatively, of course, a board which wishes its society to remain independent must have a clear strategic view of how that can be achieved in a variety of realistic planning scenarios. Whether or not a board is considering a merger, it should as a matter of prudence,

know how it would respond to a proposal or counterproposal to merge or to transfer its business to a commercial company.

- 2.5 If a board foresees the possibility of a merger, then it should plan for that eventuality. Societies which see themselves as transferees will need to consider the desired characteristics of potential partners, including, for example, geographical presence, mortgage book quality, and product market share. Societies contemplating the transfer of their engagements will need to consider whether the interests of their members would best be served by a local or regional alliance or access to a national network of branches and services. Although the interests of shareholding and borrowing members are paramount, boards also have an obligation to consider the consequences of merger options upon the terms and conditions of employment and job prospects of their staff, and the interests of their pensioners. It is also reasonable, particularly for local and regional societies, to consider the implications for the local economy, where, for example, a regional or head office may eventually be closed to achieve economies of scale.
- 2.6 The range of issues which both boards have to consider will vary from case to case and is for the board to decide. At one end of the scale there will be the case where a small society merges with a large one and, at the other end, where two or more societies of broadly comparable size join to form one significantly larger. Whatever the proposal under consideration the board will necessarily have regard to this primary duty to reach a view on what is in the best interests of the society, and its members as a whole. It will also be conscious of the need to give an account of the board's rationale in recommending the merger to members, in particular if a statutory merger statement is included in the Merger Document (see paragraph 3.23).

### **Terms of a Merger**

- 2.7 The terms negotiated between the parties in a merger will be set out in a formal agreement. In the case of a transfer of engagements, Section 94(6) of the 1986 Act requires the "extent of the transfer", and in practice the other agreed terms, to be recorded in an Instrument of Transfer. For an amalgamation, Section 93(2) of the 1986 Act requires the parties to agree on a Memorandum and Rules for the successor society, and each to approve the terms of the amalgamation by Merger Resolutions, so that there must be agreement on the terms. The Authority will expect the Instrument of Transfer or amalgamation agreement to be signed before the Authority approves

the Schedule 16 statement, although it will be conditional on, among other things, approval by members and confirmation by the Authority. In both cases the boards of the societies will have approved the Instrument or agreement and the Schedule 16 statement and, in the case of an amalgamation, the Memorandum and Rules of the successor society. Before such approval by the boards, drafts of the proposed Memorandum and Rules should have been cleared with the Central Office. The Rules of transferee societies should provide that members of transferor societies are not disenfranchised for any period after the merger is effected (see paragraph 3.16 and rule 4(9) of the BSA Model Rules 5th edition).

2.8 Although vesting of the “property, rights and liabilities” of the transferor society in the transferee society on completion of a transfer of engagements is a statutory process by virtue of Section 94(8) of the 1986 Act, the Instrument of Transfer performs an important function. Not only is it required by the 1986 Act, but it is required to identify the extent of the transfer (Section 94(6)), since a transfer can be of all or part of the engagements of the transferor society. Thus, on a transfer of all the engagements of a society, the Instrument of Transfer should include a specific statement that all are included. If the transfer is of part only, then the instrument should specify precisely what is being transferred. As explained, an amalgamation agreement is required in practice for all amalgamations, but again the actual process of transferring the assets of the societies to, and vesting them in, the new society is by operation of the 1986 Act. Section 93(4) of the 1986 Act, which does this, does not allow for exceptions to the vesting since the nature of an amalgamation is that all the assets of all the societies are vested in the successor society.

2.9 The Instrument of Transfer, or amalgamation agreement, will also allow matters of detail to be recorded. So it will contain, for example, provision for:

- (a) any changes to the terms and conditions of PIBS and share and deposit accounts, including the integration of the product lines of the transferor society(ies) into those of the transferee or successor society;
- (b) any changes to the terms and conditions of mortgage accounts and other loans;

- (c) any bonus to be paid to members;
- (d) the terms and conditions on which staff will be employed or made redundant;
- (e) pension scheme arrangements;
- (f) integration of operations;
- (g) the terms and conditions on which directors and other officers are to continue in office or cease to hold office, including the posts they will hold and any extra-contractual compensation to be paid for loss of office or reduction in emoluments;
- (h) the specified target date for completion of the merger, bearing in mind that the actual date is a product of the 1986 Act (Sections 93(3)(b) & (4) and 94(8)), and for action if that date is not achieved;
- (i) any conditions precedent, such as members' votes and the Authority's confirmation, and for the circumstances in which the Instrument or amalgamation agreement might be terminated.

*Bonus Payments to Members*

2.10 Whether any bonus is to be paid to members and, if so, its amount and distribution, are matters to be agreed by the boards of the societies concerned and to be approved by their members, subject to the discretion described in paragraphs 4.41 and 4.42. However, the Authority will wish to be satisfied that the combined society will maintain a prudent solvency ratio after the bonus is paid. A bonus may, for example, be paid to the members of a transferor society with a higher capital ratio than the transferee society so as to equalise the reserves which both bring to the combined society. If it is thought desirable also to pay a bonus to the members of the transferee society, then the reserves of the combined society may be "equalised" at a level below the capital ratio of the transferee society, but only if it is prudent to do so. The statutory requirements for approval of bonus payments are described in paragraph 4.4.

2.11 A bonus is a distribution of the funds of either or both societies, and may be paid by a number of methods, or some combination of them, including, for example: a flat rate lump sum; a sum calculated as a percentage of balances; or an increase or (for mortgage accounts) a decrease in the interest rates paid or charged for a limited period. Maintenance of interest rate differentials existing before the date of completion of the merger between those offered by (say) the transferor society and the transferee society would not normally be characterised as a bonus. However, each society, and the Authority, will wish to be satisfied that any differential is consistent with its established pricing policy and is not the result of a change adopted, for example, when the society decided to seek a merger. Each case where interest rate differentials are to be maintained, for whatever period, will need to be considered to determine whether or not it constitutes a bonus, and societies may wish to take professional advice on the matter.

#### *Compensation to Directors and Other Officers*

2.12 Any compensation proposed to be paid to directors or other officers must be disclosed in the Schedule 16 Statement and approved by a separate special resolution of the members (see paragraphs 3.11 and 4.3). “Compensation” is not defined in the 1986 Act. In the Authority’s opinion, compensation does not include statutory redundancy payments, damages for breach of contract or other payments, for example, falling due under the terms of a pre-existing contract of employment, or a pre-existing arrangement giving rise to a reasonable expectation. However, it does include any proposed ex-gratia payments in money or money’s worth. Societies should consider very carefully the extent to which any proposed payment may exceed the amount provided for by statute or contract. In view of the requirement in Section 96(3) of the 1986 Act that unauthorised payments must be repaid by the recipient, societies are advised to take legal advice on any payments which are not specifically authorised by the terms of a resolution passed by the members in accordance with Section 96(1) of the 1986 Act. All proposed payments requiring approval by such special resolution should be disclosed in the Schedule 16 Statement under the power in paragraph 1(4)(f) of that Schedule. In addition, the Schedule 16 Statement should disclose any other payments to directors or other officers arising directly from the merger. So that members are aware of the direct interest of the directors or other officers in a merger, societies should consider whether the amount, as distinct from the fact, of statutory or contractual payments should be disclosed where these arise directly from the merger. More generally, societies need to consider whether any facts relevant to any director or other officer, or to any person(s) connected with them, should be disclosed where

these are material to the interests of the members who are to be asked to vote on the proposed merger. In determining the amount of compensation which might be justified, the board must strike a balance between fairness to the individuals who will suffer a loss of income and the interests of the members, bearing in mind that the compensation will be at a cost either to any bonus to the members or to the reserves to be transferred to the combined society.

### **Public Announcement**

- 2.13 Boards of both societies may wish to announce a merger proposal as soon as agreement in principle has been reached between them and, in particular, to inform their members and staff of the proposed terms. However, boards will often wish to delay an announcement for as long as possible, perhaps for prudential or commercial reasons, or because they first wish to settle all the details of the proposed terms. Societies with *listed* PIBS will need to have regard to the FSA's requirement concerning early disclosure of information affecting the price of securities. Subject to this, there is no objection to delay, in principle, and there may be good reasons for it. Unfortunately, experience shows that every day's delay after agreement in principle has been reached carries an increasing risk of premature leak. Indeed, the very reasons for delay may make the merger a subject for intense speculation and increase the risks of a leak. In these circumstances then, boards must have contingency plans to make an early announcement to deal with any potentially damaging rumours and to avoid members being misled or left in a state of uncertainty.
- 2.14 The announcement, particularly information provided directly to members and staff, should make it clear that the merger proposal is subject to approval by the members and completion of the statutory procedures. Boards should be careful to avoid giving even the impression that the outcome is a foregone conclusion, and should indicate any matters of substance on which the proposed terms of the merger remain to be settled. Briefing of staff who will be responsible for responding to enquiries from members and the press should be considered carefully and prepared in advance of the announcement to avoid any risk of members being unintentionally misled.
- 2.15 The Authority is not required to approve the content or wording of announcements or preliminary information sent to members. However, it will be happy to comment on drafts shown to it at an early stage, and may be able to help societies to avoid unintentionally misleading statements.

## **Prudential Issues**

- 2.16 Before a firm proposal is agreed, the participating societies should consult with the Authority's staff to discover whether there is any prudential objection to the proposal. The Authority will need to be satisfied that the combined society will be managed prudently from the date of completion of the merger and comply with the Principles for Businesses and with all the relevant rules made by the Authority. The Authority will also wish to know that post-merger arrangements and agreements provide for the proper integration or rationalisation of the operations of the combined society, and of its connected undertakings, joint ventures or arrangements with third parties (for example, for the provision of unsecured loans, insurance and investment services) and that any commercial conflicts of interest have been resolved.
- 2.17 In all cases, prudential information should be provided, but the amount of information will depend upon the circumstances of each case. For example, if a merger involves societies of much the same total asset size, or where the merger will result in a significant increase in the transferee society's assets, or involves a change of strategy, new kinds of business or carrying on business in a new geographical area, the Authority will expect substantial prudential information and societies should also expect this to form the basis of more detailed discussions with the Authority's staff. On the other hand, in a merger where a small society is transferring its engagements to a very much larger one, the prudential information to be provided is likely to be that much less. In all cases the Authority will ask for the prudential information at an early stage so that there is adequate time for discussion before it is asked formally to approve the Schedule 16 Statement.
- 2.18 Boards should note, however, that while the Authority will expect the kinds of information described here, it is for the boards themselves to exercise due diligence and to be satisfied that the merger and its terms are prudent and in the interests of their members.
- 2.19 As is noted, the Authority's need for prudential information can be expected generally to relate to prudential issues, but societies may find it helpful to note the following paragraphs which describe some of the particular issues which the Authority will expect to be addressed. In all cases, societies should have regard to the relevant chapters of the IPSB.



### *Direction and management*

- 2.20 Current and future board composition and succession plans for, say, the three years immediately following the merger.
- 2.21 Current and future senior management and structure, indicating spans of responsibility (which may most easily be presented in chart form) and any areas where there may be a need for additional expertise or experience to be acquired by the combined society with plans and timescale for acquiring such expertise.

### *Accounting and control systems*

- 2.22 Generally, outline plans and timetables for the integration of accounting, control and inspection systems, including the linking or harmonisation of computer systems. This may usefully be divided between initial or short term arrangements and foreseen longer term developments. More particularly, the information should include arrangements to ensure continuity and the integration of:
- (a) accounting records;
  - (b) systems of internal control, including management information systems and IT systems; and
  - (c) systems of inspection (internal audit)

For all significant mergers the Authority will wish to receive, prior to the effective date of the merger, a letter from the transferee society's external auditors stating whether, in their opinion, the accounting records and systems of control and of inspection established for the merged society will be effective from the effective date.

### *Business plan*

- 2.23 The rationale for the merger will need to be explained and justified in full, including existing and potential future business and marketing opportunities, the benefits of geographical concentration or diversification of business, economies of scale (particularly administrative), and future funding and lending strategies. Proposals for rationalisation or integration of administrative offices and branches will need to be set

out in full, including the implications of the proposed merger for the terms and conditions of staff employment and their future job prospects with the combined society.

*Financial prospects*

2.24 Information on the financial prospects for the combined society will need to include:

- (a) estimates, broken down to an appropriate level of detail, of short term additional costs and long term savings (if any) anticipated from the merger; and
- (b) revenue account, balance sheet and solvency ratio projections for the first three to five years of operation.

This information must be supported by statements of the assumptions on which it has been based. In addition, the effect of changes on those assumptions should be illustrated, from a best case to a worst case scenario.

*Connected undertakings and agencies*

2.25 The integration and future operation, management and control of connected undertakings, together with arrangements with other parties for the continuing provision of services under agency agreements, should be described in full.

### 3. INFORMATION PROVIDED TO MEMBERS

#### Statutory Requirements

- 3.1 Part I of Schedule 16 to the 1986 Act requires a building society which desires to merge with another society to send to every member entitled to notice of a meeting of the society a statement concerning the matters specified in the Schedule. The statement is to be included in or with the notice of the meeting at which the Merger Resolutions are to be moved. No statement shall be sent unless its contents, so far as they concern the specified matters, have been approved by the Authority. Where the transferee society has obtained the consent of the Authority to proceed by board resolution then it is exempt from this requirement (see paragraphs 4.41 and 4.42).
- 3.2 Meeting arrangements and resolutions are discussed in section 4.

#### The Schedule 16 Statement

- 3.3 The Schedule 16 Statement must set out the present financial positions of each of the merging societies, the terms of the merger agreed between them and summarise the main provisions of the Instrument of Transfer. It must also include any other matter which the Authority may require. In the case of an **amalgamation**, the Statement must additionally include the proposed Memorandum and Rules of the successor society which are to be approved by the special resolution required to approve the merger (Section 93(2) of the 1986 Act), as well as the terms of the amalgamation agreement between the societies.
- 3.4 The Schedule 16 Statement does not have to be a discrete document. In fact it will usually be convenient to include it in a comprehensive Merger Document also containing the board's rationale for recommending the merger, the notice of the meeting at which the Merger Resolutions are to be moved, an explanation of the merger procedure (including details of the confirmation stage - see section 5) and a description of the requirements of the society's Rules concerning entitlement to vote. However, the Schedule 16 Statement within the Merger Document should be clearly identified as such (either by printing it on a different colour of paper or by some other means). An example of a *pro forma* Merger Document is given in Annex A.
- 3.5 The required contents of the Schedule 16 Statement are discussed in detail in the following paragraphs.

### *The Financial Position*

- 3.6 Paragraph 1(4)(a) of Schedule 16 to the 1986 Act requires the Statement to contain information concerning the financial position of each of the societies participating in the merger. The members should be given sufficient information to enable them to gain an accurate understanding of the key financial features of their businesses. The information will include a balance sheet, recent results and certain financial ratios; for this purpose it is necessarily rather more detailed than is required for the annual Summary Financial Statement. In addition, further information will be required concerning accounting policies and other matters, as set out in paragraph 3.10.
- 3.7 The information should comprise consolidated accounts of each society and its connected undertakings prepared at a common balance sheet date which should be no more than 6 months before the date on which the Statement is approved by the Authority, or the date on which the Statement is to be sent to the members if that is expected to be significantly later. Information regarding results should relate to the relevant period ending on the chosen balance sheet date. The figures may be derived from audited or unaudited accounts. In either case, the source must be stated. If unaudited figures are used, the Authority will require a “letter of comfort” from the relevant society’s external auditors confirming that, in their opinion:
- (a) the figures have been correctly abstracted from the society’s records;
  - (b) the financial information is not misleading in the context in which it appears; and
  - (c) in reviewing the data relating to the Statement, nothing has come to their attention which would cast doubt on the directors’ statement (see paragraph 3.8) that there has been no material change affecting the information given.
- 3.8 Since the financial information will necessarily relate to a period ending somewhat before the date of approval of the Schedule 16 Statement, the board is required to state whether or not there have been any material changes to the financial position in the interim. If the effect of a change cannot be quantified, it must be described so that the members at least know that it has been identified and is relevant to their consideration of the proposed merger. Failure to disclose such changes will be relevant to the Authority’s subsequent consideration of the society’s application for confirmation of the merger (see paragraphs 5.4, 5.12 and 5.13).

3.9 Differences in accounting policies could result in some loss of comparability between the financial information given for each society. Some adjustments to the figures may, therefore, be necessary to give the members a proper understanding of the societies' relative financial positions. Any adjustments made should be explained by way of a note. If there are no significant differences in accounting policies, then that should be stated for the avoidance of doubt.

3.10 Notes to the financial position should also provide information on the following matters:

- (a) the book amounts and market values of listed securities held as liquid assets;
- (b) the book amounts and current market values of land and buildings; with an indication of the basis on which current market value has been determined;
- (c) any significant differences in policy or practice with regard to the depreciation and estimated asset lives of tangible fixed assets;
- (d) pension arrangements of each society including, for funded schemes, details of latest actuarial valuations;
- (e) summary information on the business of connected undertakings;
- (f) an estimate of the costs and benefits of the proposed merger.

*Interests of Directors and Other Officers*

3.11 Subparagraphs 1(4)(b) and (c) of Schedule 16 to the 1986 Act require the Statement to disclose any interests of the directors in the merger and any compensation to be paid to them or other officers. This information must be comprehensive and clear. It should include the following:

- (a) the interests of the directors in the merger, including appointment of existing directors to the main board or local board of the combined society, or to any other position with that society, together with any significant resultant change in present or expected future levels of fees or other emoluments and benefits in kind;

- (b) any compensation payable to directors or other officers for loss of office or reduction in emoluments, and the basis on which it is calculated; if a global sum is proposed to be given to a group of persons, the intended manner of apportionment should be stated (see paragraph 2.12);
  - (c) any payments to be made to directors or other officers arising from the merger, whether provided for in contracts of employment or under covenant or some arrangement giving rise to a reasonable expectation;
  - (d) any proposed benefits to directors or other officers by way of fees for professional services, stating the nature of the services to be provided and the anticipated annual fee income; and
  - (e) any other benefits to directors or other officers, or to any persons connected with them, arising from, or as a consequence of, the merger.
- 3.12 If the directors or other officers have no material interest, either by way of change in remuneration, as widely defined above, or by payment of compensation for loss of office or in any other form, for example, a pension, this should be stated explicitly, for the avoidance of doubt.

#### *Bonus Payments to Members*

- 3.13 Paragraph 1(4)(d) of Schedule 16 to the 1986 Act requires the Statement to specify the bonus, if any, to be paid to members in consideration of the merger. The Authority's views on what may, or may not, be regarded as bonus are given in paragraph 2.11, and the statutory requirements for approval of bonus payments are described in paragraph 4.4.
- 3.14 The method of calculation of a bonus should be explained in the Schedule 16 Statement; for example, x% of the lower of the share account balances held at the end of the last financial year and those balances held on the effective date of merger (giving precise dates and times for calculating the balances), and the estimated maximum total amount payable to members. The effect on the reserves of the combined society should be shown by stating the estimated gross and net costs of the bonus and the resulting reduction in the reserve/asset ratio (see also Annex A, items A.3 and B.6).

### *Other Matters*

- 3.15 As is noted in paragraph 2.9, the Instrument of Transfer (or amalgamation agreement) will normally make provision for a number of matters in addition to those concerning the interests of directors and other officers and any bonus to be paid to the members. Such matters must be explained in the Schedule 16 Statement, together with any other matters of which the Authority may require particulars to be given (see paragraph 1(4)(f) of Schedule 16 to the 1986 Act). They are discussed in the following paragraphs.
- 3.16 **Post-merger membership rights** should be secured by the adoption of BSA Model Rule 4(9) (Fifth Edition, November 1997) or a similar Rule to the same effect. The purpose of the Rule is to ensure that members of a transferor society are not disenfranchised. It provides that they are deemed to have been members of the transferee society from the date when they became members of the transferor society. Societies' Rules, in conformity with the 1986 Act, must provide, inter alia, that a member is entitled to vote on a resolution of the society if he was a member at the end of the last financial year before the voting date and on the voting date. If, for example, a transferee society has a financial year ending on 31 December, its AGM in the following April and the effective date for a merger is in March, then the deemed membership Rule will enfranchise those who were members of the transferor society on or before 31 December. The existence, or absence, of this Rule must be recorded in the Schedule 16 Statement in any case where it is likely to have any significant effect on members' rights.
- 3.17 **Proposed changes to the terms and conditions of share and deposit accounts** must be fully and clearly explained in the Schedule 16 Statement. In a transfer of engagements, shares and deposits held with the transferor society will become held with the transferee society. Such accounts will either be transferred into the nearest equivalent account of the transferee society, become new products of the transferee society, or continue on existing terms but be closed to new investors. It is most helpful to tabulate the proposed integration of accounts in a schedule listing the accounts of the transferor society opposite the accounts of the transferee society to which they are to be transferred, together with the interest rates payable, or proposed to be paid, on each account. A similar presentation will be required to show the proposed integration of accounts in an amalgamation. In preparing this the provisions of Section 8 of the 1986 Act should be borne in mind.

- 3.18 **Proposed changes to the terms and conditions of mortgage accounts** must be explained (see paragraph 1(4)(e) of Schedule 16 to the 1986 Act). Alternatively, if no changes are proposed to be made, the Schedule 16 Statement must include an assurance to that effect, for the avoidance of doubt.
- 3.19 **Terms and conditions of employment of staff**, including any special bonus or other benefits in connection with the merger, as provided by the Instrument of Transfer (or amalgamation agreement), must be set out. In addition, the Authority will require the Schedule 16 Statement to include an explanation of the Board's intentions with regard to the closure or integration of head office departments and branches, any reductions in the number of staff employed and redundancies, insofar as these matters are not provided for in the Instrument of Transfer (or amalgamation agreement).
- 3.20 **Future pension arrangements** for staff, directors and other officers, as provided by the Instrument of Transfer (or amalgamation agreement), are to be set out.
- 3.21 Finally, the **conditional and termination clauses** of the Instrument of Transfer (or amalgamation agreement) should be summarised.

### **Board Rationale and Statements**

- 3.22 A board putting a merger proposal to its members has, in addition to its statutory duty to provide a Schedule 16 Statement, a fiduciary duty to provide its members with essential factual information and a fair assessment of the issues so that they can take informed decisions on whether to approve the board's proposals. The Authority, therefore, expects that the Merger Document (see paragraph 3.4) will include an explanation by or on behalf of the board of the reasons for the merger and the choice of merger partner. This rationale should give a fair assessment of the advantages and disadvantages of the merger and should be entirely consistent with the facts set out in the Schedule 16 Statement. In addition to explaining the rationale and its consequences for the members, it should explain the effect on the staff's terms and conditions of employment and expectations for future employment prospects. The planned timescale for integration of the businesses should also be explained.
- 3.23 The 1986 Act requires that members must be notified of written non-confidential proposals to their society either to merge with another society or to be taken over by a commercial company. Part II of Schedule 16 to the 1986 Act imposes a duty to send a **merger statement** to members, advising them of a proposal to merge, and Part IA of



Schedule 17 to the 1986 Act imposes a like duty to send a **transfer proposal notification**, advising them of a proposed takeover. If a proposal of either kind has been received, then notification of the prescribed particulars must be sent to every member entitled to notice of a meeting, either separately or together with every notice of the society's annual general meeting, and (where such notification has not already been given) must be included with every notice of the special meeting at which Merger Resolutions are to be moved.

- 3.24 Where notification of takeover or other merger proposals accompanies the notice of a meeting to consider Merger Resolutions, then
- (a) any merger statement must give notice of the fact that a written merger proposal has been received unless notice has already been given to members, or it was received 42 or less days before the meeting, with details of the identity of the proposer, with or without particulars regarding the proposal. If the proposer requests in writing that the proposal be treated as confidential, disclosure is not required. The merger which the members are being asked to vote upon need not be the subject of a merger statement.
  - (b) any transfer proposal notification must give notice of the fact that a written proposal has been received with details of the identity of the proposer, with or without particulars regarding the proposal. If the proposer requests in writing that the proposal be treated as confidential, disclosure is not required.

An invitation to discuss a possible proposal probably would not constitute a proposal within either Schedule.

Provision of merger or transfer proposal statements is a statutory requirement. Provided they accompany the notice of meeting, they may be included in a Schedule 16 Statement, or alternatively may more conveniently be included as one or more discrete paragraphs within the board's rationale explaining its choice of merger partner.

- 3.25 The rationale itself is not a statutory requirement, and is not subject to approval by the Authority. However, the Authority will take account of the information it provides when considering whether to confirm the merger (see section 5, particularly paragraphs 5.9 and 5.12). Societies will, therefore, find it helpful to consult the Authority's staff about the drafting and content of the rationale.

- 3.26 The whole Merger Document should be covered by a **responsibility statement** by the directors of each society. This may be given along the following lines:

“The directors of ..... Building Society and the directors of ..... Building Society accept responsibility for the information relating to their respective societies which is contained in this document. To the best of the knowledge and belief of the directors (who have taken all reasonable care to ensure that such is the case) the information contained in this document is in accordance with the facts and does not omit anything likely to affect the import of such information”.

- 3.27 The Authority will require the Schedule 16 Statement to include a statement as to whether or not the merger will conflict with any **contractual obligations**, including agency agreements, of either society or their connected undertakings.

#### **Application and the Authority’s Approval**

- 3.28 A society’s formal application to the Authority for approval of a Schedule 16 Statement is likely to be the culmination of many weeks of discussion with the Authority’s staff who will have reviewed and commented upon a draft or successive drafts of the Statement, having had regard also to drafts of the Instrument of Transfer (or amalgamation agreement) and the prudential information described in section 2. Societies should also have cleared any proposed Rule changes or, in the case of an amalgamation, the proposed Memorandum and Rules of the successor society, with the Central Office. The probable sequence of events is described more fully in section 8. The case where the Authority has consented to a transferee society proceeding by board resolution, and thereby exempting it from the requirement to put Merger Resolutions, and sending a Schedule 16 Statement, to its members, is described in paragraphs 4.41 and 4.42.

- 3.29 Schedule 16 Statements must be prepared to the same standards as apply to financial statements and directors’ reports. An application to the Authority for approval of a Schedule 16 Statement must be made in writing and should include a declaration made on behalf of the board, that the Statement is complete and includes all material information of which, in the opinion of the directors, the members should be aware. That declaration should say whether or not there have been any other merger or takeover proposals (confidential or otherwise see paragraph 3.23) and confirm that the

information about them is correct. The application should be accompanied by the following documents:

- (a) an authenticated copy of the executed amalgamation agreement or Instrument of Transfer, as the case may be;
- (b) two authenticated copies of the final draft of the Merger Document (or documents) in printer's proof form, including the Schedule 16 Statement, the board rationale, the notice of the general meeting and Merger Resolutions (including, in the case of an amalgamation, the proposed Memorandum and Rules of the successor society), any merger or transfer proposal statements as mentioned in paragraphs 3.23 and 3.24, and the directors' responsibility statements;
- (c) any other documents, such as a covering letter for the Merger Document(s) and proxy voting forms;
- (d) an assurance from the chairman of each society that the Schedule 16 Statement is complete, accompanied by a compliance schedule listing the requirements of the 1986 Act and of this chapter for a Schedule 16 Statement and indicating where in the statement of that society that requirement has been met and confirmation that all the interests of the directors and officers are included in it.
- (e) an assurance by, or on behalf, of the board that the society's systems for verification of membership records are capable of providing the information required to fulfil the relevant requirements of the 1986 Act and the Rules (see paragraph 4.15);
- (f) a letter of comfort from the society's external auditors as specified in paragraph 3.7;
- (g) the appropriate fee as specified in the current Fees Rules;
- (h) confirmation that the final draft as submitted for approval does not differ from that previously seen by the Authority or, where it does, indicating each change that has been made.

3.30 The Authority's approval of the Schedule 16 Statement will be confirmed by returning to the society one authenticated copy of the Statement with the Authority's certificate of approval signed by an authorised signatory for the Authority. There is no statutory requirement for copies of Schedule 16 Statements to be placed on the public files of societies but, because the documents are in the public domain, it is the Authority's practice to pass copies to the Central Office for filing. Were a public announcement about the merger not to be made until after the Authority had approved the Schedule 16 Statement, the Authority would not pass a copy of the Statement to the Central Office until after the announcement. The supporting documents listed above will not be passed to the Central Office.

#### 4. GENERAL MEETINGS AND RESOLUTIONS

**This section describes the requirements of the 1986 Act concerning members' entitlement to vote, the register of members and the sending of notices of meetings. It also discusses general meeting arrangements, the resolutions and majorities required and the counting of votes. Finally, it gives guidance on the discretion which the Authority may exercise in these matters. The directors of each society must satisfy themselves that they observe the general law on meetings, the relevant provisions of the 1986 Act and their own Rules.**

##### **Resolutions and Voting Majorities**

4.1 The 1986 Act provides that a merger must be approved by the requisite Merger Resolutions (Sections 93(2)(c) and 94(2) and (5)(a)) as follows

- (a) **a shareholding members' resolution** (see definition in paragraph 27A of Schedule 2 to the 1986 Act) passed on a poll by a majority of at least 75% of shareholders qualified to vote and voting; and
- (b) **a borrowing members' resolution** passed on a poll by a simple majority of borrowing members qualified to vote and voting (see definition in paragraph 29(1) of Schedule 2 to the 1986 Act);

provided that, in each case, notice has been duly given that the resolution is to be moved as a shareholding members' resolution or a borrowing members' resolution, as the case may be. A member may vote either in person at the meeting or by appointing a proxy (paragraphs 27A(b) and 29(1) of Schedule 2 to the 1986 Act do not provide that the voting on these may be conducted by postal ballot).

4.2 In the case of a **partial transfer of engagements**, in addition to the approval of the members as a whole by passage of the shareholding members' resolution and borrowing members' resolution described above, the society must obtain the approval of an "affected shareholders' resolution", which must be passed by the majority of the affected shareholders eligible to vote; that is, those shareholders in respect of whose

shares it is proposed that the engagements should be transferred (Section 94(3) and (4)) of the 1986 Act. But note that the resolution must be passed by a majority of the affected members eligible to vote, not just a simple majority of those who actually do vote.

4.3 Section 96(1) of the 1986 Act provides that, where a society wishes to pay **compensation** to directors or other officers for loss of office or diminution of emoluments, such compensation must be approved by a special resolution of the society's members (see also paragraph 2.12), separate from the Merger Resolutions. The special resolution must be passed by a majority of at least 75% of those qualified to vote and voting. The Treasury has not made regulations under Section 96(2) of the 1986 Act to set limits below which compensation may be paid without the authority of a special resolution. Therefore, in every case where compensation is proposed, the members must vote on the proposal as a separate issue from whether they approve the merger itself. "Other officers" include, in addition to the Chief Executive and Secretary, any persons who exercise managerial functions under the immediate authority of a director or the Chief Executive of a society (Section 119 of the 1986 Act defines "manager" and "officer").

4.4 The **members' approval of bonus payments** is required as part of the Merger Resolutions (see Section 96(4) to (6) of the 1986 Act) and see paragraph 2.11 for the Authority's view of what may constitute a bonus). If the total gross cost of the proposed bonus(es) (i.e. without any adjustment for prospective corporation tax recovery) is within the prescribed limit, then approval for it need only be included in each of the Merger Resolutions of the society whose funds are to be distributed. If it exceeds that limit then it must be included in each of the Merger Resolutions of each participating society. The prescribed limit was changed by the Building Societies (Mergers) (Amendment) Regulations SI 1995/1874 amending SI 1987/2005 and now is:

- (a) in either a full transfer of engagements or an amalgamation, 5% of the total assets, as stated in the Schedule 16 Statement, of the society to whose members the bonus is to be paid;
- (b) in a partial transfer of engagements, 5% of the share liabilities, as given in the Schedule 16 Statement, to be transferred;

or a sum equal to the society's reserves after deducting its fixed assets (apportioned pro rata in respect of 4.4(b)), whichever is the less. The Regulations should be consulted for the full detail of the calculations.

### **Entitlement to Vote**

- 4.5 Paragraph 5 of Schedule 2 to the 1986 Act provides that no person may be a member of a building society unless he or she is a shareholding member or a borrowing member. A shareholding member is a person who holds a share in the society (that is, an investment in a share account or PIBS). A borrowing member is a person who is indebted to the society in respect of a loan fully secured on land. However, the Rules may provide that borrowing membership is conferred by a loan substantially secured on land, or shall cease if the loan is foreclosed or the land is taken into possession by the society. A minor (that is a person under 18 years of age) may be a member, but may not vote on any resolution.
- 4.6 The mandatory provisions of Schedule 2 to the 1986 Act concerning a member's entitlement to vote on a resolution, which must be reflected in societies' Rules, are that the member must be a member on the voting date, must have been a member at the end of the last financial year before the voting date (paragraph 23(1) of Schedule 2) and must have attained the age of 18 years (paragraphs 5(3) and 34(2) of Schedule 2) on or before the date of the meeting. So far as borrowing members are concerned, the member is not entitled to vote in that capacity if his indebtedness to the society at any relevant date is less than £100 (paragraphs 29(2) and 36 of Schedule 2).
- 4.7 However, Schedule 2 specifies the following further provisions, some, none or all of which **may** be included in a society's Rules with respect to the **entitlement of shareholding members to vote** on any resolution; a person must (see Schedule 2 paragraphs 23(3) to (5) and 36):
- (a) have a qualifying shareholding (which must not be set higher than £100), in one or more share accounts or PIBS, on the "qualifying shareholding date";
  - (b) hold shares on the voting date; and
  - (c) have held shares continuously between those two dates.

4.8 The “**qualifying shareholding date**” is either the last day of the financial year preceding the voting date or, if the voting date falls during that part of a financial year which follows the conclusion of the society’s Annual General Meeting commenced in that year, the first day of the period beginning 56 days before the date of the meeting. Therefore, if a society’s Rules, following the BSA Model Rules (Fifth Edition), include the provisions concerning shareholding and continuity of membership described in paragraph 4.7, **and if the voting date is later than the AGM in that year**, a person to be entitled to vote on a shareholding members’ resolution must:

- (a) have been a shareholding member on the last day of the previous financial year;
- (b) have held shares to the value of at least £100 on the day 56 days before the date of the meeting;
- (c) have held shares continuously from the 56th day through to the voting date; and
- (d) hold shares on the voting date

But note that there is no requirement for continuity of shareholding between 4.8(a) and (b). (In contrast, in the case of an ordinary or special resolution, membership at 4.8(a) may be satisfied by either borrowing or shareholding membership provided the shareholding member satisfies the other conditions of 4.8(b) to (d) in order to vote in his or her capacity as a shareholder.) Note also that a person cannot meet a requirement for “holding shares” on a given date, or during a given period, by relying on his holding of a share account with an overdrawn balance; and a person cannot meet a requirement for being a “member” on a given date (for example, at 4.8(a)) by relying on his holding of such a share account.

4.9 The mandatory provisions of Schedule 2 to the 1986 Act concerning **entitlement to vote on a borrowing members’ resolution** are, as noted above, that the member must have been, and be, indebted to the society for at least £100 (whether on one or



more accounts) at the end of the last financial year before the voting date, and on the voting date, in respect of an advance fully secured (or, if the Rules permit, substantially secured) on land (paragraphs 5(2), 23(1), 29(2) and 36 of Schedule 2) and have attained the age of 18 years by the date of the meeting (paragraphs 5(3) and 34(2) of Schedule 2). But note that there is no dispensation in the 1986 Act for the Rules to reduce the qualifying amount below £100, nor to provide for a continuity of membership qualification.

4.10 Schedule 2 makes provision in respect of **joint shareholders** (paragraph 7) and **joint borrowers** (paragraph 8). The only person entitled to exercise the right to vote on behalf of the joint shareholders or joint borrowers is the one who is named first in the records of the society, described respectively as the “representative joint (share)holder” or the “representative joint borrower”.

4.11 A member may vote once only on any resolution, irrespective of the number of accounts he or she may hold. The amount of the balance(s) held on an account(s) is not material, except to qualify to vote (see paragraphs 4.7 and 4.8). Thus, a member with several share accounts and/or several mortgage accounts, whether as sole and/or representative joint shareholder or representative joint borrower, may vote once only on any resolution. When the membership votes as a whole on an ordinary or a special resolution, each member may vote only once, whether he or she is a shareholding or a borrowing member or both. Where shareholding members and borrowing members vote separately, as on the Merger Resolutions, members entitled to vote may vote only once, if a shareholding member, on the shareholding members’ resolution and once, if a borrowing member, on the borrowing members’ resolution. A person entitled to vote both as a shareholding member and as a borrowing member may, of course, vote once on each resolution.

4.12 The “**voting date**” is defined by paragraph 23(6) of Schedule 2 as, for this purpose, either:

- (a) for members who appoint a proxy, the last date specified by the society for the receipt of proxy voting forms, which may not be more than 7 days before the

date of the meeting (paragraph 24(6) of Schedule 2). A proxy vote remains valid if the member ceases to be a member after the proxy voting date but before the date of the meeting (paragraph 24(2) of Schedule 2); or

(b) for all other members, the date of the meeting.

4.13 The guidance given in the foregoing paragraphs of this section is intended to give a general description of the provisions of the 1986 Act and of the Rules suggested by the BSA Model Rules. Societies should satisfy themselves that they observe the specific provisions of the 1986 Act and of their own Rules.

### **Register of Members**

4.14 Every society is required to maintain a register of the names and addresses of its members and whether each member is a shareholding member or a borrowing member or both (paragraph 13 of Schedule 2 to the 1986 Act). The register should, so far as possible, be “de-duplicated”; that is, multiple account holders should be identified and their names recorded once only in the register. A society’s systems must also be capable of recognising those members who are eligible to vote by, for example, aggregating share account balances of multiple account holders to check that they have the requisite qualifying shareholding, by checking members’ continuity of shareholding (if and where applicable), and by identifying minors including (separately) those who will shortly attain their majority (see paragraphs 4.6 and 4.9). Other situations requiring careful consideration are, for example, in relation to powers of attorney, personal representatives, and death of the representative joint holder or borrower. This information is required to ensure that the notice of the meeting is sent to all the members entitled to receive it and so that the scrutineers have adequate systems to validate the votes cast on the Merger Resolutions (see also paragraph 4.20).

4.15 It will be necessary for the directors of a society contemplating a merger to satisfy themselves, in consultation with their external auditors, that the society’s systems are capable of delivering the information described above. The Authority will require an assurance on this point when the society applies for approval of the Schedule 16 Statement (see paragraph 3.29(e)). One of the criteria which the Authority has to consider at the confirmation stage is whether some relevant requirement of the 1986 Act or the Rules was not fulfilled (see paragraphs 5.15 to 5.19).

- 4.16 The problem of avoiding duplication in the register of members is significant for most societies of any size. It has been aggravated by the proliferation of types of account over the last decade or so. Societies generally now seek to establish, when new accounts are opened, whether or not the applicant is an existing member and, if so, which accounts are relevant to voting and other membership rights. The task of identifying multiple account holders is complicated by confidentiality requirements. For example, if two accounts are held by a Mr A Smith and a Dr A Smith, both at the same address, the society cannot know (in the absence of other information such as date of birth) whether the two accounts belong to the same person, one opened before and one after he qualified, or by the doctor and his son. A letter of enquiry to one asking about both accounts would risk breaching customer confidentiality. If it is the same person, there is a risk that he will be given the opportunity to vote twice or, if neither account holds more than £100 but they aggregate above that qualifying amount, be denied a vote to which he is entitled.
- 4.17 Where a society identifies a number of accounts which appear to be held by a single member, but it cannot be sure, then it must send separate meeting notices in respect of each account. However, its systems should identify the possible multiple holding so that, if more than one vote is received in respect of that group of accounts, the scrutineers are alerted to the possibility, and can check the proxy forms for evidence of invalid duplicate votes. The voter's declaration suggested by the BSA, in conformity with paragraph 34 of Schedule 2 to the 1986 Act, provides some protection against votes being cast by minors, and attempts the same for duplicate votes (see Enclosure 2 to BSA Circular 5177). It is, however, the duty of each society to make sure that its register of members is reliable.

### **General Meeting Arrangements**

- 4.18 Paragraphs 4.19 to 4.34 consider the requirements for sending notices of meetings and Schedule 16 Statements to members, and the conduct of meetings at which Merger Resolutions are to be moved. It is for societies to satisfy themselves that they comply with the relevant requirements of the 1986 Act, their Rules and the general law on meetings.

## *Notice of Meeting*

- 4.19 The statutory requirements concerning notices are in paragraph 22 of Schedule 2 to the 1986 Act. Notice of the meeting must be given to each shareholding and borrowing member of the society who would be eligible to vote at the meeting if the meeting were held on the date of the notice (a single date for all notices irrespective of when they are despatched). In addition, notice must also be given to any person who will attain the age of 18 years after the date of the notice but on or before the date of the meeting, and to every person who becomes a shareholding or borrowing member of the society after the date of the notice but before the final date for receipt of proxy voting forms, and who would, in either case, be eligible to vote at the meeting if he remained a member until then. (In practice, this may mean sending out a notice to every such person, even if they will, in fact, not be entitled to vote). The Schedule 16 Statement must be sent in or with the notices (paragraph 1(2) of Schedule 16 to the 1986 Act). Accidental omission to give notice of a meeting to any person entitled to receive it does not invalidate the proceedings at the meeting. However, “accidental omission” does not include a systemic failure to send notices (e.g. omitting to send notices to new members, or omission of a group or class of members from the mailing list arising from a fault in a computer programme), nor all cases of error by management - see also paragraph 4.39.
- 4.20 The 1986 Act also provides, in paragraph 21 of Schedule 2, for the **length of notice** to be given to members. The period of notice given must be not less than 21 days or such longer period as the society’s Rules prescribe. The precise procedures for sending notices, the way in which the days are to be counted, and presumed receipt of notices duly sent, will normally be set out in the Rules. Particular points to note are:
- (a) the 21 days’ notice expires with the closing date for the receipt of proxy voting forms, not the date of the meeting;
  - (b) if reliance is to be placed on a provision in the Rules that notices can be deemed to be served 24 hours after posting, then first class post or equivalent means of delivery should be used, but it is advisable to allow a margin of at least an extra day or two, or more if second class post is used;
  - (c) if a society contracts with a commercial mailing firm, it must ensure that the firm is comprehensively instructed about the society’s despatch and delivery requirements, and the society should carry out spot checks to satisfy itself that

its instructions are being properly carried out. A failure by the contractor may invalidate the meeting, even if the society itself has used its best endeavours to police the operation.

- 4.21 The Schedule 16 Statement is required, by paragraph 1(2) of that Schedule, to be sent “**in or with**” the notice of the meeting to every member entitled to that notice. As is suggested in paragraph 3.4, it may be expedient to include both in a comprehensive Merger Document.
- 4.22 Notices and Statements need not be sent to any member in whose case the society has reason to believe that communications sent to him at his registered address are unlikely to be received by him (paragraph 14 of Schedule 2 to the 1986 Act). However, a society is required instead to place notices of the meeting prominently in every branch office, or to place advertisements in newspapers circulating in the areas in which the society’s members live. Such notices or advertisements must be placed at least 21 days before the date of the meeting, and must state where members can obtain copies of the Schedule 16 Statement, the Merger Resolutions and proxy voting forms (Schedule 2, paragraph 35(4)).
- 4.23 It should be noted, however, that a member’s “registered address” may not be the address shown in the society’s register of members but a different address to which the member has requested that communications from the society be sent (Schedule 2, paragraph 13(4)).

#### *Conduct of the Meeting*

- 4.24 The meeting should be held at a time and place considered by the board to be most convenient for the generality of the society’s members. This may well not be the same as the traditional time and place for the annual general meeting. In deciding on this, the board should take account of the geographical location of their members. For example, for a society with a majority of its members living in a compact geographical region there must be a strong presumption in favour of an evening meeting. Consideration should be given to the possibility of a larger attendance than usual at a meeting to consider a merger.
- 4.25 Subject to the society’s Rules, its chairman will normally chair the meeting. His function as chairman of the meeting is to ensure that all views are presented and properly discussed. He is unlikely to be able to fulfil that role if he acts also as chief

advocate of a merger which is controversial among members. In such cases it might be appropriate to give to another director the initial task of explaining the merger and of responding to questions from members.

- 4.26 Merger Resolutions or the other resolutions mentioned in paragraphs 4.1 to 4.3, cannot be amended at the meeting except in a way which does not change their substance at all. This is because an amendment to such a resolution has to be subject to the same procedure and period of notice to members as the resolution itself. If a board decides, after due notice of such a resolution has been sent to the members, that the resolution should be amended, then it will be necessary to submit the amended resolution, with due notice, to a general meeting at a later date, unless of course there is still time to fulfil the notice requirements.

#### *Conduct of the Voting*

- 4.27 The conduct of the voting must not only be fair but also be seen to be fair, otherwise the result may be called into question. So it is highly desirable that the votes are counted by independent scrutineers. The board may ask the scrutineers, in advance of the meeting, for a running tally of the number of votes being cast if it thinks it might properly encourage more members to vote if the response is low. However, to ask the scrutineers **how** the votes are being cast, before the time comes at the meeting to instruct proxies, carries the risk of accusations, however unfounded they may be, and possible challenge at the confirmation stage, that the board suppressed proxy votes against the resolutions, or unduly influenced members to vote in favour. A board which asks the scrutineers for a running tally of votes, and which circulates its members with further exhortations to vote, must be prepared to argue its case in the face of such accusations at the confirmation hearing. Any circular to members sent after the Merger Document must, therefore, be very carefully considered.
- 4.28 Experience has demonstrated the need for societies to take the greatest care to ensure that they comply strictly with the statutory procedural requirements and their own Rules on meetings and resolutions. The chairman of the meeting should ensure that he or she is well briefed and aware of the Rules and the general law relating to procedural resolutions, such as resolutions to adjourn the meeting. The Authority will require a confirmatory report from the scrutineers on the validity of the voting procedures when the society applies for confirmation (see paragraph 4.38).

4.29 The procedures for the conduct of proxy voting will normally be provided for in the society's Rules, in conformity with paragraphs 24 and 34 of Schedule 2 to the 1986 Act which requires that every proxy form sent by a society to its members must enable the member to direct the proxy how to vote (Schedule 2 paragraph 24(4A)). To minimise the risk of the society's proxy voting procedures being misunderstood, the Authority recommends that the proxy form should include:

- (a) adequate space to insert the name of a proxy other than the chairman of the meeting, and a statement (which must also appear in the notice of the meeting) that the proxy appointed need not be a member of the society (a reminder that the voting member's own name should **not** be inserted might avoid a common problem);
- (b) provision to instruct the proxy to vote either in favour of the resolution, or against it;
- (c) an explicit statement that if the member does not instruct the proxy to vote for or against the resolution, then the proxy will cast the vote, or abstain, as he or she thinks fit;
- (d) the declaration in accordance with paragraph 34 of Schedule 2;
- (e) full recital of the text of the shareholding members' resolution or borrowing members' resolution or, if this is not practicable (e.g. because of space restrictions), a clear indication that the full text may be found in the notice of the meeting;
- (f) instructions as to the return of the completed proxy forms, including the last date for receipt by the society or by the scrutineers. A pre-addressed and pre-paid envelope or other sealed means of return should be provided.

4.30 The 1986 Act does not require societies to send proxy voting forms to members with notices of meetings (except where directors are to be elected). However, the Authority believes that, on a matter as important as a merger, societies would be well advised to send a proxy voting form to members with the notice of meeting. This will avoid any suggestion that members were discouraged from voting, that obstacles were put in their way, or that the society wished (for whatever reason) to be able to identify those who had requested proxy voting forms. If a society decides, nevertheless, not to

send proxy forms to members entitled to vote, then it should make clear to the members that proxy voting forms can be obtained on demand from its branches and/or by application to a central point.

- 4.31 The arrangements for the collection of the proxy forms should be such as to secure confidentiality and to avoid the risk of loss, whether accidental or deliberate. The procedures may provide for return of proxy forms to the scrutineers either directly (if permitted by the society's Rules) or to the society's offices. Where proxy forms are returned to the society's offices, the Authority recommends that the procedures should incorporate the following features:
- (a) the proxy form should be enveloped or otherwise sealed so that the members' voting instructions are concealed;
  - (b) the envelope provided should be clearly marked so that the society can readily identify and separate it from other mail without the envelope being opened;
  - (c) staff responsible for receiving and sorting mail should be given specific instructions about the handling of proxy forms and the overriding importance of security;
  - (d) secure storage of proxy forms should be provided up to the point at which they are handed over to the scrutineers;
  - (e) equivalent handling and security procedures should be applied to proxy forms handed in at branches.
- 4.32 The Authority suggests that proxy voting forms for shareholders and borrowers should be easily distinguishable, perhaps by colour coding, both as an aid to members who may be entitled to vote in each capacity, and as an aid to the scrutineers counting the votes.
- 4.33 Members may, after submitting a proxy vote, choose to attend the meeting and vote in person. There must, therefore, be satisfactory systems in place at the meeting to identify and cancel any proxy votes they may have returned.



### *Postal Ballots*

- 4.34 Paragraph 33 of Schedule 2 to the 1986 Act specifically excludes shareholding members' resolutions and borrowing members' resolutions from its permission for the Rules to provide for voting by postal ballot. This is reinforced in the definition of these resolutions in paragraphs 27A and 29 of Schedule 2. Although other resolutions associated with the merger process might be capable of being approved by postal ballot, in practice voting on all resolutions related to the merger will be by members voting in person or by proxy at a general meeting.

### **Scrutineers' Report**

- 4.35 The scrutineers are responsible for checking the validity of votes cast in person and by proxy. Given the need to ensure that the vote represents the views of the members, the scrutineers should be independent of the society and should not have a direct interest in the result of the voting. It will usually be appropriate to appoint the society's auditors, and it is desirable that they should be appointed not just for the arithmetical count of votes but also to supervise the voting process as a whole so that they are in a position to confirm, after the vote, that all the requirements of the 1986 Act and the society's Rules have been complied with. This would include:
- (a) determining and validating member mailing lists for notices of meetings and Schedule 16 Statements;
  - (b) despatch procedures;
  - (c) timing of notices and despatch of documents;
  - (d) form and content of proxy voting forms;
  - (e) receipt and custody of completed proxy voting forms;
  - (f) validation of completed proxy voting forms to establish that members are qualified to vote and that forms are properly completed;
  - (g) identification and validation of members attending and voting at the general meeting;

- (h) voting procedures at the meeting including casting of proxy votes, count of votes cast in person and aggregation of proxy and personal votes.

4.36 To fulfil the duties outlined above, it is suggested that the scrutineers would need to:

- (a) examine the systems and procedures to be employed by the society, before they are implemented, to ensure that they are satisfactory;
- (b) carry out such checks and tests as they consider necessary during the operation of the procedures as will enable them to be satisfied that the specified procedures are being carried out in practice;
- (c) provide that where validation functions are carried out by the society's staff this is done under the direction and supervision of the scrutineers;
- (d) direct and supervise the count of the votes cast both by proxy and personally at the meeting.

4.37 Validation checks during the counting of votes may be expected to include the following:

- (a) only proxy forms which comply with the 1986 Act and the society's Rules have been used;
- (b) the member is eligible to vote under the 1986 Act and under the society's Rules (a proxy vote may still be valid even though the member ceases to be a member after the closing date for receipt of proxies - see paragraph 4.12 (b));
- (c) only one proxy form per member eligible to vote is included in the count (separate forms may be sent to and returned by a person eligible to vote on both a shareholding members' resolution and a borrowing members' resolution);
- (d) minors are excluded or that there is an explicit confirmation by each member voting by proxy that he is aged 18 or over;
- (e) the proxy form is completed and signed and is otherwise valid (where a proxy voting form lacks a signature but is otherwise valid, it is usual, if time permits,

for the scrutineers to return the form to the member for signature and return in a pre-paid envelope).

4.38 The scrutineers' initial report will be made to the society at the meeting (which may be adjourned for this purpose). The Authority will require, in support of a society's application for confirmation under Sections 93(2)(d), 94(7)(a) and 95(3), a report from the scrutineers on the result of the vote (distinguishing between votes cast in person and by proxy), the total number of members eligible to vote (and the proportion of that number that the votes cast represent), and also confirmation that, in the opinion of the scrutineers the arrangements for the conduct of voting were such as to ensure that:

- (a) notices of the meeting and Schedule 16 Statements were sent to all those entitled to receive them, in accordance with the 1986 Act and the Rules of the society having regard, among other things, to the matters referred to in this chapter;
- (b) the periods of notice given complied with the requirements of the 1986 Act and of the society's Rules, taking into consideration established conventions for the counting of days;
- (c) there were satisfactory procedures to ensure confidentiality of proxy voting forms and to minimise the risk of loss or unauthorised access;
- (d) there were satisfactory procedures to ensure that the count of votes cast personally at the meeting included only votes cast by members eligible to vote and who had not mandated, or had withdrawn, a proxy vote.

4.39 In relation to the notice of the meeting, the scrutineers' report may properly have regard to the provision of paragraph 22(3) of Schedule 2 to the 1986 Act that "accidental omission to give notice of a meeting to, or non-receipt of notice of a meeting by, any person entitled to receive notice of the meeting shall not invalidate the proceedings at that meeting". It should be noted, however, that there is authority to the effect that "accidental" and "non-receipt" would not cover all cases of "error" on the part of the society, for example an erroneous decision of management not to send notices to particular persons or groups of persons.

4.40 The Authority would find it helpful if the scrutineers' report would also comment upon any procedural difficulties encountered and give an analysis of the reasons why

votes were found to be invalid, if the numbers of invalid votes appear to be significant (see also paragraph 5.14).

### **The Authority's Discretion**

- 4.41 The Authority has power under Section 94(5)(b) of the 1986 Act to exempt the transferee society in a transfer of engagements from the duty to call a meeting and put a Schedule 16 Statement and Merger Resolutions to its members, but to proceed instead by board resolution (see paragraph 1(1) of Schedule 16 to the 1986 Act). Before it exercises this discretion the Authority will wish to review the prudential information described in section 2 and, in particular, will wish to be satisfied that the merger will not affect the interests of the members of the transferee society to any significant extent. The Authority will also wish to know whether the merger will mean a change of policy by the society, for example by a significant move into a new geographical area or into a new business activity. Unless it is persuaded otherwise in the circumstances of any particular case, the Authority will not normally grant this exemption unless the total assets of the transferee society are substantially larger than the total assets of the transferor society, and a total asset ratio of 5:1 will be used by the Authority as a broad first measure of relative significance. The general presumption will be that a society, being a mutual institution, should consult its members over an issue as important as a merger unless there are compelling arguments to the contrary.
- 4.42 However, if the transferor society proposes to pay bonuses in excess of the prescribed limit (see paragraph 4.4) then, notwithstanding that the Authority has granted an exemption, the transferee society must seek the approval of its members of a resolution on the terms of the merger (Section 96(4)(b) of the 1986 Act). Similarly, if the transferee society has to change its Rules to avoid disenfranchising members of the transferor society (see paragraph 3.16) it must do so by special resolution. It would be wrong to invite the members to approve a Rule change which was a consequence of a merger without inviting them to approve the merger itself.

## 5. CONFIRMATION

**No merger can take effect until it has been confirmed by the Authority. This section describes the form of application and public notice required and explains the Authority's view of how the statutory Confirmation Criteria should be interpreted. Finally, it gives guidance on the procedure customarily followed by the Authority when considering confirmation applications and hearing representations.**

### **Application**

- 5.1 Section 93(2)(d) of the 1986 Act, on amalgamations, and Section 94(7)(a), on transfers of engagements, together with paragraph 7 of Schedule 16, provide that when the necessary Merger Resolutions have been passed the societies concerned must apply to the Authority for confirmation of the merger in such manner as the Authority may direct. The societies are also required, by paragraph 8 of Schedule 16, to publish notices of their applications in one or more of the London, Edinburgh and Belfast Gazettes as the Authority directs, and if it so directs, in one or more newspapers. The choice of official Gazettes and national or local newspapers will, of course, have regard to the area in which the societies' members live.
- 5.2 The parties in an amalgamation should make a joint application for confirmation to the Authority, while the parties to a transfer of engagements should make separate applications for confirmation of the transfer. These applications should specify the date on which the merger is intended to take effect and should be accompanied by two authenticated copies of the Instrument of Transfer, or the amalgamation agreement, and of the Merger Document or separate Schedule 16 Statement. In addition, in the case of an amalgamation, three signed copies of the Memorandum and Rules of the successor to the amalgamating societies should be sent to the Central Office. The scrutineers' report described in paragraphs 4.38 to 4.40, and a certified copy of the minutes of the general meeting at which the Merger Resolutions were moved, must be enclosed with each application.
- 5.3 A pro forma public notice of application, and pro forma letters of application are set out in Annex B.

## The Confirmation Criteria

### *Statutory Provisions*

- 5.4 Section 95(3) and (4) of the 1986 Act provides that the Authority must confirm an amalgamation or transfer of engagements **unless** it considers that any one or more of the following Three Criteria apply:
- (a) some information material to the members' decision about the merger was not made available to all the members eligible to vote; or
  - (b) the vote on any resolution approving the merger does not represent the views of the members eligible to vote; or
  - (c) some relevant requirement of the 1986 Act or of the Rules of any of the societies was not fulfilled.

Section 95(5) then provides that the Authority shall not be precluded from confirming a merger by virtue only of the non-fulfilment of some relevant requirement of the 1986 Act or the Rules (the Third Criterion in 5.4(c)) if it appears to the Authority that the failure could not have been material to the members' decision about the merger, and the Authority gives a direction under that sub-section that the failure is to be disregarded.

- 5.5 Where the Authority would be precluded from confirming a merger by reason of any of the defects specified in the Three Criteria, Section 95(6) provides that it may direct a society to remedy the defects. A direction under that sub-section may require a society to call a further meeting; for example, to vote again in the light of a revised Schedule 16 Statement containing material information previously omitted, or after correction of defects in the systems for sending notices of meeting and Statements and validation of votes. If the Authority is then satisfied, having considered evidence furnished by the society, that the defects have been substantially remedied, it must confirm the merger. If not, then confirmation must be refused.

### *Scope of the Authority's Powers*

- 5.6 The Authority's powers in connection with applications for confirmation of a merger are confined to considerations of whether, in the light of the facts, any of the Three

Criteria apply. It is not for the Authority to consider, or make judgements about, the merits of a proposed merger or the fairness of its terms; these matters are first for the board of a society, and then for its members to decide. Once the members have approved the merger and its terms, the Authority has no powers to require a society to make any changes to those terms. The Authority's discretionary powers are similarly confined to the matters described in paragraphs 5.4 and 5.5.

- 5.7 The Authority has no general power to determine disputes between a society and its members. Disputes concerning the services provided by societies in the ordinary course of their business are generally a matter, in the first instance, for a society's internal complaints procedure. They may also fall within the jurisdiction of the Financial Services Ombudsman. Disputes between a building society and a member of the society, in his capacity as a member, in respect of any rights or obligations arising from the Rules of the society or the provisions of the 1986 Act, fall within the jurisdiction of the High Court or, in Scotland, the Court of Session (Section 85 of and Schedule 14 to the 1986 Act). However, the Authority does have power, on the written application of an eligible member, to direct that the member has the right to obtain names and addresses from the society's register of members. Before it gives such a direction, the Authority is required to be satisfied that the member requires that right for the purpose of communicating with members of the society on a subject relating to its affairs, and must have regard to the interests of the members as a whole and to all the other circumstances (Schedule 2, paragraph 15). A fee is payable by the applicant. Chapter 1 on applications for access to the register of members explains who is eligible to apply.

#### *Purpose of Confirmation*

- 5.8 The purpose of the confirmation process is to enable:
- (a) interested parties to make representations with regard to the Three Criteria;
  - (b) the society to respond to those representations;
  - (c) the Authority to make such enquiry as it considers necessary to reach informed conclusions on the Three Criteria.
- 5.9 The Authority, in reaching its view on each of the Three Criteria, has to assess not only the points made to it in representations, and the society's responses, but also to

make such further enquiries as it considers necessary. In deciding how far it should pursue such enquiries, the Authority has to have regard to the role and effect of confirmation, and to the mischief which it is intended to prevent. The Authority considers that one role of confirmation is to provide a protection to members against the provision to them by the society of information which is inadequate, obscure or misleading, and against voting irregularities: in other words to ensure that the vote represents the informed decision of the members. The Authority would hope that this safeguard would work in the majority of cases by raising relevant issues early - by causing the board of a society to take care **not** to put confirmation at risk on this account - rather than by the Authority finding that it needed to withhold confirmation at the last stage. In considering the First Criterion, the Authority will have regard to the totality of the information provided to the members by the board of a society and not exclusively to the Schedule 16 Statement.

5.10 The task of the Authority is accordingly:

- (a) to reach a considered view on each of the Three Criteria;
- (b) if that view is that none applies, to confirm;
- (c) if either of the First Two Criteria apply to direct the appropriate remedial action, or to refuse confirmation;
- (d) if the Third Criterion applies, to consider whether it is appropriate to direct that any failure be disregarded: if not, to direct the appropriate remedial action or to refuse confirmation.

In considering the Three Criteria, the Authority may well have to look again at the Schedule 16 Statement, or at issues which were considered in connection with approving that Statement. In doing so, it has a duty to consider information and arguments put to it by representers and by the society, which of their nature were not available earlier, as well as those arising from its own further consideration of the criteria. The Authority would clearly only change the view reached at the time of approval of the Schedule 16 Statement if there were good reasons to do so. But it is under a duty to examine the Statement and connected issues at the time of confirmation in the light of any new information and arguments which become available. Accordingly, the Authority cannot be bound at the confirmation stage to the



view that was taken at the earlier stage as to whether further factual information should be included in the Schedule 16 Statement or as to the accuracy of its contents.

- 5.11 The task of considering each of the Three Criteria is still necessary even if there are no representations. Without such enquiry and consideration the confirmation process would not properly be carried out. The Authority's view of how the Three Criteria should be interpreted and applied is given in the following paragraphs.

*The First Criterion*

- 5.12 This criterion requires the Authority to consider whether some material information was not made available to the members. The Authority's own view, in which it concurs with the view developed by the Commission in its confirmation decisions, can be summed up as follows:

- (a) the words “**made available to all the members eligible to vote**” mean that the criterion is mainly, if not exclusively, directed to the information provided by a society to the generality of its members;
- (b) the extent of “**information .... not made available**” can reasonably be assessed by considering how far the totality of information made available falls short of what might be expected to be put to its members by a financial institution of standing and repute seeking to put sufficient information and a fair and balanced assessment of it, and the board's conclusions, to the members to enable them to take an informed decision;
- (c) the words “**material to the members' decision**” require the Authority then to focus on whether it is within the bounds of reasonable possibility that the members' decision would have been different, had any deficiency in information been made good, i.e. whether it could have changed the decisions on voting of sufficient members to lead to a different conclusion. If it is within the bounds of reasonable possibility that the deficiency might have changed the outcome, it is not for the Authority to determine whether it would actually have done so - it should put the decision back to the members. This test requires the Authority to take account both of the size of the vote and of the size of the majority within it;

- (d) the relevance of a particular piece of information to an investor and to a borrower may well be different. Accordingly, it is necessary to consider materiality separately in relation to the shareholding members' resolution and the borrowing members' resolution.

5.13 The Authority's approach to determining whether this criterion is met will accordingly be:

- (a) to review the material put to members, in the light of the members' representations made and the society's responses, but also taking points of its own accord;
- (b) to consider, on the basis of that review, what information relevant to the decision of shareholders, or of borrowers, or both, might reasonably have been expected to be put to members by the board of a society of repute considering its fiduciary duty, and the extent to which (if at all) the information actually put falls short of that;
- (c) to consider separately in relation to the shareholding members' resolution and in relation to the borrowing members' resolution, whether any deficiency so identified was sufficient to amount to "information material to the members' decision".

#### *The Second Criterion*

5.14 This criterion requires the Authority to consider whether the votes on the Merger Resolutions do not represent the views of the members. The main mischief to which it appears to be directed is a merger approved by a small and unrepresentative vote. However, a very low turnout, of itself, does not necessarily mean that the criterion applies. It has to be considered in the context of the other criteria, and of any other factors which may have affected the turnout: for example, whether all the members entitled to vote were fully and clearly informed of the terms of the merger proposal and its consequences; whether the members were afforded adequate facilities and opportunity to cast their votes; and the scrutineers' report on the conduct and counting of votes, including the number of, and reasons for, invalid proxy votes.

### *The Third Criterion*

5.15 This criterion requires the Authority to consider whether the relevant requirements of the 1986 Act and the Rules have been fulfilled. The phrase “**some relevant requirement of this Act or the rules of the society**” appears explicitly three times in Section 95 of the 1986 Act:

- (a) sub-section (4)(c) in the specification of this criterion;
- (b) sub-section (5) which gives the Authority power to disregard certain non-fulfilments;
- (c) sub-section (10) which provides that a failure to meet such a relevant requirement shall not invalidate a transfer of engagements, although such failure by a society without a reasonable excuse is a criminal offence.

The interpretation of the phrase is also directly relevant to sub-section (6) - the power of the Authority to give the society a direction to remedy defects specified in paragraphs (a) to (c) of sub-section (4).

5.16 Sub-section (11) defines “relevant requirement”:

“In this section “relevant requirement”, with reference to this Act or the rules of a society, means a requirement of section 93 or 94 or this section or of Schedule 16 to this Act or of any rules prescribing the procedure to be followed by the society in approving or effecting an amalgamation or transfer of engagements”.

The Authority considers that this sub-section should be read naturally. The words “prescribing the procedure to be followed by the society in approving or effecting” a merger apply only to the Rules, in order to specify which of the Rules of the society are “relevant requirements”. They do not apply as a matter of normal construction of the sentence to the “applicable provisions of this Act”: nor is it necessary that they should do so, since those provisions are specified in the sub-section.

5.17 The Authority recognises that the interpretation of “relevant requirement of the Act”, which it considers stems from the natural construction of Section 95(11) of the 1986 Act and which is necessary to give effect to Parliament’s intentions for Section 95(6)

and (10), does not quite fit Section 95(5). The test which the Authority has to apply in the case of sub-section (5) to a non-fulfilment of a relevant requirement of the 1986 Act is:

“if it appears to the Authority that it could not have been material to the members’ decision about the amalgamation or transfer”.

That test clearly is designed to relate to a failure to meet a procedural requirement or to some other failure which might have an effect on the voting.

5.18 The wording of Section 95 of the 1986 Act is such that no construction of the phrase is entirely free from difficulty. The Authority’s view is that the wording, and the intentions of Parliament, are best met by following the natural construction of sub-section (11), as a result applying a wide interpretation in sub-sections (4), (6) and (10), but only considering that it is open to the Authority to make a direction under sub-section (5) in relation to non-fulfilment of a procedural requirement or other failure to which the test in that sub-section is apposite.

5.19 The Authority considers that the relevant requirements of the Rules are those which prescribe the procedure to be followed that is, in particular, the Rules concerning membership, special meetings, notice of meetings, procedure at meetings, entitlement of members to vote on resolutions, appointment of proxies and joint shareholders and borrowers.

### **Procedure**

5.20 The procedure to be followed in the confirmation process is prescribed by Part III, paragraphs 7 to 9, of Schedule 16 to the 1986 Act. Any interested party has the right to make written representations, and/or to give notice of intention to make oral representations to the Authority with respect to a society’s application for confirmation. Written representations are to be copied to the participating societies, which are to be afforded the opportunity to comment on them in writing or orally at the hearing of their applications. (The FSA will in general be prepared to use electronic rather than paper-based communication if requested by the society or a prospective presenter and some of the following procedures may have to be adapted accordingly.)

## *Representations*

- 5.21 Persons making representations should state why they claim to be interested parties, for example their category of membership of the society, and the ground or grounds for their representations by reference to the Three Criteria discussed above. Written representations, or notice of a person's intention to make oral representations, or both, must be in writing. They must reach the Authority at the address, and by the date, given in the Merger Document issued to members and subsequently published by notice in the official Gazettes and newspapers as required by the 1986 Act. Persons who make written representations and who subsequently decide also to make oral representations must, nevertheless, give notice of that intention in writing to the Authority by the same date. Representations received out of time will not be considered unless, exceptionally and at the sole discretion of the Authority, they appear to the Authority to raise matters of substance relevant to the Three Criteria which are not already under consideration.
- 5.22 Representations or notices to the Authority will fall into one of the following three categories:
- (a) written representations only
  - (b) written representations with notice of intention to make oral representations
  - (c) notice of intention to make oral representations only.
- 5.23 The Authority will acknowledge the receipt of each representation or notice and will send a copy of chapter 4 of this IPSB on confirmation procedures to each representer. It will send copies of all written representations to the societies concerned and will afford them an opportunity to comment on them.
- 5.24 Copies of the society's comments on representations in category 5.22(b) will be sent to those who made the representations so that they may concentrate their oral representations on the points which they consider to remain at issue. Persons making written representations who wish to see the society's response must, therefore, give notice of intention to make oral representations. The Authority will consider the written representations in category 5.22(a) and the societies' responses to them in advance of the date set for hearing oral representations. The society may, exceptionally, apply to put to the Authority in confidence documents which the

society considers to be commercially sensitive: the Authority will decide on the merits of each case whether, and on what terms, to accept them as being confidential.

Persons in category 5.22(c) will be asked to inform the Authority, in advance of the hearing, of the subject and general grounds of the representations they intend to make and their responses will be copied to the society.

- 5.25 Interested parties may join together in making collective representations and they may also appoint a person, either one of their number or another, to represent them at the hearing. They should notify the Authority in advance if this is what they intend to do.

#### *Conduct of the hearing*

- 5.26 The Authority may appoint one or more persons to hear and decide applications on its behalf. In the absence of notices of intention to make oral representations the Authority would expect to decide the applications having regard to the written representations, the societies' responses and other information available to it, without the need for an oral hearing.

- 5.27 The Authority will notify the societies and those making oral representations of the time and place of the hearing. If there are a significant number of persons wishing to make oral representations, then the hearing may extend beyond one day and may be adjourned from time to time and from place to place. The Authority will try to advise participants of the day when they may expect to make their representations and when the societies' representatives may be expected to respond.

- 5.28 The Authority expects that hearings will be in public. Members of the general public and the press will be asked to wait outside at the outset of the hearing. The participants will then be asked if any of them has good reason to object to the admission of the general public and the press (such as, for example, the need to refer to personal financial affairs). The Authority may decide that parts of the hearing shall be in private if that appears to it to be desirable. If there are no reasonable objections, the general public and the press will then be admitted, within the limits of the space available.

- 5.29 The procedure will be informal. While all participants will be invited to speak concisely and to avoid repetition the Authority will be considerate towards those who are not professionally represented. The individual or panel taking the hearing on

behalf of the Authority may question the participants as the hearing proceeds. The sequence of events will be broadly as follows:

- (a) any preliminary matters (such as the admission of the public or other procedural questions) will be dealt with;
- (b) the person(s) appointed to hear the applications will introduce the proceedings;
- (c) the representatives of the societies will be invited to present their applications for confirmation, including a description of the events at the meetings at which the Merger Resolutions were put to the members, the statement of the voting on the resolutions, as well as any other matters which they wish to introduce at that stage;
- (d) the other participants will be invited to make their representations; where appropriate the Authority would expect to call them in a list marshalled, so far as possible, by subject matter;
- (e) the representatives of the societies (or of the relevant society) will be invited to reply to, or comment on, the points made by the other participants;
- (f) the other participants will be invited to comment on the societies' replies in so far as those replies raise new issues.

5.30 The above procedure may be varied according to the circumstances at the hearing, and is intended only as a guide to the probable order of events. The hearing may be adjourned if the Authority considers that is necessary to enable facts to be checked or additional information to be obtained.

#### *The Authority's decision*

5.31 The Authority will not normally give an oral decision at the end of the hearing and may be expected to reserve its decision to be issued later in writing, setting out its reasons. Copies of the written decision will be sent to the participants and, on request, to any other person. The decision may also be published, and the Authority usually asks the Central Office to place copies on the public files of the participating societies.

## 6. TRANSFER OF ENGAGEMENTS UNDER DIRECTION

**This section describes the Authority’s powers to direct a society to transfer all its engagements to one or more other societies and/or to proceed by board resolution, and the modified merger procedure consequently prescribed by the 1986 Act.**

- 6.1 Section 42B of the 1986 Act provides that, if the Authority considers it expedient to do so to protect the investments of shareholders or depositors, it may direct a society, among other things, to transfer all its engagements to one or more other societies within a specified period (subsection (1)(a)). In such a case, or where the Authority would have directed a transfer of engagements, but for the fact that negotiations were already under way, the Authority may also direct that the approval of the transfer of engagements by the transferor society may be by board resolution rather than by Merger Resolution. In these circumstances, because neither a Schedule 16 Statement nor Merger Resolutions are required, the 1986 Act requires the society instead to send to every member entitled to notice of a meeting a statement (referred to below as a “**Merger Notification Statement**”) before it applies for confirmation of the transfer of engagements, (paragraphs 3 and 4 of Schedule 8A to the 1986 Act). Finally, in these circumstances, the First and Second Criteria concerning information made available to, and the views of, the members (see section 5) are replaced by a single criterion:

“the members or a proportion of them would be unreasonably prejudiced by the transfer;” (paragraph 5 of Schedule 8A to the 1986 Act).

- 6.2 Where a society is proceeding under a Section 42B(3) direction by board resolution, the Schedule 16 Statement is replaced by a Merger Notification Statement and a general meeting of the society is not required. The contents of the Merger Notification Statement are prescribed by The Building Societies (Merger Notification Statement) Regulations 1999 (SI1999/1215).
- 6.3 The Merger Notification Statement must have been approved by the Authority before it is sent to the members, and must be sent within the specified time limit. Applications for approval should, in general, follow the procedure described in



paragraph 3.28, and the final draft of the Merger Notification Statement should be accompanied by the relevant documents listed in paragraph 3.29, but as appropriate to the particular case and the less extensive information the statement is required to contain. The statement must include particulars of any compensation payable to directors or other officers to which the Authority has given its consent under paragraph 2(1) of Schedule 8A to the 1986 Act.

- 6.4 Section 4 (General Meetings and Resolutions) does not apply, except that the directors will need to be satisfied that the society's register of members is correct to enable the society to send Merger Notification Statements to those entitled to receive them.
- 6.5 When the board has resolved to transfer the society's engagements and Merger Notification Statements have been sent to its members, the society may apply to the Authority for confirmation of the transfer of engagements, but using an adaptation agreed with the Authority of the *pro forma* in Annex B1. The procedure described in section 5 is to be followed, including the publication of notices in the official Gazettes and newspapers and the form of application. However, the lapse of time between each stage of the procedure may be modified according to the particular circumstances of a case, and having regard to the need to protect the investments of shareholders or depositors. While a scrutineer's report will not be required, the Authority will require a report from the society's external auditors on the adequacy of the society's systems to fulfil the requirements of the 1986 Act and the Rules with regard to the sending of Merger Notification Statements. This is, of course, relevant to the Authority's consideration of the Third Criterion.
- 6.6 As is noted in paragraph 6.1, the First and Second Criteria are replaced, in those circumstances, by a single criterion as to whether the members or a proportion of them "would be unreasonably prejudiced by the transfer". Whether this special criterion applies will be a matter of judgement for the Authority to make in the light of any representations made to it and its own enquiries in respect of the particular case. It follows also that, in considering the Third Criterion, the Authority will take account of the modified procedure.

## 7. REGISTRATION AND DISSOLUTION

- 7.1 When the Authority has confirmed a merger (whether voluntary or under direction) it will notify the Central Office and the societies concerned.
- 7.2 **In the case of an amalgamation**, the Central Office is required to be satisfied as regards the proposed Rules, Memorandum and name of the successor society. The amalgamating societies are, therefore, advised to clear drafts of the proposed Rules and Memorandum with the Central Office at an early stage (see paragraph 3.28). When they apply to the Authority for confirmation under Section 93(2) of the 1986 Act, the amalgamating societies must also send three signed copies of the Rules and Memorandum to the Central Office (Section 93(2)(d)). If the Central Office is satisfied on these matters it will, upon confirmation, register the successor society and issue to it a certificate of incorporation specifying the date (the specified date) from which the incorporation takes effect, and will return to it one copy each of the Rules and Memorandum together with a certificate of registration. Copies are placed on the public file of the successor society.
- 7.3 On the specified date of the amalgamation, all the property, rights and liabilities of the amalgamating societies are transferred to the successor society, the successor is given such permission under Part IV of the Act as the Authority considers appropriate, and the amalgamated societies are dissolved and their registrations cancelled (Section 93, sub-sections (4), (5) and (6) and Section 103(1) of the 1986 Act). In deciding on the appropriate terms of the permission for the successor society, the Authority will have regard to the terms of the permissions of the amalgamating societies, including any limitations or requirements. It will also have regard to the business plan for the successor society.
- 7.4 **In the case of a transfer of engagements**, the Central Office will register a copy of the Instrument of Transfer of Engagements and issue a registration certificate to the transferee society. A copy of the Instrument of Transfer and the registration certificate are placed on the public file of the transferee society. On the date specified in the registration certificate, the property, rights and liabilities of the transferor society are transferred to the transferee society, by virtue of Section 94(8) of the 1986 Act, the transferor society's authorisation is revoked by the Authority, and the society itself is dissolved (Section 94(10)). The transferor society's registration is subsequently cancelled by the Central Office under Section 103(1).

## 8 TIMETABLE

8.1 The time taken to complete a merger will vary from case to case. As a general rule of thumb, it is unlikely that a merger can proceed from board decision through approval of the Schedule 16 Statement, general meeting and confirmation hearing, to the effective date, in less than 6 months. It is essential to the good and orderly management of a merger that the societies concerned meet with the Authority's staff as soon as their boards have resolved to seek a merger, and agree upon a provisional timetable. This can then be fixed by the time the Schedule 16 Statement is approved. The members can then be notified, as they must be, of the date provisionally set for the confirmation hearing and of the proposed date of completion of the merger in the Merger Document.

8.2 The likely sequence of events is as follows:

Stage 1            Informal consultations with the Authority's supervisory staff on both substance and timing of the proposed merger.

Stage 2            Submission to the Authority of:

(a)            prudential information: this should be available to the Authority for discussion with the society well before the Schedule 16 Statement is submitted for approval;

(b)            written details of the proposed terms of the merger: it will be helpful for both the societies and the Authority to be clear about these matters as soon as possible after Stage 1 and well before Stage 3 is reached.

Submission to the Central Office, in the case of an amalgamation, of preliminary draft Rules and Memorandum, noting any unresolved issues.

Stage 3            Submission to the Authority and, in respect of (b) below, to the Central Office in draft of the following:

- (a) the Instrument of Transfer or amalgamation agreement embodying the merger terms provisionally agreed by the respective boards of directors;
- (b) in the case of an amalgamation, the proposed Rules and Memorandum of the successor society;
- (c) the Merger Document, including the Schedule 16 Statement, unless consent to proceed by way of board resolution is being sought in respect of the transferee society, together with the explanations of change, comparability and commitments referred to in paragraphs 3.8 to 3.10 and 3.27;
- (d) notice of the meeting at which the Merger Resolutions are to be moved, which may form part of (c) above;
- (e) the proxy voting forms to be used.

After examination of these drafts, the Authority or, as the case may be, Central Office staff will return them with any comments and, if necessary, will discuss them with the societies and their advisers. Any clearance by the Authority at this stage is provisional, and the Authority may seek further modification of the documents in the light of later information. Similarly, any clearance given by the Central Office is subject to review of the proofs submitted at stage 4.

If the transferee society is applying for consent to proceed by way of board resolution, formal application to do so (with supporting justification) should be made to the Authority at this stage.

- Stage 4      Submission of printers' proofs of the above draft documents.
  - Stage 5      Informal clearance of near-final proofs (particularly of the Schedule 16 Statement(s)) by the Authority.
- Informal clearance of proof copies of Rules and Memorandum by the Central Office, in the case of an amalgamation.

Stage 6            Formal submission of the Schedule 16 Statement(s) for approval by the Authority. The covering letter should include a declaration on behalf of the board of the society either:

- (a)     that there has been no material change in the financial position of the society since the date of the information provided in the Schedule 16 Statement; or
- (b)     that there has been such a change and that it is fairly reflected in the wording of the statement.

This submission should be accompanied by:

- (c)     a certified copy of the Instrument of Transfer or amalgamation agreement as executed;
- (d)     two copies of the final printers' proof of the Schedule 16 Statement signed by the Secretaries of each society;
- (e)     a final printers' proof of the complete Merger Document to be sent to members, together with any covering letter and other documents to be sent with it, including proxy voting forms;
- (f)     an assurance from the chairman of each society that the Schedule 16 Statement is complete and that all material interests of directors and officers are disclosed in it;
- (g)     an assurance by or on behalf of the board on systems.
- (h)     letter of comfort from the society's external auditors when required (see paragraph 3.7);
- (i)     confirmation that drafts submitted for approval are identical to those seen at stage 5;
- (j)     the fee payable by each society to the Authority.

NB Schedule 16 Statements should not be printed for distribution to members until after Stage 7.

- Stage 7 Approval by the Authority of the Schedule 16 Statement, or the Authority's consent to proceed by board resolution. Approval or consent will be given by letter and one proof copy of the Schedule 16 Statement, with the certificate of approval signed on behalf of the Authority, will be returned to the society.
- Stage 8 Printing and circulation of documents to members in time to be received by them at least 21 days before the voting date for the meeting at which the Merger Resolutions are to be moved (see paragraphs 4.12, 4.19 and 4.20).
- Stage 9 The meetings at which the Merger Resolutions are moved.
- Stage 10 If the Merger Resolutions have been passed, application to the Authority for confirmation and publication of notices of that application in the London and Edinburgh or Belfast Gazettes, and in other newspapers (as the Authority directs). The application must notify the Authority of the specified effective date for the merger, and be accompanied by two authenticated copies of the Instrument of Transfer or amalgamation agreement. In addition, in an amalgamation, four signed copies of the Memorandum and Rules of the successor society should be sent to the Central Office. The societies must report to the Authority on the outcome of their meetings.
- Stage 11 Notification by the Authority of the time and place of the confirmation hearing, if it is necessary to hold an oral hearing. The societies should allow sufficient time before the proposed effective date for the Authority to consider and write its decision, and in case it proves necessary to adjourn the hearing.
- Stage 12 Confirmation hearing and decision by the Authority whether to confirm the merger.
- Stage 13 Registration by the Central Office to give effect to the amalgamation or transfer of engagements.

8.3 The following table indicates the likely minimum time to be taken by the main stages outlined above:

Pre Day 1	Board Resolution to Merge Initial discussions with Authority re timetable and prudential information Submission of terms and initial prudential information to Authority Submission of draft Rules and Memorandum to Central Office (amalgamations)
Day 1	First draft of Schedule 16 Statement and chairman's letter and notice of meetings, draft Rules and Memorandum (amalgamations) (Stage 3)
Day 28	Authority gives informal approval to Schedule 16 Statement, Instrument of Transfer signed (Stage 5)
Day 35	Formal Schedule 16 approval by the Authority (Stage 7)
Day 35-43	Printing, enveloping and mailing of Schedule 16 Statement and notice of meetings (Stage 8)
Day 65 - 70	Last date for receipt of proxy votes (depending on Act and Rules)
Day 72	SGM (Stage 9)
Day 75	Application to Authority for confirmation (Stage 10) Rules and Memorandum to Central Office (amalgamations)
Day 93	Closing date for receipt of representations
Day 114	Confirmation hearing (Stage 12)
Day 142	Authority's Decision on Confirmation (Stage 12)
Day 160	Effective Date

**Notes:**

- (a) Within the above timetable prudential information to be submitted.
- (b) A significant amount of financial information needs to be assessed by the Authority prior to approval of Schedule 16 Statement.
- (c) Prior to approval of Schedule 16 Statement a plan/timetable for integration of systems to be drawn up. Auditors sign off required prior to effective date.

## PRO FORMA MERGER DOCUMENT

### 1. Title Page

Including suggestion to consult professional advisers and reference to meeting notice and voting procedures.

### 2. Directors' Responsibility Statement

See paragraph 3.26.

### 3. Board Rationale

Including statutory Merger Statement, if required (see paragraphs 3.23 and 3.24).

### 4. The Merger Process

Description and explanation of:

- (a) the general meeting and Merger Resolutions;
- (b) the confirmation process, including the right of interested parties to make representations to the Authority, the dates provisionally set for receipt of written representations and notice of intention to make oral representations, and for the confirmation hearing, and the confirmation criteria specified in Section 95 of the 1986 Act;
- (c) the planned effective date of the merger.

### 5. The Instrument of Transfer of Engagements or Amalgamation Agreement

The address of the principal office of the society where the Instrument of Transfer or amalgamation agreement will be available for inspection, and whether copies of the Instrument or agreement will also be available at branch offices, with a cross-reference to Section B of the Schedule 16 Statement.



## 6. The Schedule 16 Statement

### *Statement Required by Schedule 16 to the Building Societies Act 1986*

#### **Proposed Transfer of Engagements of [ABC] Building Society to [DEF] Building Society**

or

#### **Proposed Amalgamation of [ABC] Building Society and [DEF] Building Society to form [GHI] Building Society**

#### *Section A: Financial Position of Each Society*

##### 1. *Balance Sheets*

Summarised balance sheets derived from the audited [unaudited] [consolidated] accounts of [ABC] [society] [Group] for the financial year ended (date) [as at (date)] and from the audited [unaudited] [consolidated] accounts of [DEF] [society][Group] for the financial year ended (date) [as at (date)] are set out below:

	Notes	ABC [Group] £m	DEF [Group] £m
<i>Assets</i>			
Liquid assets	4(b)	•	•
Mortgages	4(e)	•	•
Other loans	4(e)	•	•
Fixed and other assets	4(c),(d)	•	•
		<hr/>	<hr/>
		•	•
<i>Liabilities</i>			
Shares		•	•
Borrowings		•	•
Other liabilities		•	•
Subordinated liabilities		•	•
Subscribed capital		•	•
Reserves		•	•
Other capital		•	•
- revaluation reserve		•	•
[ - other]		•	•
		<hr/>	<hr/>
		•	•

2. *Results*

Particulars derived from the audited [unaudited] [consolidated] accounts of [ABC] [Group] for the period ended (date) and from the audited [unaudited] [consolidated] accounts of [DEF] [Group] for the period ended (date):

	<b>ABC [Group] £m</b>	<b>DEF [Group] £m</b>
Net interest receivable	•	•
Other income and charges	•	•
Administrative expenses	•	•
Provisions	•	•
	<hr/>	<hr/>
Profit/loss for the period before taxation	•	•
Taxation	•	•
Minority interests	•	•
Profit/loss for the period	•	•
	<hr/>	<hr/>

3. *Key Financial Ratios*

	<b>ABC [Group] %</b>	<b>DEF [Group] %</b>
As a percentage of shares and borrowings:		
Gross capital	•	•
Liquid assets	•	•
As a percentage of mean total assets:		
Profit after taxation for the period	•	•
Management expenses for the period	•	•

The above percentages have been calculated from the balance sheets summarised above.

Gross capital comprises reserves and other capital, plus subscribed capital and subordinated liabilities, and amounts to £..... million for [ABC] and £..... million for [DEF].

Shares and borrowings, adjusted to exclude interest accrued but not yet credited to accounts, amount to £..... million for [ABC] and £.... million for [DEF].

Average total assets is calculated as the mean of the total assets at the beginning and end of the period and amounts to £..... million for [ABC] and £..... million for [DEF].

The estimated gross and net costs of the bonus to be paid to members are £....

The ratio of gross capital to shares and borrowing of the combined society, after allowing for the net cost of the bonus to be paid to members, is estimated to be .....%. On the same basis of calculation, but not accounting for the bonus payment, this ratio is estimated to be .....%.

#### 4. *Notes to the Financial Position*

(a) Accounting policies

[Identify any significant differences between the accounting policies adopted by the two societies, and quantify the impact of a change in policy to achieve consistency. If there are no such differences then this should be stated].

(b) Liquid assets include listed securities as follows:

	<b>ABC [Group] £m</b>	<b>DEF [Group] £m</b>
Amount included in the balance sheet	• _____	• _____
Market value	• _____	• _____

(c) Fixed and other assets

	<b>ABC</b> <b>[Group]</b> <b>£m</b>	<b>DEF</b> <b>[Group]</b> <b>£m</b>
Tangible fixed assets	•	•
[Intangible fixed assets]	•	•
Other assets	•	•
	<hr/>	<hr/>
	•	•
	<hr/>	<hr/>

[Describe the nature of any intangible fixed assets and the method of amortisation thereof, if any]

(d) Tangible fixed assets

	<b>ABC</b> <b>[Group]</b> <b>£m</b>	<b>DEF</b> <b>[Group]</b> <b>£m</b>
Net book amount of land and buildings		
Freehold	•	•
Long leasehold	•	•
Short leasehold	•	•
	<hr/>	<hr/>
	•	•
Other tangible fixed assets	•	•
	<hr/>	<hr/>
	•	•
	<hr/>	<hr/>

[For each society's land and buildings give the difference between the net book amount and estimated current market value, or a director's opinion that there is no material difference between the two. Indicate the basis on which current market value has been determined, the effective date of the valuation and the name(s) of the valuer(s)]

[Identify significant differences in depreciation policy or estimated asset lives, quantifying the impact of any change to a common basis]

(e) Provisions for losses on mortgages and other loans

	<b>ABC [Group] £m</b>	<b>DEF [Group] £m</b>
Specific provisions	•	•
General provisions	•	•
	<hr/>	<hr/>
Total amount offset against mortgages and other loans	•	•
	<hr/>	<hr/>

(f) Pensions

[Describe the pension schemes of each society and the extent to which funded schemes are, on the basis of the latest actuarial valuations, in surplus or deficit. Give date of most recent actuarial valuation.]

(g) Summary information on the businesses of [connected undertakings]

The financial information given above includes the assets and liabilities and results of the Society and the following subsidiary undertakings and associated undertakings.

ABC [Group]

Subsidiary undertakings [names]	Principal activity
------------------------------------	--------------------

Other associated undertakings  
[names]

DEF [Group]

Subsidiary undertakings [names]
------------------------------------

Other associated undertakings  
[names]

(h) Post balance sheet events

[see paragraph 3.8]

5. *Costs and benefits of the merger*

[Give a factual assessment of the quantifiable and unquantifiable actual and expected costs and benefits, including integration, rationalisation and future business plans]

***Section B: Instrument of Transfer of Engagements or Amalgamation Agreement***

*The paragraphs below prefaced by “Note” do not appear in [nor are they a paraphrase of the text in] the Instrument of Transfer or amalgamation agreement and are intended for the additional information of members.*

The Instrument of Transfer or amalgamation agreement provides, inter alia, for the following matters.

1. *Name of Society*

The name of the combined society will be ..... Building Society.

2. *Transfer of Assets and Liabilities*

On the Effective Date (see item 10) the property, rights and liabilities of [ABC] Building Society will be transferred to and vest in [DEF] Building Society (the combined society). [In an amalgamation, the assets and liabilities of both societies are vested in the new successor society.]

3. *Membership Rights*

[Give the provisions of the Instrument of Transfer or amalgamation agreement concerning deemed membership. See paragraph 3.16]

4. *Share Accounts and Deposit Accounts*

On the Effective Date, share and deposit account balances of [ABC] Building Society will become share and deposit account balances with [DEF] Building Society on the following terms:

[Give the provisions of the Instrument of Transfer or amalgamation agreement and refer to the Investment Schedules in Section C]

Note: interest rates which are variable are subject to change either before or after the Effective Date of the merger.

[Provisions concerning PIBS]

5. *Mortgage Accounts*

On the Effective Date, the indebtedness of any person to [ABC] Building Society for a loan made by it [fully] secured on residential property will become indebtedness to [DEF] Building Society to the same extent and such indebtedness will be subject to the same terms and conditions as presently apply except that the Rules of [DEF] Building Society rather than the Rules of [ABC] Building Society shall apply.

[Alternatively, give the provisions of the Instrument of Transfer or amalgamation agreement concerning any change in terms and conditions]

Note: [give any further explanation necessary to a clear statement of any changes, including those effected by the transferee society's Rules]

6. *Bonus to Members*

[Give the provisions of the Instrument of Transfer or amalgamation agreement and the estimated net cost of the bonus. See paragraphs 3.13 and 3.14]

7. *Directors and Other Officers*

[Give the provisions of the Instrument of Transfer or amalgamation agreement]

Note: [Describe any changes in fees and contracts of employment or bonus schemes, or whether there will be no change]

Note: [Describe any compensation to be authorised by separate special resolution, or state that no such compensation is to be paid. State whether any person is not to take up employment with the combined society and that any payments to be made under their contracts of employment do not fall to be approved by special resolution. See paragraphs 3.11 and 3.12]

8. *Employees*

[Give the provisions of the Instrument of Transfer or amalgamation agreement]

Note: [State, unless the Instrument or agreement so provides, whether there are to be any changes to terms and conditions of employment, and what they are, and explain how any staff reductions are to be achieved and the planned timescale.]

9. *Pension Arrangements*

[Give the provisions of the Instrument of Transfer or amalgamation agreement]

10. *Conditions and Termination Provisions*

[Give details of the provisions of the Instrument of Transfer or amalgamation agreement which (a) impose conditions on the completion of the transfer of engagements, such as approval by the members and confirmation by the Authority, and (b) provide for the termination of the agreement if one or more of the conditions is not met or in any other circumstances.]

11. *Rules and Memorandum*

[Explain any proposed Rule changes and, in the case of an amalgamation, any differences in the proposed Rules and Memorandum compared with the existing societies.]



### ***Section C: The Investment Schedules***

[These are the schedules referred to in Section B.4 and in paragraph 3.17]

### ***Section D: Information for Holders of PIBS***

[If either society has issued Permanent Interest Bearing Shares]

### ***Section E: Other Matters***

1. Save for [the following and] the matters referred to in Section B.7 no director or other officer of [ABC] Building Society or [DEF] Building Society will receive any benefits in connection with the merger or will have any material interest in the merger.

[Describe any other interests of directors or other officers and persons (including companies) connected with them by way of, for example, fees for professional services, or supply of goods and services]

2. The directors of [ABC] Building Society and the directors of [DEF] Building Society confirm that the transfer of engagements [amalgamation] will not conflict with any contractual commitments of their Society or its connected undertakings.
3. The directors of [ABC] Building Society and the directors of [DEF] Building Society confirm that there has been no material change in the financial position of their Society or its connected undertakings since [date], the date to which the information in Section A relates [other than the post balance sheet event(s) described in Section A 4(h)].

[Name]  
Secretary  
[ABC] Building Society  
[date]

[Name]  
Secretary  
[DEF] Building Society  
[date]

## 7. Notice of Special General Meeting

## 8. Guidance on Voting

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- generally
- joint members
- minors

The Poll

Merger Resolutions:

- shareholding members
- borrowing members
- members who are shareholding and borrowing members

[Affected Members Resolution]

[Directors Compensation Resolution]

[Distribution to Members Resolution]

Voting in person

Voting by proxy

[Making enquiries, Helpline]

**PRO FORMA NOTICE OF, AND APPLICATIONS FOR, CONFIRMATION**

- 1. Notice of Application**
- 2. Application - amalgamation**
- 3. Application – transferor society**
- 4. Application – transferee society**

*Publication of Notice of application to the Authority for confirmation of an amalgamation or transfer of engagements in the London, Edinburgh, or Belfast Gazettes and in any newspapers as may be directed by the Authority.*

-----

**BUILDING SOCIETIES ACT 1986**

**Notice under paragraph 8 of Schedule 16 to the said Act.**

Notice is hereby given that ..... Building Society, Register No.....B, whose principal office is at ....., desires to amalgamate with\*/transfer its engagements to\*/accept a transfer of the engagements of\* ..... Building Society, Register No.....B, and that both societies have jointly\*/each society has\* applied to the Financial Services Authority to confirm the amalgamation\*/transfer\*.

Any interested party may make written representations to the Authority and/or give notice of intention to make oral representations to the Authority with respect to the application. Written representations and notices of intention to make oral representations should be received by the Authority at 25 The North Colonnade, Canary Wharf, London E14 5HS by ..... 20 .... If notice is given of oral representations these will be heard by the Authority on .....20 ....., at a time and place to be determined by the Authority.

**\*delete as applicable**

*Form of application to the Authority for confirmation of an amalgamation*

-----

To the Financial Services Authority

**BUILDING SOCIETIES ACT 1986**

**APPLICATION UNDER SECTION 93(2)(d) OF THE ACT FOR CONFIRMATION OF AN AMALGAMATION**

..... **BUILDING SOCIETY, REGISTER NO.....B, AND**

.....**BUILDING SOCIETY, REGISTER NO.....B**

The above-named societies desire to amalgamate on .....[insert effective date] and apply to the Authority to confirm the amalgamation.

In making this application the societies declare that:

1. At a meeting of..... Building Society held on ..... 20..., and at a meeting of ..... Building Society held on .....20..., the following resolutions were passed:

A shareholding members' resolution, as required by section 93(2)(c)(i) of the Act, that the societies do amalgamate in accordance with the terms of an amalgamation agreement, two copies of which, signed by the Secretary of each society for identification, are enclosed with this application.

A borrowing members' resolution, as required by section 93(2)(c)(ii) of the Act, that the societies do amalgamate in accordance with the terms of the above-mentioned agreement.

2. A statement, in accordance with Schedule 16 to the Act, approved by the Authority, so far as it concerned matters specified in that Schedule, was sent to each member of ..... Building Society and of ..... Building Society who was entitled to receive it.
3. Three copies of the Memorandum and Rules of the successor society have been sent to the Central Office.

(Seals of the societies making the application)

Date:.....

*Form of application to the Authority for confirmation of transfer of engagements (transferor society)*

-----

To the Financial Services Authority

**BUILDING SOCIETIES ACT 1986**

**APPLICATION UNDER SECTION 95(3) OF THE ACT FOR CONFIRMATION OF A TRANSFER OF ENGAGEMENTS**

..... **BUILDING SOCIETY, REGISTER NO.....B**

The above-named society desires to transfer its engagements to ..... Building Society on .....20... [insert effective date] and applies to the Authority to confirm the transfer.

In making this application the society declares that:

1. At a meeting of ..... Building Society held on .....20.. the following resolutions were passed:

A shareholding members' resolution, as required by section 94(2) of the Act, that ..... Building Society do transfer its engagements to ..... Building Society in accordance with the terms of an instrument of transfer, two copies of which, signed by the Secretary of each society for identification, are enclosed with this application.

A borrowing members' resolution, as required by section 94(2) of the Act that ..... Building Society do transfer its engagements to ..... Building Society in accordance with the terms of the above-named instrument.

2. A statement, in accordance with Schedule 16 to the Act, approved by the Authority, so far as it concerned matters specified in that Schedule, was sent to each member of ..... Building Society who was entitled to receive it.

(Seal of the Society making the application)

Date.....

*Form of application to the Authority for confirmation of a transfer of engagements (transferee society)*

-----  
To the Financial Services Authority

**BUILDING SOCIETIES ACT 1986**

**APPLICATION UNDER SECTION 95(3) OF THE ACT FOR CONFIRMATION OF A TRANSFER OF ENGAGEMENTS**

..... **BUILDING SOCIETY, REGISTER NO.....B**

The above-named society desires to accept a transfer of engagements of ..... Building Society on .....20.. [insert effective date] and applies to the Authority to confirm the transfer.

In making this application the society declares that:

\*1. At a meeting of ..... Building Society held on ..... 20.., the following resolutions were passed:

A shareholding members' resolution, as required by section 94(5)(a) of the Act, that .....Building Society shall undertake to fulfil the engagements of ..... Building Society in accordance with the terms of an instrument of transfer, two copies of which, signed by the Secretary of each society for identification, are enclosed with this application.

A borrowing members' resolution, as required by section 94(5)(a) of the Act, that ..... Building Society shall undertake to fulfil the engagements of ..... Building Society in accordance with the terms of the above-mentioned instrument.

\*2. The ..... Building Society, pursuant to the consent of the Authority in accordance with section 94(5)(b) of the Act, has undertaken by a resolution of its Board of Directors to fulfil the engagements of ..... Building Society in accordance with the terms of an instrument of transfer two copies of which, signed by the Secretary of each society for identification, are enclosed with this application.

\*3 A statement in accordance with Schedule 16 to the Building Societies Act 1986, approved by the Authority, so far as it concerned matters specified in that Schedule, was sent to each member of ..... Building Society who was entitled to receive it.

(Seal of the Society making this application)

Date.....

**\*delete as applicable (either paragraph 2, or both paragraphs 1 and 3)**





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# Interim Prudential Sourcebook for Building Societies

## 3 TRANSFER PROCEDURES

### G

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## DEFINITIONS AND NOTES

“the Act”	the Financial Services and Markets Act 2000
“the 1986 Act”	the Building Societies Act 1986 as amended <sup>(1)</sup>
“AGM”	Annual General Meeting
“the Authority”	the Financial Services Authority
“the Banking Regulator”	the Authority or other competent authority in another EEA state, as the case may be <sup>(2)</sup>
“the board”	the board of directors of a society
“borrower” or “borrowing member”	a person who is indebted to a society in respect of a loan fully secured or, where the Rules so provide, substantially secured on land
“the BSA”	the Building Societies Association
“the Central Office”	the department of the Authority carrying out the registration functions transferred from the Central Office of the Registry of Friendly Societies <sup>(2)</sup>
“the Commission”	the former Building Societies Commission <sup>(2)</sup>
“the Confirmation Criteria”	the criteria specified in Section 98(3) of the 1986 Act which the Authority has to consider when deciding whether to confirm a transfer of the business of a society to a commercial company <sup>(3)</sup>
“conversion”	the transfer of the business of a society to a specially formed company
“existing company”	a company which is a company within the meaning of the Companies Act 1985 or the Companies (Northern Ireland) Order 1986 and is a public company limited by shares, or is incorporated in an EEA State other than the United Kingdom and has power to offer its shares and debentures to the public, and which is carrying on business as a going concern on the date of the Transfer Agreement

## DEFINITIONS AND NOTES (Continued)

“the Fees Rules”	the Rules made by the Authority from time to time under paragraph 17 of Schedule 1 to the Act prescribing the fees to be paid in connection with the discharge of its functions under the 1986 Act
“the First, Second, Third and Fourth Criteria”	see the “Confirmation Criteria”, and relating respectively to the criteria specified in subsections (a), (b), (c) and (d) of Section 98(3) of the 1986 Act <sup>(3)</sup>
“member”	a shareholding or borrowing member of a society
“PIBS”	Permanent interest bearing share, a type of deferred share in a society
“proxy voting form”	an instrument appointing a proxy to attend a meeting of a society and vote on the member's behalf
“Qualifying Day”	the day specified in the Transfer Agreement as the qualifying day for the purposes of Section 100 of the 1986 Act
“Rules”	the Rules of a society
“SGM”	Special General Meeting
“shareholder” or “shareholding member”	a person holding shares in a society (by virtue of investing in one or more share accounts or holding PIBS or other deferred shares)
“society”	a building society
“specially formed company”	a company formed by a society (and by no other than its nominees) for the purpose of assuming and conducting the society's business in its place, which is a company within the meaning of the Companies Act 1985 or the Companies (Northern Ireland) Order 1986 and is a public company limited by shares, or is incorporated in an EEA State other than the United Kingdom and has power to offer its shares or debentures to the public

## DEFINITIONS AND NOTES (Continued)

“Statutory Cash Bonus”	the bonus required by Section 100(2)(b) and (4) of the 1986 Act to be paid to every shareholder of the society who held shares on the Qualifying Day and was not eligible to vote on the requisite shareholding members' resolution
“successor” or “successor company”	a company, whether an existing company or a specially formed company, to which the business of a society is proposed to be transferred
“takeover”	the transfer of the business of a society to an existing company
“transfer”	a conversion or takeover, or both, as the context requires
“Transfer Agreement”	the agreement required by Section 97(4)(b) of the 1986 Act between a society and its successor company on the terms of the transfer
“Transfer Document”	the document or booklet containing, <i>inter alia</i> , either the Transfer Statement or the Transfer Summary
“Transfer Regulations”	the Building Societies (Transfer of Business) Regulations 1998 (SI 1998/212)
“Transfer Resolutions”	the shareholding members' resolution and borrowing members' resolution required to approve a transfer where no direction under Section 42B(4) of the 1986 Act has been given
“Transfer Statement”	the statement required by Schedule 17 to the 1986 Act to be sent in or with the notice of the meeting at which the Transfer Resolutions are to be considered or, if a Transfer Summary is sent, made available to every member entitled to notice of a meeting of the society
“Transfer Summary”	the summary of the Transfer Statement which may, in accordance with Schedule 17 to the 1986 Act, be sent, instead of the Transfer Statement, in or with the notice of the meeting at which the Transfer Resolutions are to be considered, to every member entitled to receive that notice

## DEFINITIONS AND NOTES (Continued)

“Trustee Account Holder”	a person who is a shareholding or borrowing member of a society, by virtue of being the sole or representative joint holder of an account which he holds in trust for another person or persons any one or more of whom cannot reasonably practicably act in relation to that account themselves by reason of ill-health or old age or any physical or mental incapacity or disability, as provided by Section 102D of the 1986 Act, whether or not the account holder is a shareholding or borrowing member in respect of any other accounts
“the UKLA”	the UK Listing Authority (currently the Authority)
“vesting date”	the date on which all the property, rights and liabilities of the society making the transfer, except any shares in the successor company, are transferred to the successor company.

### NOTES:

- (1) The Building Societies Act 1986 was amended by the Building Societies Act 1997 and by and under the Financial Services and Markets Act 2000. The 1986 Act has also been amended by other legislation.
- (2) The functions of the Bank of England under the Banking Act 1987, which was repealed by the Act, were transferred to the Authority by the Bank of England Act 1998. Similarly, the functions of the Commission, and of the Central Office of the Registry of Friendly Societies were transferred to the Authority by and under the Financial Services and Markets Act 2000.
- (3) The Confirmation Criteria are varied in certain circumstances - see Section 7.

# 1. INTRODUCTION

## The Purpose of this Chapter

- 1.1 This chapter replaces the Transfer Procedures Guidance Note published by the Commission in April 1998. It gives guidance on the requirements of the 1986 Act relevant to, and on the procedures to be followed by, a building society proposing to transfer its business to a company having permission under the Act to carry on those regulated activities which it will undertake as a result of the transfer. **It is not intended to be exhaustive, and is not a substitute for looking at the 1986 Act and the Transfer Regulations, on which a society should seek its own legal advice.** It describes the relevant provisions of the 1986 Act, and the information which must be made available to the Financial Services Authority and to the society's members, and outlines the procedures to be followed at general meetings, including the voting majorities required to pass the Transfer Resolutions. The chapter also describes the role of the Authority in approving the Transfer Statement which must be sent to the members and in the confirmation procedure, together with its ongoing prudential supervision during the transfer process. The Transfer Summary, which a society may send to its members instead of the Transfer Statement, is also discussed. **Except as described in section 7, to which section 8 also applies, this section is concerned only with voluntary transfers under Section 97 of the 1986 Act.**
- 1.1.1 **Electronic Communications Order 2003:** Societies should be aware that this Order modifies various relevant provisions of the 1986 Act. This enables the use of electronic communications between societies, their members and other persons on matters relating to a proposed transfer of business, such as the transfer statement and voting arrangements. The Order requires that societies must obtain consent before using electronic means of communication. The remaining text of this chapter has not been amended to take account of the Order. A society proposing to use electronic communications in relation to a transfer of business will need to take its own legal advice as to how the procedures described in this chapter will have to be adapted. In that event the FSA will also adapt its own procedures appropriately.
- 1.2 It is for the directors of a society to assess the case for transfer, and they must explain and recommend their decision to the members. However, the Authority's staff are willing to discuss with a society the procedures to be followed and the information required to ensure that the members can reach fully informed decisions. **Societies are strongly recommended to consult the Authority early on in the formative stages of transfer**

**proposals.** Such consultation will, of course, be treated in the strictest confidence. It will be helpful, also, to have regard to the indicative timetable set out in section 9.

1.3 Societies should consult their own legal advisers about the application of the provisions of the 1986 Act, and the general law, to the particular features of a proposed transfer.

1.4 This chapter considers each stage of the transfer procedure in chronological order. The remainder of this section gives a synopsis of the relevant requirements of the 1986 Act, which are then discussed in more detail in subsequent sections, as follows:

*Section 2, Preliminary Matters,* considers the rationale for a transfer and the handling of public announcements, and gives guidance on certain prudential issues.

*Section 3, Terms of a Transfer,* considers the mandatory provisions of Section 100 of the 1986 Act concerning the successor company's obligation to treat former shareholders of the society as depositors with it, and the Statutory Cash Bonus. It also considers the mandatory provisions of Sections 102B to D of the 1986 Act, concerning distributions to members who are Trustee Account Holders, the statutory restrictions on distributions to members in Section 100, and the permissive provisions of Sections 100 and 102A. The protective provisions for specially formed successor companies are also discussed.

*Section 4, Information Provided to Members,* discusses the form and content of the statutory Transfer Statement and the Transfer Summary, and the accompanying rationale and other statements by the board, and describes the form of application to be made to the Authority for approval of the Transfer Statement.

*Section 5, General Meetings and Resolutions,* discusses the register of members and members' entitlement to vote, the arrangements for general meetings, the conduct of voting on the Transfer Resolutions and the scrutineers' report.

*Section 6, Confirmation,* describes the form of application to the Authority for confirmation of a transfer, and the procedures which the Authority expects to follow in considering and hearing written and oral representations and in reaching its decision.

*Section 7, Transfers Under Direction,* describes the modified procedure to be followed when a society has been directed by the Authority to transfer its business to a company and to proceed by board resolution.

*Section 8, Notification and Dissolution*, briefly discusses the process of notification of the vesting date and dissolution of the society.

*Section 9, Timetable*, reviews the several stages of a transfer from start to finish.

## **Statutory Requirements**

- 1.5 The provisions of the 1986 Act concerning transfers are in Sections 97 to 102D of, and paragraph 30 of Schedule 2 and Schedule 17 to the 1986 Act, where two types of transfer of business are provided for:

to a **specially formed company**, known as conversion; or

to an **existing company**, known as a takeover\*.

The procedures are the same in each case, except that the specification of the turnout required to pass the shareholding members' resolution to approve a takeover is, in effect, higher than is required to approve a conversion. The 1986 Act also provides that a specially formed company shall have qualified protection from takeover for up to five years after the vesting date.

- 1.6 One of the principal purposes of these provisions of the 1986 Act is to ensure that the members are given all the material information they need about the terms of the transfer which they are asked to approve, and proper opportunity to cast their votes. Subsequently, they are given the opportunity to make representations about that process before the transfer is confirmed. The 1986 Act also prescribes certain mandatory terms, and places restrictions on certain permitted terms, of a transfer.
- 1.7 The 1986 Act makes no provision for a transfer to be initiated by any means other than a recommendation of an agreed proposal put by the board of a society to its members (see paragraph 11.10 of the Commission's *Decision to confirm the transfer of Halifax Building Society to Halifax plc*, which related to alternative distribution schemes) and the transfer Regulations require the board of a society to give particulars, in the Transfer Statement, of the options for the future conduct of the society's business which it considered before deciding to recommend the transfer to the members and of the reasons why it recommends the proposed terms. Each member who is entitled to receive notice

of the general meeting at which the Transfer Resolutions are to be moved must also receive (or have made readily available to him if the Transfer Summary is provided) a copy of a statutory Transfer Statement. A transfer must be approved by **a shareholding members' resolution** and **a borrowing members' resolution**. The majorities required to pass these resolutions are described in section 5.

- 1.8 If the terms of a transfer include provision for the payment of **compensation to directors or other officers** for loss of office or of income attributable to the transfer, then the proposed payments must be authorised by a separate **special resolution**. If the terms include provision for any director or other officer to receive **increased emoluments** in consequence of the transfer, then an **ordinary resolution** approving that provision must be put before a meeting of the society.
- 1.9 The 1986 Act specifies certain procedures for the consideration of representations by interested parties concerning **confirmation**, and the criteria which the Authority must consider before deciding whether or not to confirm a transfer. **The matters which the Authority may consider do not include the merits of the transfer proposals, nor the fairness of the terms, which the members will have approved by passing the Transfer Resolutions.**
- 1.10 The statutory requirements of the 1986 Act are explained and discussed in more detail in subsequent sections of this chapter. However, as is stated in paragraph 1.1, this chapter is not exhaustive and is not a substitute for considering, and taking professional advice on, the primary documents, which include:

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\*A takeover may take the form of a transfer of the business of a society to a subsidiary of the society which is an existing company carrying on business as a going concern, as in the case of Halifax plc (formerly Halifax Syndicated Loans Limited).



the Building Societies Act 1986, as amended by or under other legislation, including:

- the Building Societies (Joint Account Holders) Act 1995
- the Building Societies (Distributions) Act 1997
- the Building Societies Act 1997 and
- the Financial Services and Markets Act 2000 (in particular by the Financial Services and Markets Act 2000 (Mutual Societies) Order 2001) and the Financial Services and Markets Act 2000 (Consequential Amendments and Repeals) Order 2001

the Building Societies (Transfer of Business) Regulations 1998  
(SI 1998/212)

Judgments of the High Court in:

- Abbey National Building Society v The Building Societies Commission [1989] 5 BCC 259
- Cheltenham & Gloucester Building Society v The Building Societies Commission [1994] 4 All ER 65, [1995] Ch 185, and [1994] 3 WLR 1238
- The Building Societies Commission v Halifax Building Society and Leeds Permanent Building Society [1995] 3 All ER 193
- R v The Building Societies Commission, ex parte Whitmey, unreported, 16 April 1997, Lightman J (relating to the Alliance & Leicester Confirmation Decision).

Building Societies Commission Confirmation Decisions on applications by:

- Abbey National Building Society (5 June 1989)
- Cheltenham & Gloucester Building Society (5 July 1995)
- National & Provincial Building Society (3 July 1996)
- Alliance & Leicester Building Society (11 March 1997)
- Woolwich Building Society (16 May 1997)
- Halifax Building Society (23 May 1997)
- Bristol and West Building Society (9 July 1997)
- Northern Rock Building Society (18 July 1997)
- Birmingham Midshires Building Society (18 March 1999)
- Bradford & Bingley Building Society (28 September 2000)

## **2. PRELIMINARY MATTERS**

### **Rationale for a Transfer**

2.1 It is a matter for the board of a society to decide whether to recommend a transfer to its members. The overriding duty of the board is to reach a view having regard to what is in the best interests of the society in the short and long term, including the interests of the members as a whole, both present and future, as members of a building society, both borrowing members and shareholding members. The board of a society may also reasonably consider the interests of customers who are not members, of the staff, of suppliers of goods and services, and of the wider community.

2.2 The decision of the board to recommend a transfer must be based on a proper evaluation of the issues in relation to a strategic assessment of how the society can best serve its members. One element of that assessment will be the forward business plan of the successor company (including, in the case of a takeover, how the successor company plans to integrate the business of the society) which will be relevant to:

the presentation of the case to the members; and

the submission to the Banking Regulator for permission to carry on the regulated activities which it will undertake as a result of the transfer.

Copies of the plan should be provided to the Authority and to the Banking Regulator (if the latter is a different authority in another member state).

2.3 Neither conversion nor takeover are likely to figure routinely as options in societies' corporate plans. However, a board may develop the society's business in ways which point to the need to consider the transfer option: in which case, a transfer should be foreseen and emerge from the board's strategic plans. If a board is considering the options of conversion or merger with another society, it should, as a matter of prudence, consider how it would respond to a counter proposal and develop appropriate contingency plans.

2.4 When a board is seriously considering conversion or a takeover, the range of issues which it will need to assess will vary from case to case and is for the board to decide. However, the board will necessarily have regard to its primary duty to reach a view on what is in the best interest of the members, as members of a building society, and not

only their short-term interests. It will also be conscious of the requirement to give, in the Transfer Statement, a factual account of the options which it considered and of the reasons why it decided to recommend to the members the terms of any proposed transfer and of the qualifying conditions for any distribution of funds or shares in the successor company in consideration of the transfer.

## **Public Announcement**

- 2.5 A board will usually wish to announce its proposals as soon as possible after it has decided to recommend a transfer to the society's members. In particular, the board will no doubt wish to inform the members and staff of the proposed terms so that they do not then operate their accounts, or otherwise act, in ignorance of proposals which would have affected their behaviour. The board will also wish to avoid misleading potential investors and borrowers; and societies with listed PIBS must have regard to the UKLA requirements concerning early disclosure of any information which might affect the price of securities. However, a board may not feel able to make an immediate announcement, perhaps for prudential or commercial reasons, or because it first wishes to settle all the details of the proposed terms. In these circumstances, the board must have contingency plans to make an early announcement to deal with any potentially damaging rumours and to avoid members being misled or left in a state of uncertainty. In considering the timing and terms of an announcement, the board will wish to minimise the risk of destabilising flows of funds.
- 2.6 The announcement, particularly information provided directly to members and staff, should make it clear that the proposal is subject to approval by the members and completion of the statutory procedures. It should also be made clear, in the case of a takeover, and if such is the case, that the proposal is subject to completion of due diligence investigations by the acquirer and, in either a conversion or takeover when shares in the successor company are to be issued, that the proposal is subject to the shares being listed on the London Stock Exchange or elsewhere. Boards should be careful to avoid appearing to assume that the outcome is a foregone conclusion, and should identify any matters of substance on which the proposed terms of the transfer remain to be settled. Briefing of staff who will be responsible for responding to enquiries from members and the Press should be considered carefully and prepared in advance of the announcement to avoid any risk of members being unintentionally misled. A freephone helpline may be desirable for members' enquiries about whether they qualify for any distribution under the proposed transfer scheme, but again the staff must be well briefed. It is essential that the announcement, and subsequent information given to members before they are sent the statutory Transfer Statement, or Summary,

and in any briefing of the Press, is entirely consistent with what will appear in that Statement. In particular, members should be advised to await the Transfer Summary, and especially the Transfer Statement which will contain full details of the proposals and the information relevant to their decision on how they wish to vote.

- 2.7 The Authority is not required to approve the content or wording of announcements or preliminary information sent to members. However, it will be happy to comment on drafts shown to it at an early stage, and may be able to help societies to avoid unintentionally misleading statements.
- 2.8 The board should consult the Authority and, if a different body, the Banking Regulator at an early stage in its consideration of transfer proposals, and certainly no later than its decision in principle to seek a transfer. The complexities of the statutory provisions are such that it is necessary to have the proposed transfer terms specified very closely indeed before it is possible for the Authority to take a view on whether the proposals are fully in conformity with the 1986 Act. The Banking Regulator will not be in a position, at this early stage, to give positive assurances as to the permission to be given to the successor company. However, a prudent board will seek the views of the Authority, and also, if different, of the Banking Regulator, before it decides to announce its transfer proposals to the members. This preliminary discussion with the Authority will necessarily cover the proposed structure of the successor company or group and a written specification of the transfer terms, particularly the scheme for distribution of any consideration to be offered to the members for the loss of their membership rights in the society, which members and other persons are to benefit, and the criteria for qualification.
- 2.9 Should there be a difference of view between the Authority and the society as to whether a scheme, or a particular feature of it, is in conformity with the 1986 Act, it may prove desirable to apply to the High Court for a declaration. It will then be necessary for any preliminary announcement of the board's proposals to make the position clear, and for it to allow sufficient time in its proposed timetable for the application to be heard, and for any appeal.

### **Prudential Issues**

- 2.10 In addition to information about the proposed transfer scheme, the Authority will expect the board to provide it with information about its plans for ensuring the prudent management of the society through to the proposed vesting date. That information will be consistent with what the board itself will require, bearing in mind that it is for the

board to exercise due diligence and to be satisfied that the society's business continues to be directed and managed prudently. The information required is:

- (a) the names and responsibilities of senior managers assigned to manage the transfer process;
- (b) an assessment of the systems requirements of the transfer process, together with the specification of work to be done by consultants (e.g. the external auditors/scrutineers) and their report(s);
- (c) contingency plans, with sensitivity and risk assessments, for managing funding and liquidity during the transitional period;
- (d) copies of the business plans of the successor company as submitted in connection with its permission to carry on the regulated activities which it will undertake as a result of the transfer.

2.11 The Authority will also wish to have a letter of consent, from or on behalf of the board, to the Authority discussing the society's affairs with the Banking Regulator (if a different body) and the UKLA (if a different body and an issue of shares in the successor company is intended to be made in connection with the transfer).

2.12 A transfer is exceptionally time-consuming for senior management. The Authority will wish to be satisfied that the society has sufficient management resources to cover both the transfer and its day-to-day business within its proposed transfer timetable. It will usually be necessary for the society severely to limit new business developments and initiatives during the transitional period. It should also be noted that the requirements for information to be provided to members mean that full disclosure will be required in the Transfer Statement of any negotiations in progress on acquisition or other links during the transfer process. The Banking Regulator must be kept fully informed of any such plans because any changes to the society's business, structure, controls etc. may well be relevant to the terms of its successor company's permission.

2.13 The Authority will appoint a project team, responsible for operational management of the Authority's functions in relation to the transfer process. The expectation would be that the team will include the Manager responsible for the society's supervision and one of the Authority's legal advisers. Names and contact numbers will be provided to the society. The Authority would strongly advise a society similarly to appoint a project team, headed by a senior manager responsible to the board for management of the whole

process and with authority to control the drafting and verification of the Transfer Document, other briefing and information to members, and responses to representations at the confirmation stage. Strong central control under the direction of the board is, in the Authority's view, essential for effective management of a transfer.

- 2.14 The society will be expected to provide the Authority with a systems report from its auditors together with an action plan to remedy any shortcomings. The Banking Regulator, if a different body, may have similar requirements. This report is only part of the full information package which the Banking Regulator will (or is likely to) require in connection with the successor company's permission to carry on the regulated activities which it will undertake as a result of the transfer, and which will be needed so that the Authority can be satisfied in relation to its requirements up to the vesting date.
- 2.15 The society will need to develop plans to deal with a number of possible contingencies; for example, receipt of a counter-offer (whether private or public) during the transfer process, changes in market conditions or financial results which materially affect the information given in the Transfer Statement, failure to obtain the members' approval, delay of the planned vesting date and of any flotation, and greater exposure to liquidity risk during the transitional period. The Transfer Agreement should include provision for its termination if, for any reason, flotation does not take place within a specified period after confirmation, and for the board to decide not to proceed if market conditions or other developments mean that it would not be reasonable to do so having regard to the basis on which it secured the approval of the members. The Authority will wish to see the society's contingency plans.
- 2.16 Before it approves the Transfer Statement, the Authority will wish to be satisfied that the successor company is expected to have permission to carry on such regulated activities as will enable it to undertake the business it will have as a result of the transfer. It will also ask the Banking Regulator, if different, to confirm that the information given in the draft Transfer Statement appears to be consistent with, and has no material omission of, information available to the Banking Regulator.

### 3. TERMS OF A TRANSFER

**This section discusses the provisions of the 1986 Act which prescribe the terms of a transfer which must be included in the Transfer Agreement and the restrictions on terms which may be included. It also discusses the formation of, and protective provisions for, specially formed companies and the status of existing companies.**

- 3.1 Section 97(4) of the 1986 Act provides that in order to transfer its business to a company, *inter alia*, a society must agree conditionally with its successor in a Transfer Agreement on the terms of the transfer which, in so far as they are “regulated terms” (as defined in Section 97(12)), comply with Sections 99 and 100 of the 1986 Act and with the Transfer Regulations. In the case of a specially formed company, a society must also secure that the articles of association of the successor company have the requisite protective provisions prescribed by Section 101(2) of the 1986 Act.

#### **The Qualifying Day**

- 3.2 The choice of Qualifying Day is important because it is a determining factor in deciding which members must have conferred upon them a right to the Statutory Cash Bonus provided by Section 100 of the 1986 Act. It may also be relevant in deciding which members may receive certain rights under a proposed distribution of funds or of shares in the successor company. The Commission’s view was that there can be only one Qualifying Day for these purposes, which must be clearly distinguished from any other “reference dates” which may be chosen by a society for the purposes of its transfer scheme. Subsection (13) of Section 100 defines the Qualifying Day as the day specified in the Transfer Agreement as the qualifying day for the purposes of that subsection. This does not appear to restrict the society’s choice of qualifying day. A number of arguments for such a restriction have been advanced, including that the use of the past tense “which expired with the qualifying day” in subsection (9), read in the context of Section 100 as a whole, indicates that the Qualifying Day must pre-date the Transfer Agreement. The Authority has not been required to express a view on the matter (and see paragraphs 4.20 and 17.4 of the Commission’s *Decision to confirm the transfer of the business of Cheltenham & Gloucester Building Society to a subsidiary of Lloyds Bank plc*).
- 3.3 For completeness, it should be noted that the Authority takes the view that the conditional Transfer Agreement must have been signed by the society and its successor company and commenced (albeit conditionally) before the Authority can approve the Transfer Statement. This is because the Authority must be satisfied, before it approves

the Transfer Statement, that the Statement correctly describes the proposed terms of the transfer as provided by the Transfer Agreement, and the Agreement cannot properly be said to exist until it has been signed by the parties concerned. The Transfer Agreement, as is made clear by its definition in Section 97(12) of the 1986 Act, is necessarily conditional, *inter alia*, on the society's members' approval of the Transfer Resolutions under Section 97(4)(c), and confirmation of the transfer by the Authority (which includes confirmation by the Banking Regulator that it expects to authorise the successor company) under Section 98(2) of the 1986 Act.

### Share Accounts

- 3.4 Section 100(2)(a) and (3) of the 1986 Act provide that the terms of a transfer **must** require the successor company to assume as from the vesting date a liability in respect of a deposit to every member of the society equal to the value of the shares held by such member immediately before the vesting date. In other words, amounts held in share accounts on the eve of the vesting date must become identical amounts held in deposit accounts from the start of the vesting date.

### Statutory Cash Bonus

- 3.5 Section 100(2)(b) and (4) of the 1986 Act provide that the terms of a transfer **must** confer a right to a distribution of funds by way of bonus, whether paid by the society or its successor company, on every member of the society who held shares in the society on the Qualifying Day but was not eligible to vote on the shareholding members' resolution. Where the account is in joint names, see also paragraph 3.12, Schedule 2 to the 1986 Act and the Rules of a society prescribe who is eligible to vote (see section 5). Broadly speaking, members who are not entitled to vote on the resolution are those who are under 18 years of age on the date of the meeting or, if the Rules so provide, those who had less than the qualifying shareholding (usually £100) on the qualifying shareholding date or who ceased to hold shares in the period between the qualifying shareholding date and the voting date. However, the High Court declared in *Abbey National Building Society v The Building Societies Commission* that, in order to qualify for the Statutory Cash Bonus, in addition to having held shares in the society on the Qualifying Day, a member also must have held shares continuously between the Qualifying Day and the vesting date. In coming to this judgement, the Vice Chancellor found the sequence of tenses used in subsection (4) of Section 100 of the 1986 Act to be illuminating: "It says that a member **is** ..... a qualifying member if he **held** ..... shares in the society on the qualifying day and **was not** ..... eligible to vote .... The subsection is therefore looking at somebody who at a particular point of time is a member and who had certain qualifications in the



past ..... the relevant date for establishing membership is the vesting day ..... it is implicit in subsection (4) that the person .... must have been a member on the qualifying day and have remained a member thereafter continuously through until the vesting day”. In settling the terms of the declaration, the Vice Chancellor confirmed that when referring to the member remaining a member between the two dates, he intended to mean as a member holding shares.

- 3.6 The bonus is to be calculated as that proportion which the society’s reserves bear to its total liability to its members in respect of shares, as shown in the latest balance sheet of the society, applied to the value of the shares held by the member on the Qualifying Day. If a Transfer Statement is approved and sent to the members just before, or shortly after, the end of the financial year of the society, it will be important to note that the Annual Report and Accounts for the year will have been published by the vesting date, when qualifying membership has to be established and the bonus is due to be paid. In those circumstances, “the latest balance sheet of the society” will be that published in the most recent Annual Accounts. The same considerations may apply when a society publishes half-yearly results.
- 3.7 The Authority may direct, however, where it confirms a transfer of a society’s business to an existing company (i.e. only in a takeover), that no Statutory Cash Bonus is paid or that a lesser amount is paid than that referred to in paragraph 3.6, having regard to what is equitable between the members.

### **Distributions To Members**

- 3.8 Section 100(1) of the 1986 Act provides that:

“Subject to subsections (2) to (10), the terms of a transfer of business by a building society to the company which is to be its successor may include provision for part of the funds of the society or its successor to be distributed among, or other rights in relation to shares in the successor conferred on, members of the society, in consideration of the transfer”.

- 3.9 In respect of rights to shares, Section 100(8) of the 1986 Act provides that:

“Where, in connection with any transfer, rights are to be conferred on members of the society to acquire shares in priority to other subscribers, the right shall be restricted to those of its members who held shares in the society throughout the

period of two years which expired with the qualifying day; and it is unlawful for any right in relation to shares to be conferred in contravention of this subsection”;

and, in respect of a distribution of funds, Section 100(9) of the 1986 Act provides that:

“Where the successor is an existing company, any distribution of funds to members of the society, except for the distribution required by subsection (2)(b), shall only be made to those members who held shares in the society throughout the period of two years which expired with the qualifying day; and it is unlawful for any distribution to be made in contravention of the provisions of this subsection”;

while, in respect of a transfer to a specially formed company, Section 100(10) of the 1986 Act provides:

“The following restrictions apply to any distribution of funds, or any conferring of rights in relation to shares, in connection with the transfer of its business from the society to its successor where the successor is a company specially formed by the society, that is to say-

(a) no distribution shall be made except that required by subsection (2)(b);  
and

(b) where negotiable instruments acknowledging rights to shares are issued by the successor within the period of two years beginning with the vesting date, no such instruments shall be issued to former members of the society unless they are also issued, and on the same terms, to all other members of the company;

and it is unlawful for any distribution of funds to be made in contravention of the provisions of this subsection”.

3.10 The meanings of subsections (1), (8), (9) and (10) of Section 100 of the 1986 Act have been considered by the High Court in four cases: *Cheltenham & Gloucester Building Society v The Building Societies Commission*, in relation to distributions of funds, and *Abbey National Building Society v The Building Societies Commission*, *The Building Societies Commission v Halifax Building Society and Leeds Permanent Building Society* and *R v The Building Societies Commission, ex parte Whitmey* in relation to share distributions. These judgments related to specific proposals and may not necessarily be

directly relevant in all respects to transfer schemes proposed by other societies in the future. A society must obtain its own advice when formulating proposals for a cash or share distribution scheme.

- 3.11 As is explained in paragraph 2.8, the Authority will have to see a fully specified description of the distribution scheme before it can form its own view of whether it is in conformity with the 1986 Act. The Authority would find it helpful if the society enclosed copies of the legal advice it has received when submitting a scheme for consideration.

### **Joint Share Account Holders**

- 3.12 Paragraph 7 of Schedule 2 to the 1986 Act deals with joint shareholders and defines the “representative joint holder” as “that one of the joint holders who is named first in the records of the society.” Paragraphs 7(5) and (5A) of that Schedule provide that, for the purposes of Sections 87 and 93 to 102 of the 1986 Act, the shares shall be treated as held by the representative joint holder alone and, accordingly, joint holders, other than the representative joint holder, shall not be regarded as members of the society by reason only of being a joint holder of those shares. The effect of this provision (but subject to the provisions of Section 102A) is that if, for example, the representative joint holder dies, or the order of names on the account is changed in the two years preceding the Qualifying Day, any rights to a distribution under a transfer scheme, which are conferred on those who have held shares for two years up to the Qualifying Day, cannot devolve upon any other joint account holder, unless that holder is in his or her own right, by virtue of another account holding, a two-year shareholding member.
- 3.13 Section 102A, however, provides that, in certain circumstances, second named joint holders, **who have themselves held shares in the society continuously during the two year qualifying period**, whether as sole or joint holders of shares, may qualify for a right which otherwise could only have gone to a first named holder. Cases which would be covered by the provisions of Section 102A include: the death of the first named holder, including where, for example, a third named joint account holder would move up the scale if both the previous first named and second named holders were killed in the same car accident; the creation of a joint account, for example, on marriage or the formation of a civil partnership; the division of a joint account on divorce, dissolution of a civil partnership or separation, or for any other reason, **where the previous first named holder has ceased to hold shares in the society**; and when there has been a change in the order of names within an account.

3.14 Points to note are that Section 102A applies only to joint share account holders (joint borrowers are not affected) and is only relevant where the application of the two year qualifying period prescribed by Section 100 is relevant to a proposed distribution of funds or conferring of rights to shares. The provisions of Section 102A are permissive, not mandatory (see paragraphs 13.2 to 13.5 of the Commission's *Confirmation Decision on the application by National & Provincial Building Society*) and are not "relevant requirements" of the 1986 Act (see paragraph 6.17). It is for the society's board when proposing a transfer scheme to decide whether to incorporate in its distribution scheme none, some, or all of the cases where Section 102A allows membership of a joint account, other than as the first named holder, to count towards the two year qualifying period. Finally, these provisions do not affect the position of the personal representatives or beneficiaries of deceased sole holders of share accounts. Societies should obtain their own advice on all these matters when considering how they wish to construct the terms of a proposed distribution scheme.

### **Trustee Account Holders**

3.15 A member who holds funds in a share account, or holds a mortgage account, on trust for another person is not a Trustee Account Holder unless the following conditions are satisfied. Sections 102B to D of the 1986 Act require that, if the terms of a transfer include distributions of funds or of rights to shares to members of the society, then each Trustee Account Holder shall be treated by the society and its successor as not being disentitled from receiving, in addition to any distribution to which he or she may be entitled in any other capacity, a separate distribution in respect of each account which he or she holds in trust for certain categories of beneficiaries (provided that, as holder of that account, he or she meets the conditions for receipt of a distribution under the scheme). An account may be either a share account or a mortgage account of which the Trustee Account Holder may be the sole or representative joint holder. A member may receive only one distribution for each account he or she holds as a Trustee Account Holder (irrespective of the number of account holders or beneficiaries of that account) and a member who holds only one account may receive only one distribution in respect of that account whether as a member or, if he or she so decides, as a Trustee Account Holder. If a person is a qualifying beneficiary of more than one account held by a Trustee Account Holder (referred to in Section 102D(5) as "duplicate accounts"), then only a single distribution is required to be paid in respect of the duplicate accounts whether or not there are other qualifying beneficiaries of those accounts. A change in the identity of the Trustee Account Holder during any qualifying period for a distribution does not affect the entitlement to a distribution in respect of the account. The categories of qualifying beneficiaries of such accounts are

persons who cannot reasonably practicably act in relation to the accounts themselves by reason of ill-health or old age or any physical or mental incapacity or disability.

- 3.16 A society will need to take its own legal advice as to the interpretation of these Sections and whether and, if so, what advice it should give to its members to help them decide whether they are Trustee Account Holders. The Authority will wish to see that advice to help it reach a view on whether the society's proposals appear to it to be lawful, while recognising that only the courts can interpret the law. With that important proviso in mind, the Authority has taken the view that a scheme may provide that a member is a Trustee Account Holder if the funds (or debt) in the relevant account are held either wholly or partly for one or more qualifying beneficiaries. PIBS do not appear to be share "accounts" as described by Sections 102B to D so that a person could not be a Trustee Account Holder in respect of a holding of PIBS.
- 3.17 A society is not required to notify its members of these provisions. However, unless it does so, it will not gain the protection of Section 102B(4) which provides that a Trustee Account Holder will not be entitled to a distribution in that capacity if the society has notified him that he must make a statutory declaration and the Trustee Account Holder has not made such a declaration before the date specified in the society's notice to him. Moreover, the Transfer Regulations require that the Transfer Statement must contain a forecast of the amount and proportion of the total consideration which is expected to be distributed to Trustee Account Holders (see paragraph 4.2c).
- 3.18 It appears to the Authority that it will be desirable for the final date for receipt of statutory declarations from Trustee Account Holders to be shortly before the vesting date so that declarations may take account of any changes in the identity of the account holder or the status of the beneficiary or beneficiaries. Trustee Account Holders must also be able to make an informed judgement as to whether the terms of the distribution scheme are such that making a statutory declaration will be in the best interests of the beneficiary or beneficiaries of an account; they cannot do this until the full terms of the proposed scheme have been published in the Transfer Statement and made available for inspection in the Transfer Agreement. The Authority expects, therefore, that societies will issue notices under section 102B to Trustee Account Holders not later than despatch of notices of the SGM at which the Transfer Resolutions are to be considered, and that the specified date for returning statutory declarations by Trustee Account Holders will be on, or shortly before, the vesting date or, in any event, not less than 1 month after the despatch of the notices. No

regulations have been made by the Treasury under Section 102D(11). However, to meet the requirement that the Transfer Statement must contain a forecast of distributions to Trustee Account Holders, and so that it can determine the qualifying conditions for, and estimate the value of distributions to members generally, and individually, particularly if the scheme includes a variable element, the Authority expects that a society will need to write to all its members at least 2 months before the Transfer Statement is expected to be issued advising them of the procedures for dealing with distributions to Trustee Account Holders, perhaps also with the notices envisaged by Section 102B(4), and asking them, if appropriate, to register their interest in making statutory declarations as Trustee Account Holders.

### **The Successor Company**

- 3.19 **In a conversion**, the successor company must be specially formed by the society (and by no others than its nominees) wholly or partly for the purpose of assuming and conducting the society's business in its place and must be a company within the meaning of the Companies Act 1985 or the Companies (Northern Ireland) Order 1986 which is a public company limited by shares (Section 97(12) of the 1986 Act) or a body corporate incorporated in another EEA State with power to offer its shares or debentures to the public (Section (97(13)). Section 98(3) of the 1986 Act provides that the Authority shall not confirm the transfer if there is a substantial risk that the successor will not have such permission under the Act as will enable it to carry on the business which it will have as a result of the transfer. The society must secure that the successor company is formed having articles of association with the "requisite protective provisions" (Section 97(4)(a) of the 1986 Act).
- 3.20 The terms of the transfer must include provision to secure that the society ceases to hold any shares in the specially formed successor company by the date on which the society is to dissolve (Section 100(11) of the 1986 Act). The provisions of the 1986 Act concerning the dissolution of the society and the disposal of any shares in its successor are discussed in section 8.
- 3.21 The "requisite protective provisions" are the provisions of Section 101 of the 1986 Act which require the successor company to ensure that it does not allow one person, or two or more persons acting in concert, to hold more than 15% of the shares of the company during the period from the company's incorporation until 5 years after the vesting date. The purpose of this provision is, clearly, to protect the newly converted bank from takeover. The provisions will cease to apply if the Authority so directs, or if the successor company acquires another financial institution, as defined in Section 101(6), or

if the shareholders resolve to that effect by a majority representing at least 75% of the nominal value of shares giving voting rights.

- 3.22 **For a takeover**, an existing company, which is to assume and conduct the society's business in its place, is defined in Section 97(12) and (13) of the 1986 Act as a company within the meaning of the Companies Act 1985 or the Companies (Northern Ireland) Order 1986 which is a public company limited by shares, or a body corporate incorporated in another EEA State with power to offer shares or debentures to the public, "carrying on business as a going concern on the date of the transfer agreement". Section 98(3) provides that the Authority shall not confirm the transfer if there is a substantial risk that the successor will not have such permission under the Act as will enable it to carry on the business which it will have a result of the transfer. The effect of these provisions is that the business of a society may be transferred to a body corporate incorporated in another EEA State which, at the date of the Transfer Agreement, is a going concern and which is acceptable as a deposit taker to the appropriate regulatory authority. To be a going concern, the company must actively be carrying on a business before it can enter into an agreement to acquire the business of a society. Conversely, it would not seem possible to use a company which carries on no substantive business, other than employing its capital, simply as a vehicle for taking over a society.
- 3.23 The successor company does not need to have the required permission under the Act at the time of the takeover offer or the Transfer Agreement; but it must be carrying on business as a going concern. However, the subsequent obtaining of the necessary permission is a key criterion. An offer will not be credible unless the company has first obtained an indication from the Authority or other EEA competent authority that it is prepared to authorise, or to continue the authorisation of, the successor company, upon transfer on terms which will enable it to carry on the business it will have following the transfer. As a practical matter, the authorities would find it difficult to authorise an institution whose business from the time of authorisation was not predominantly banking or deposit taking and would require to be satisfied that the parent company (if any) as controller was fit and proper.

### **Compensation For Loss of Office and Increased Emoluments**

- 3.24 **Any compensation** for loss of office or diminution of emoluments attributable to the transfer which is proposed to be paid to directors and other officers must be approved by a separate special resolution, in addition to the Transfer Resolutions required to approve the terms of transfer as a whole (Section 99 of the 1986 Act). Loss of office includes loss

of office in any other body held by virtue of the director's or other officer's position in the society. "Compensation" is not defined in the 1986 Act, except to the extent that Section 99(6) says that it includes benefits in kind. In the Authority's opinion, compensation does not include statutory redundancy payments, damages for breach of contract, or other payments, for example, falling due under the terms of a pre-existing contract of employment, or a pre-existing arrangement giving rise to a reasonable expectation. However, it does include any proposed ex-gratia payments or other provision of benefits in money or money's worth. Societies should consider very carefully the extent to which any proposed payment may exceed the amount provided for by statute or contract. In view of the requirement in Section 99(4) that unauthorised payments must be repaid by the recipient, societies are advised to take legal advice on any payments which are not specifically authorised by the terms of a special resolution passed by the members in accordance with Section 99(2)(a). The Treasury has not made any regulations under Section 99(2)(b) and (3).

- 3.25 All proposed payments requiring approval by special resolution must be disclosed in the Transfer Statement. In addition, the Authority will require disclosure in the Transfer Statement of any other payments to directors or other officers arising directly from the transfer. So that members are aware of the direct interest of the directors or other officers in a transfer, societies should consider whether the amount, as distinct from the fact, of any statutory or contractual payments should be disclosed where these arise directly from the transfer. More generally, societies need to consider whether any facts relevant to any director or other officer, or to any person(s) connected with any director, should be disclosed where these are material to the decision of the members who are to be asked to vote on the proposed transfer.
- 3.26 **Increased emoluments** are defined by Section 99A of the 1986 Act as an increase in consequence of the transfer, and included in the terms of the transfer, for any director or other officer, whether by way of increased remuneration or the grant of share options or otherwise. The Authority is of the view that this formulation would include the receipt of distributions of funds or of rights to shares in consideration of the transfer which are made to directors or other officers in their capacity as employees or pensioners of the society or any of its subsidiaries. However, this is a matter which can only be conclusively determined by the courts.
- 3.27 Any such increase in emoluments is required by Section 99A(2) of the 1986 Act to be put before a meeting of the society in an ordinary resolution approving such provision. However, although such an ordinary resolution must be put to a meeting, it is not required to be passed in order to authorise such increases which will be authorised by the



general approval of the transfer and its terms provided by the passage of the Transfer Resolutions. Neither is it required that the ordinary resolution be put before the meeting which is to consider the Transfer Resolutions. However, as is explained below, any proposed increase in emoluments will have to be explained in the Transfer Statement, and the Authority will have to be satisfied that the requisite ordinary resolution was put before a meeting of the society when it considers a society's application for confirmation of a transfer.

## 4. INFORMATION PROVIDED TO MEMBERS

### Statutory Requirements

- 4.1 Section 98(1) of and Part I of Schedule 17 to the 1986 Act require a building society which desires to transfer its business to a company to send a statement relating to the proposed transfer to every member entitled to notice of a meeting of the society. This may be either a Transfer Statement or a Transfer Summary, and is to be included in or with the notice of the meeting at which the Transfer Resolutions are to be moved. If a Transfer Summary is sent, then the society must also make the Transfer Statement available forthwith, free of charge, to every member who asks for it. The Treasury has power to make regulations for the purpose of specifying the matters of which Transfer Statements and Transfer Summaries are to give particulars. No Transfer Statement shall be sent or made available unless its contents, so far as they concern the matters so specified, and any other matters which the Authority may require in the case of a particular transfer, have been approved by the Authority. The Transfer Summary, however, is not required to be approved by the Authority.

### The Transfer Statement

- 4.2 The Transfer Statement has to contain the particulars of the “prescribed matters” which are set out in Schedule 1 to the Transfer Regulations. It must also include particulars of any other matters which the Authority may require (paragraph 3(1)(b) of Schedule 17 to the 1986 Act). Note that Regulation 3(2) of the Transfer Regulations provides that if a particular matter is not ascertainable at the time, a forecast may be given; for example, of the percentage amount of the Statutory Cash Bonus, or of the division of any distribution of shares or cash among different classes of recipient (see subparagraph c). The principal matters which a Transfer Statement must contain can be summarised as follows:

- (a) a factual statement of the strategic options considered by the board and the reasons why it decided to **recommend** the particular proposals being put to the members. In the case of a takeover, the board must also provide a valuation of the business compared with the consideration which is proposed to be paid by the successor company, and state whether it considers the offer price to be fair and reasonable;

- (b) disclosure of the names of any building societies or companies from which written proposals for merger or takeover were received within the preceding 12 months as required by Regulation 3 of the Transfer Regulations. The fact of the proposal, the name of the proposer and the terms of the proposal must be disclosed, unless the proposer has requested either that the whole matter, or just the terms of the proposal, be treated as confidential. An invitation to discuss a possible merger or takeover would probably not constitute a “proposal”. A society should consider carefully, and take advice on, whether any approach it has received does qualify as a disclosable proposal. If no proposals have been received that fact could be stated in the Transfer Statement, for the avoidance of doubt;
- (c) details of any share and/or cash distribution scheme, as provided by the Transfer Agreement, and showing separately the estimated amount of the benefits (if any) to be conferred on members, Trustee Account Holders, and on others such as employees and pensioners of the society, and giving information about the value of any shares including, if unquoted ordinary shares, an illustrative estimate of the market price of the shares if they had been issued at some specified date within the previous 6 months;
- (d) the consequences of the transfer for members of the society, including a clear explanation of the potential effects on interest rates and containing, in particular, a factual statement of changes in the factors relevant to the determination of interest rates on retail deposits and loans by the successor company compared with the society (having regard to the need for the company to pay dividends to its shareholders), and including any change in the terms on which deposits are to be held and any changes in the applicable terms of the statutory protection scheme and complaints handling arrangements;
- (e) the consequences of the transfer for employees of the society, including any changes in the branch structure or economies in head office departments;
- (f) the financial interests of the directors and other officers arising from, or as a consequence of, the transfer. If directors or other officers have no financial interests in the transfer, either by way of increased emoluments, compensation or other benefits, this should be stated explicitly, for the avoidance of doubt;

- (g) the main features of the published consolidated annual accounts of the society group for the last 3 financial years and its current financial position, including the amount of the society's reserves, at a date not more than 6 months prior to the date of the Transfer Statement;
- (h) in the case of a takeover, the main features of the published annual accounts of the successor company group for the last 3 financial years, its current financial position at a date not more than 6 months prior to the date of the Transfer Statement, and key business indicators of the society group and the successor company group for each of the past 3 financial years. If the successor company is a significant subsidiary within a group, the Authority may require corresponding information about the company alone to be given;
- (i) the future financial prospects of the successor company;
- (j) the intended range and relative importance of the activities of the successor company and any change proposed following the transfer;
- (k) in the case of a takeover, the structure and activities of any group to which the successor company belongs;
- (l) a summary of the provisions of the Transfer Agreement concerning the conditions precedent to its completion and providing for its termination;
- (m) a statement as to whether the transfer will conflict with any contractual obligations of the society (which would include agency agreements);
- (n) the total estimated costs and expenses of the transfer, together with (if applicable) the estimated amount of, and the terms on which, fees and disbursements will be paid to advisers, such as merchant bankers, relating to the valuation of the business;
- (o) responsibility statements by the directors of the society and the successor company, and opinions of the external auditors and any other experts, such as merchant bank advisers;
- (p) if a Transfer Summary is issued, a statement that the full Transfer Statement will be provided free and on request and how it can be obtained.

## **The Transfer Summary**

- 4.3 A Transfer Summary may be sent, instead of the Transfer Statement, in or with the notice of the meeting at which the Transfer Resolutions are to be considered, to every member entitled to that notice. As its title indicates, the Transfer Summary must contain information derived from the Transfer Statement, particulars of which are prescribed by Schedule 2 to the Transfer Regulations: principally, that is, the matters described in paragraph 4.2, in summary form, excepting detailed financial information and terms of the Transfer Agreement. The basic qualifying conditions for a distribution of funds or shares might, for example, be summarised in the form of flow charts. More complex information, such as that relating to successors to deceased members, or second named joint account holders, should also be summarised with affected persons being referred to the Transfer Statement and, perhaps, special leaflets on particular terms.
- 4.4 Unlike the Transfer Statement, the Transfer Summary does not have to be approved by the Authority. It is to be compiled by, and on the responsibility of, the directors of the society and of the successor company. If a society decides to send a Transfer Summary, rather than the Transfer Statement, with the notice of the meeting, then the Transfer Summary must contain the directors' responsibility statements and state that it has not been approved by the Authority while the full Transfer Statement, which has been so approved, is on request available free of charge, to any member of the society to whom the Transfer Summary was sent, at any branch or office of the society or by post.

## **The Transfer Document**

- 4.5 The Transfer Statement or Transfer Summary does not have to be a separate document. In practice it will usually be convenient to include it in a comprehensive Transfer Document which will also contain the notice of the meeting at which the Transfer Resolutions are to be moved, an explanation of the transfer procedure (including details of the confirmation stage - see section 6) and a description of the requirements of the society's Rules concerning entitlement to vote. It may also be convenient to include additional material required by the UKLA in connection with a flotation. However, the statutory Transfer Statement or Transfer Summary within the Transfer Document should be clearly identified as such (either by printing it on a different colour of paper or by some other means). An illustrative example of the structure of a Transfer Document containing a Transfer Statement is given in Annex A to this chapter. A Transfer Document containing a Transfer Summary should take much the same form (in that

case, the Transfer Statement made available to the members on request could be a separate document).

- 4.6 If shares in the successor company are proposed to be offered to members, either for subscription or free of charge, the society will need to consider whether and, if so, how it should combine the information relevant to the members' decision on the proposed transfer, and that relevant to the share offer, in one document. The two requirements differ, particularly in extent. Combining the Transfer Statement and share prospectus may run the risk of confusing the issues for some members.
- 4.7 The Authority and its staff may be willing, but only if time and its resources permit, to comment informally on material additional to the statutory Transfer Statement which the board proposes to put to the members. The Authority considers that, if asked, it can best help the board and the members by making informal comments at the formative stage. However, it will only comment on the clear understanding that the final decision on what information to put to the members outwith the Transfer Statement is for the board to decide. The Authority is conscious that it may have to assess such additional material in the light of representations on the society's application for confirmation of the proposed transfer, and any comments which it does offer are without prejudice to its position in those proceedings.
- 4.8 However, the Authority cannot undertake the additional work of reviewing and commenting upon the draft Transfer Summary. As is noted in paragraph 4.4, the board alone is responsible for ensuring that the Summary fairly and accurately summarises the prescribed information in the Transfer Statement, and that it fulfils the requirements of the 1986 Act and the Transfer Regulations. As with the other information provided to the members in addition to the Transfer Statement, the Authority will review the Transfer Summary at the confirmation stage of the transfer procedure.

### **Board Statements**

- 4.9 The Transfer Regulations, deliberately confine the particulars required to be included in the statutory Transfer Statement to information which is factual and which can be verified by a society and its professional advisers, including factual statements of the reasons why the board decided to recommend the transfer and its terms (which may include statements of the board's belief and opinions, clearly identified as such) and the options it considered for the future conduct of the society's business, all of which can be verified by reference to the board's minutes and papers. A board may choose to engage

in more general advocacy of the merits or fairness of its proposals elsewhere in the documents sent to members, in which case, the Authority may have to have regard to whether such material is consistent with the information given in the statutory Transfer Statement when it comes to consider an application for confirmation.

- 4.10 The whole Transfer Document should be covered by **responsibility statements** by the directors of the society and the successor company. This may be given along the following lines (either a joint statement or separate statements by each board):

“The directors of ..... Building Society and the directors of ..... accept responsibility for the information relating respectively to the society and the company which is contained in this document. To the best of the knowledge and belief of the directors (who have taken all reasonable care to ensure that such is the case) the information contained in this document is in accordance with the facts and does not omit anything likely to affect the import of such information”.

### **Application and Authority Approval**

- 4.11 It will be helpful to both the society and the Authority for the society to consult the Authority about the outline structure of, and main features to be contained in, the Transfer Document at an early, formative stage. The Authority will also be prepared to consider a full specification of the proposed cash or share distribution scheme. Thereafter, a formal written application for approval of the statutory Transfer Statement must be made to the Authority by, or on behalf of, the board and accompanied by a draft Transfer Statement which should be as complete as is reasonably practicable at that stage, together with the fee prescribed by the current Fees Rules.

- 4.12 The Authority will then consider the application and decide whether or not to approve the Transfer Statement. It must satisfy itself that:

- (a) in its opinion, the terms of the transfer scheme described in the Transfer Statement are consistent with the 1986 Act;
- (b) the Transfer Statement contains particulars of the matters required by the Transfer Regulations;
- (c) there is no further material information which it appears to the Authority, on the basis of what it knows at that time, is relevant to the decision of the members

and is appropriate to the Transfer Statement (since that Statement carries the explicit approval of the Authority);

- (d) the information in the Transfer Statement is presented clearly, in a balanced way, is consistent with the facts as known to the Authority, and is supported by responsibility statements from the directors and by opinions from the society's auditors and advisers.

For that purpose, the Authority will require supporting documentary information, including, in particular:

- (e) the draft Transfer Agreement, which will incorporate a full specification of the transfer distribution scheme (the Transfer Statement by itself being an inadequate basis for considering the legal issues);
- (f) a description, supported by opinions of the society's auditors and legal advisers, of the terms of the proposed scheme of distributions of funds or shares to members, Trustee Account Holders and others, including the systems and procedures required to make the distributions and copies of the notices and other documents to be used;
- (g) in the case of a specially formed company, the draft articles of association of the successor company (including the requisite protective provisions);
- (h) the Rules of the society (6 copies);
- (i) the full accounts and auditors' reports on which the financial information is based;
- (j) a checklist of the information required by the Transfer Regulations showing where each item may be found in the draft Transfer Statement.

4.13 The process of consideration will consist of discussions and correspondence between the Authority and the society, which are likely to lead to the production by the society of one or more redrafts of the Transfer Statement to take account of the Authority's comments, and refinements proposed by the society, to improve the clarity, completeness and drafting of the Statement. Clearly, the time necessary to complete this process will depend upon the quality and completeness of the draft Statement submitted with the first



application, the complexity of the proposed terms of the transfer and whether they include any novel features, and whether it proves necessary to apply to the High Court for the determination of any legal issues. The Authority will seek to deal with the process efficiently and expeditiously. However, its speed of response will necessarily be affected by the factors referred to above as well as the commitments and priorities of the Authority's relevant resources. The draft Transfer Statement must also be fully verified, to the satisfaction of the board, which process may be expected to take up to 6 weeks.

- 4.14 The Fees Rules provide that a further fee is payable by the society each time it submits a revised draft Transfer Statement to the Authority for approval. However, the Authority may waive or reduce the additional fee where it is satisfied that the revisions to the original, or previous, draft are not substantial.
- 4.15 When the society has settled on the final draft of a Transfer Statement which the Authority is minded to approve, the society should submit two authenticated copies of the final draft Transfer Statement to the Authority with the following documents:
- (a) a certified copy of the Transfer Agreement made between the society and the successor company;
  - (b) the Memorandum and Articles of Association of the successor company;
  - (c) a checklist of the information required to be included in the Transfer Statement pursuant to the Transfer Regulations;
  - (d) certified copy of an opinion from the society's auditors pursuant to paragraph 17 of Part I of Schedule 1 to the Transfer Regulations;
  - (e) certified copies of any other experts' reports or opinions which appear or are referred to in the Transfer Statement;
  - (f) certified copy of an opinion from the successor company's auditors pursuant to paragraph 17 of Part I of Schedule 1 to the Transfer Regulations;
  - (g) statutory accounts of the society and its connected undertakings for the previous 3 financial years, together with a reconciliation between those accounts and the figures appearing in the Transfer Statement;

- (h) in the case of an existing company, consolidated statutory accounts of the company/group for the previous 3 financial years, together with a reconciliation between those accounts and the figures appearing in the Transfer Statement;
- (i) certified copy of a letter of consent from the society's auditors relating to the issue of the Transfer Statement;
- (j) in the case of an existing company, certified copy of a letter of consent from the successor company's auditors relating to the issue of the Transfer Statement;
- (k) certified copy of a letter of consent from the Banking Regulator relating to the issue of the Transfer Statement with the inclusion of a statement as to the willingness of the Banking Regulator to authorise or, as the case may be, to continue to authorise the successor company on terms which will enable it to carry on the business it will have as a result of the transfer.
- (l) certified copies of letters of consent from any other experts relating to the issue of the Transfer Statement with the inclusion of any reports or opinions referred to in paragraph 4.15(e);
- (m) certified copies of responsibility letters signed by the directors of the society (see paragraph 4.10);
- (n) certified copies of responsibility letters signed by the directors of the successor company (see paragraph 4.10);
- (o) certified copies of the minutes of the boards of the society and the successor company approving the Transfer Statement, the Transfer Agreement and related documents and approving the release of the responsibility letters mentioned in 4.15(m) and (n) (respectively) to the Authority;
- (p) an assurance from the directors of the society concerning the society's register of members and its systems (see paragraph 5.15);
- (q) a declaration by the directors of the society, and a similar declaration (as appropriate) by the directors of the successor company, along the following lines:

“We confirm that the statutory Transfer Statement was approved at a meeting of the Board of Directors of the Society held on (.....). The Directors of the Society agreed that copies of the responsibility letter could be made available to the Financial Services Authority in connection with this application. We also confirm that apart from the inclusion of [.....] no other changes have been made to the statutory Transfer Statement from the Pre-Approval proof dated (.....) handed to you on (.....) and that no changes have been made to the Transfer Agreement from the draft dated (.....) and handed to you on (.....).”

“We hereby request pursuant to our application dated (.....), that the Financial Services Authority approves, in accordance with paragraph 4(3) of Schedule 17 to the 1986 Act, the contents of the statutory Transfer Statement so far as they concern the prescribed matters (as defined in paragraph 1 of that Schedule) and any matter of which particulars are required to be given under paragraph 3(1)(b) of that Schedule.”

- 4.16 The Authority’s statement of approval of the Transfer Statement will be given as is set out in Annex A.
- 4.17 The Authority’s approval of the Transfer Statement will be confirmed by returning to the society one authenticated copy of the Transfer Statement with the Authority’s certificate of approval signed by an authorised signatory for the Authority. The society will be asked to give 50 copies of the printed Transfer Document and Transfer Summary, if any, to the Authority when they are available. There is no statutory requirement for copies of the Transfer Statement and Transfer Summary to be placed on the public file of a society but, because they are both public documents, the Authority will arrange for copies of the Transfer Document and the Transfer Statement, if printed separately, to be placed on the public file. If a public announcement of the transfer proposal is not to be made until after the Authority has approved the Transfer Statement, or until the Transfer Document is sent to the society’s members, the Document and Statement will not be placed on the public file until after the announcement. None of the other documents referred to in paragraph 4.15 above will be placed on the public file.
- 4.18 The number of copies of the Transfer Statement to be printed will, of course, depend upon whether a society intends to distribute a Transfer Summary to its members with the notice of the general meeting. In that case, the society must make its own judgement about the number of copies of the full Transfer Statement to be printed, bearing in mind

the requirements of paragraph 4(2) of Schedule 17 that sufficient copies must be available at every office or branch of the society and for despatch by mail.

### **A Note on Style**

4.19 A Transfer Document is bound to be lengthy and somewhat complex. It has to contain a lot of information, but its complexity will depend to a large extent on the terms of the transfer, particularly the transfer distribution scheme, proposed by the board. Bearing in mind that the purpose of the Transfer Statement is to provide information to the generality of members, it should be written in a clear and concise style and, so far as possible, in plain English. The Authority will be concerned that, because the statutory Transfer Statement is largely concerned with matters of fact, those matters are presented clearly and unambiguously. To the extent that it is necessary to include statements of the opinion or belief of the board, those statements should be clearly identified as such in the Transfer Statement. The board's views on the fairness and merits of the proposed transfer and its terms will form a separate part of the Transfer Document, as discussed in paragraph 4.9. Annex A suggests a structure for the Transfer Document which is designed to present its readers with a clear and logical sequence of topics. The Authority suggests that one of the main tasks of the society's project manager (see paragraph 2.13) should be to ensure that the Transfer Document is drafted in a clear and concise style. This will be a great help in achieving the Authority's approval of the Transfer Statement, and the board's verification of the whole Transfer Document, without undue difficulty and within a reasonable timescale.



## 5. GENERAL MEETINGS AND RESOLUTIONS

**This section describes the requirements of the 1986 Act concerning members' entitlement to vote, the register of members and the sending of notices of meetings. It also discusses general meeting arrangements, the resolutions and majorities required and the counting of votes. *The directors of a society must satisfy themselves that they observe the general law on meetings, the relevant provisions of the 1986 Act and the society's own Rules.***

### Resolutions and Voting Majorities

5.1 The 1986 Act provides that a transfer must be approved by the requisite Transfer Resolutions in accordance with paragraph 30 of Schedule 2 (Section 97(4)(c)) as follows:

- (a) **a borrowing members' resolution** passed on a poll by a simple majority of borrowing members qualified to vote and voting (see paragraph 29(1) of Schedule 2 for the definition of a borrowing members' resolution); and
- (b) **a shareholding members' resolution** (see definition in paragraph 27A of Schedule 2) passed on a poll by a majority of at least 75% of shareholders qualified to vote and voting, and on which:
  - (i) in the case of a **conversion**, not less than 50% of shareholders qualified to vote on a shareholding members' resolution **voted** (see SI 1997/2714); or
  - (ii) in the case of a **takeover**, not less than 50% of shareholders qualified to vote on a shareholding members' resolution (or shareholders so eligible who held not less than 90% of the total share balances held on the voting date by all shareholders qualified to vote) **voted in favour**;

provided that, in each case, notice has been duly given that the resolution is to be moved as a shareholding members' resolution or a borrowing members' resolution, as the case may be, and, in the case of the shareholding members' resolution, that the resolution will not be effective unless it satisfies the requirements specified in 5.1 (b). A member may vote either in person at the meeting or by appointing a proxy, and paragraph 33(1) of

Schedule 2 provides that the voting on Transfer Resolutions may **not** be conducted by postal ballot.

- 5.2 Section 99(2) of the 1986 Act provides (see paragraph 3.24) that, where a society proposes to pay **compensation to directors or other officers** for loss of office or diminution of emoluments, attributable to the transfer, such compensation must be approved by a special resolution of the society's members; that is, a resolution passed by a majority of at least 75% of members (both shareholding and borrowing members together) qualified to vote and voting (paragraph 27 of Schedule 2 to the 1986 Act). This resolution is separate from the Transfer Resolutions required to approve the other terms of transfer. The Treasury has not made regulations under Section 99(3) of the 1986 Act to set limits below which compensation may be paid without the authority of a special resolution. Therefore, in every case where compensation is proposed, the members must vote on the proposal as a separate issue from whether they approve the proposed transfer itself. "Other officers" include, in addition to the Chief Executive and Secretary, any persons who exercise managerial functions under the immediate authority of a director or the Chief Executive of a society (see "manager" and "officer" in Section 119 of the 1986 Act).
- 5.3 As is described in paragraphs 3.26 and 3.27, if the terms of a transfer include provision **for increased emoluments of directors or other officers** in consequence of the transfer, an ordinary resolution approving any such provision must be put before a meeting of the society. An ordinary resolution is passed by a simple majority of members (both shareholding and borrowing members voting together) qualified to vote and voting. However, it is not required that the resolution must be put to the same meeting as the Transfer Resolutions, neither is approval of the ordinary resolution required to authorise such increased emoluments which, as terms of the transfer, are authorised by the passage of the Transfer Resolutions. The purpose of Section 99A of the 1986 Act is to give the members an opportunity to express their views on these matters separately from their decision on whether or not to approve the transfer and its terms.

### **Notice of the Meeting**

- 5.4 Paragraph 22 of Schedule 2 to the 1986 Act requires that notice of a meeting shall be given to every member of a society who would be eligible to vote at the meeting. The notice is also to be given to every member who will attain the age of 18 years on or before the date of the meeting, and to every person who becomes a shareholding or

borrowing member of the society after the date of the notice but before the date specified by the society as the final date for the receipt of proxy voting forms. Note also that the Transfer Statement or the Transfer Summary, as the case may be, must also be sent to every member entitled to notice of the meeting (paragraphs 2 and 4(1) of Schedule 17 to the 1986 Act).

## **Entitlement to Vote**

- 5.5 Paragraph 5 of Schedule 2 to the 1986 Act provides that no person may be a member of a building society unless he or she is a shareholding member or a borrowing member. A shareholding member is a person who holds a share in the society (that is, an investment in a share account or PIBS). A borrowing member is a person who is indebted to the society in respect of a loan fully secured on land. However, the Rules may provide that borrowing membership is conferred by a loan substantially secured on land, or shall cease if the loan is foreclosed or the land is taken into possession by the society. A minor (that is a person under 18 years of age) may be a member, but may not vote on any resolution.
- 5.6 The mandatory provisions of Schedule 2 to the 1986 Act concerning a member's entitlement to vote on a resolution, which must be reflected in societies' Rules, are that the member must be a member on the voting date, must have been a member at the end of the last financial year before the voting date (paragraph 23(1) of Schedule 2) and must have attained the age of 18 years (paragraphs 5(3) and 34(2) of Schedule 2) on or before the date of the meeting. So far as borrowing members are concerned, the member is not entitled to vote in that capacity if his indebtedness to the society at any relevant time is less than £100 (paragraphs 29(2) and 36 of Schedule 2).
- 5.7 However, Schedule 2 specifies the following further provisions, some, none or all of which **may** be included in a society's Rules with respect to the **entitlement of shareholding members to vote** on any resolution; a person must (see Schedule 2 paragraphs 23(3) to (5) and 36):
- (a) have a qualifying shareholding (which must not be set higher than £100), in one or more share accounts or PIBS, on the "qualifying shareholding date";
  - (b) hold shares on the voting date; and
  - (c) have held shares continuously between those two dates.



5.8 The “**qualifying shareholding date**” is either: the last day of the financial year preceding the voting date; or, if the voting date falls during that part of a financial year which follows the conclusion of the society’s AGM commenced in that year, the first day of the period beginning 56 days before the date of the meeting. Therefore, if a society’s Rules, following the BSA Model Rules (Fifth Edition), include the provisions concerning shareholding and continuity of membership, described in paragraph 5.7, **and if the voting date is later than the AGM in that year**, a person to be entitled to vote on a shareholding members’ resolution must:

- (a) have been a shareholding member on the last day of the previous financial year;
- (b) have held shares to the value of at least £100 on the day 56 days before the date of the meeting;
- (c) have held shares continuously from the 56<sup>th</sup> day through to the voting date; and
- (d) hold shares on the voting date.

But note that there is no requirement for continuity of shareholding between 5.8(a) and (b) (In contrast, in the case of an ordinary or special resolution, membership at 5.8(a) may be satisfied by either borrowing or shareholding membership provided the shareholding member satisfies the other conditions of (b) to (d). in order to vote in his or her capacity as a shareholder.) Note also that a person cannot meet a requirement for “holding shares” on a given date, or during a given period, by relying on his holding of a share account with an overdrawn balance; and a person cannot meet a requirement for being a “member” on a given date (for example, at 5.8(a)) by relying on his holding of such a share account.

5.9 The mandatory provisions of Schedule 2 concerning **entitlement to vote on a borrowing members’ resolution** are, as noted above, that the member must have been, and be, indebted to the society for at least £100 (whether on one or more accounts) at the end of the last financial year before the voting date, and on the voting date, in respect of an advance fully secured (or, if the Rules permit, substantially secured) on land (paragraphs 5(2), 23(1), 29(2) and 36 of Schedule 2) and have attained the age of 18 years by the date of the meeting (paragraphs 5(3) and 34(2) of Schedule 2). But note that there is no dispensation in the 1986 Act for the Rules to reduce the qualifying amount below £100, nor to provide for a continuity of membership qualification.

- 5.10 Schedule 2 makes provision in respect of **joint shareholders** (paragraph 7) and **joint borrowers** (paragraph 8). The only person entitled to exercise the right to vote on behalf of the joint shareholders or joint borrowers is the one who is named first in the records of the society, described respectively as the “representative joint holder” or the “representative joint borrower”.
- 5.11 A member may vote once only on any resolution, irrespective of the number of accounts he or she may hold. The amount of the balance(s) held on account(s) is not material, except to qualify to vote - see paragraphs 5.6 to 5.8. Thus, a member with several share accounts and/or several mortgage accounts, whether as sole and/or representative joint holder, may vote once only on any resolution. When the membership votes as a whole on an ordinary or a special resolution, each member may vote only once, whether he or she is a shareholding or a borrowing member or both. Where shareholding members and borrowing members vote separately, as on the Transfer Resolutions, members entitled to vote may vote only once, if a shareholding member, on the shareholding members’ resolution and once, if a borrowing member, on the borrowing members’ resolution. A person entitled to vote both as a shareholding member and as a borrowing member may of course, vote once on each resolution.
- 5.12 The “**voting date**” is defined by paragraph 23(6) of Schedule 2 as, for this purpose, either:
- (a) for members who appoint a proxy, the last date specified by the society for the receipt of proxy voting forms, which may not be more than 7 days before the date of the meeting (paragraph 24(6) of Schedule 2). A proxy vote remains valid if the member ceases to be a member after the proxy voting date but before the date of the meeting (paragraph 24(2) of Schedule 2); or
  - (b) for all other members, the date of the meeting.
- 5.13 The guidance given in the foregoing paragraphs of this section is intended to give a general description of the provisions of the 1986 Act and of the Rules suggested by the BSA Model Rules. Societies are advised to satisfy themselves that they observe the specific provisions of the 1986 Act and of their own Rules.

## Register of Members

- 5.14 Every society is required to maintain a register of the names and addresses of its members and whether each member is a shareholding member or a borrowing member or both. (Schedule 2, paragraph 13). The register should, so far as possible, be “de-duplicated”; that is, multiple account holders should be identified and their names recorded once only in the register. A society’s systems must also be capable of recognising those members who are eligible to vote by, for example, aggregating share account balances of multiple account holders to check that they have the requisite qualifying shareholding, by checking members’ continuity of shareholding, and by identifying minors (see paragraphs 5.5, 5.6 and 5.9). This information is required to ensure that the notice of the meeting is sent to all the members entitled to receive it, and that the scrutineers have adequate systems to validate the votes cast on the Transfer Resolutions.
- 5.15 The directors of a society contemplating a transfer must satisfy themselves, in consultation with their external auditors, or other advisers, that the society’s systems are capable of delivering the information described above. The Authority will require an assurance on this point when the society applies for approval of the Transfer Statement. One of the criteria which the Authority has to consider at the confirmation stage is whether some relevant requirement of the 1986 Act or the Rules was not fulfilled (see section 6).
- 5.16 The problem of avoiding duplication in the register of members is significant for most societies of any size. Societies generally now seek to establish, when new accounts are opened, whether or not the applicant is an existing member and, if so, which accounts are relevant to voting and other membership rights. The task of identifying multiple account holders is complicated by confidentiality requirements. For example, if two accounts are held by a Mr A Smith and a Dr A Smith, both at the same address, the society cannot know (in the absence of other information such as date of birth) whether the two accounts belong to the same person, one opened before and one after he qualified, or by the doctor and his son. A letter of enquiry to one asking about both accounts would risk breaching customer confidentiality. If it is the same person, there is a risk that he will be given the opportunity to vote twice or, if neither account holds more than £100 but they aggregate above that qualifying amount, be denied a vote to which he is entitled. It is good practice for a society, when it has announced its intention to transfer its business, to write to all its members individually setting out the information about them which it holds on its records, inviting them to confirm that the

information is correct and to say whether they have received more than one such letter as a shareholder or as a borrower.

- 5.17 Where a society identifies a number of accounts which appear to be held by a single member, but it cannot be sure, then it must send separate meeting notices in respect of each account which satisfies the qualifying conditions for entitlement to vote. Where such accounts do not separately entitle the member to vote but would do so if aggregated (by satisfying the £100 minimum shareholding condition) the society may consider it advisable to send separate notices in respect of each account with the warning that, on the information available to it, the society believes that the member is not eligible to vote. However, its systems should identify the possible multiple holding so that, if more than one vote is received in respect of that group of accounts, the scrutineers are alerted to the possibility, and can check the proxy forms for evidence of invalid duplicate votes. The voter's declaration suggested by the BSA Model Rules, in conformity with paragraph 34 of Schedule 2 to the 1986 Act, provides some protection against votes being cast by minors, but none against duplicate votes. It is, however, the duty of each society to make sure that its register of members is reliable.

### **General Meeting Arrangements**

- 5.18 Paragraphs 5.19 to 5.25 consider the requirements for sending notices of meetings and Transfer Statements, or Transfer Summaries, to members, and the conduct of meetings at which Transfer Resolutions are to be moved. It is for societies to satisfy themselves that they comply with the relevant requirements of the 1986 Act, their Rules and the general law on meetings

#### *Notice of Meeting*

- 5.19 The statutory requirements concerning notices to members are in paragraph 22 of Schedule 2 to the 1986 Act. Notice of the meeting must be given to each shareholding and borrowing member of the society who would be eligible to vote at the meeting if the meeting were held on the date of the notice (a single date for all notices irrespective of when they are despatched). In addition, notice must also be given to any person who will attain the age of 18 years after the date of the notice but on or before the date of the meeting, and to every person who becomes a shareholding or borrowing member of the society after the date of the notice but before the final date for receipt of proxy voting forms, provided, in each case, that the member will be entitled to vote. Note also that the Transfer Statement or Transfer Summary must be sent in or with the notice to every

person entitled to receive it (paragraphs 2 and 4 of Schedule 17 to the 1986 Act). Accidental omission to give notice of a meeting to any person entitled to receive it does not invalidate the proceedings at the meeting. However, “accidental omission” does not include a systemic failure to send notices (e.g. omitting to send notices to new shareholders or borrowers, or omission of a group or class of members from the mailing list arising from a fault in a computer programme), nor all cases of error by management - see also paragraph 5.38.

5.20 The 1986 Act also provides, in paragraph 21 of Schedule 2, for the **length of notice** to be given to members. The period of notice given must be not less than 21 days or such longer period as the society’s Rules prescribe. The precise procedures for sending notices, the way in which the days are to be counted, and presumed receipt of notices duly sent, will normally be set out in the Rules. Particular points to note are:

- (a) the 21 days’ notice expires with the closing date for the receipt of proxy voting forms, not the date of the meeting;
- (b) if reliance is to be placed on a provision in the Rules that notices can be deemed to be served 24 hours after posting, then first class post or equivalent means of delivery should be used. However, it is advisable to allow a margin of at least an extra day or two, but more if second class post is used;
- (c) if a society contracts with a commercial mailing firm, it must ensure that the firm is comprehensively instructed about the society’s despatch and delivery requirements, and the society should carry out spot checks to satisfy itself that its instructions are being properly carried out. A failure by the contractor may invalidate the meeting, even if the society itself has used its best endeavours to police the operation.

5.21 The Transfer Statement or Transfer Summary, as the case may be, is required, by paragraph 4(1) of Schedule 17 to the 1986 Act, to be sent “**in or with**” the notice of the meeting to every member entitled to that notice. As is suggested in section 4, it may be expedient to include both in a comprehensive Transfer Document or booklet.

5.22 Notices and Statements or Summaries need not be sent to any member in whose case the society has reason to believe that communications sent to him at his registered address are unlikely to be received by him (Schedule 2, paragraph 14). In those circumstances, a society is required to place notices of the meeting prominently in every branch office, or

to place advertisements in newspapers circulating in the areas in which the society's members live. Such notices or advertisements must be published at least 21 days before the date of the meeting, and must state where members can obtain copies of the Transfer Summary, the Transfer Statement, the Transfer Resolutions and proxy voting forms (paragraph 35 of Schedule 2 to the 1986 Act).

- 5.23 It should be noted, however, that a member's "registered address" may not be the address shown in the society's register of members but a different address to which the member has requested that communications from the society be sent (paragraph 13(4) of Schedule 2 to the 1986 Act).

#### *Conduct of the Meeting*

- 5.24 The meeting should be held at a time and place considered by the board to be most convenient for the generality of the society's members. This may not necessarily be the same as the traditional time and place for the AGM. In deciding on this, the board should take account of the geographical location of their members, and the probability that an unusually large number of members may wish to attend a meeting to consider a proposed transfer.
- 5.25 Subject to the society's Rules, its chairman will normally chair the meeting. His function as chairman of the meeting is to ensure that all views may be presented and properly discussed. He is unlikely to be able to fulfil that role if he acts also as chief advocate of proposals which are controversial among members. In such cases it might be appropriate to give to another director the tasks of explaining the board's recommendations and of responding to questions from members.
- 5.26 A Transfer Resolution cannot be amended at the meeting except in a way which does not change its substance at all. This is because an amendment to such a resolution has to be subject to the same procedure and period of notice to members as the resolution itself. If a board decides, after due notice of such a resolution has been sent to the members, that the resolution should be amended, then it will be necessary to submit the amended resolution, with due notice, to a general meeting at a later date, unless of course there is still time to fulfil the notice requirements.

### *Conduct of the Voting*

- 5.27 The conduct of the voting must not only be fair but also be seen to be fair, otherwise the result may be called into question by representers at the confirmation stage. The votes must be counted by independent scrutineers. The board may ask the scrutineers, in advance of the meeting, for a running tally of the number of votes being cast if it thinks it might properly encourage more members to vote if the response is low. However, to ask the scrutineers **how** the votes are being cast, before the time comes at the meeting to instruct proxies, carries the risk of accusations, however unfounded they may be, and possible challenge at the confirmation stage on the grounds that the board suppressed proxy votes against the Resolutions, or unduly influenced members to vote in favour. A board which asks the scrutineers for a running tally of votes, and which circulates its members with further exhortations to vote, must be prepared to argue its case in the face of such accusations at the confirmation hearing. Any circular to members sent after the Transfer Document was sent to them must, therefore, be very carefully considered.
- 5.28 Experience has demonstrated the need for societies to take the greatest care to ensure that they comply strictly with the statutory procedural requirements and their own Rules on meetings and resolutions. The person chairing the meeting should ensure that he or she is well briefed and aware of the Rules and the general law relating to procedural resolutions, such as resolutions to adjourn the meeting. The Authority will require a confirmatory report from the scrutineers on the validity of the voting procedures when the society applies for confirmation (see paragraph 5.34).
- 5.29 The procedures for the conduct of proxy voting will normally be provided for in the society's Rules, in conformity with paragraphs 24 and 34 of Schedule 2. The 1986 Act requires that every proxy form sent by a society to its members must enable the member to direct the proxy how to vote (paragraph 24(4A)). In addition, to minimise the risk of the society's proxy voting procedures being misunderstood, the Authority recommends that the design of the proxy form is carefully considered (preferably a self-contained form clearly to be returned intact) and that it should include:
- (a) adequate space to insert the name of a proxy other than the chairman of the meeting, and a statement (which must also appear in the notice of the meeting) that the proxy appointed need not be a member of the society (a reminder that the voting member's own name should not be inserted will also be helpful);

- (b) an explicit statement that if the member does not instruct his proxy to vote for or against the resolution, then the proxy will cast the vote, or abstain, as he thinks fit;
- (c) the declaration, as provided by the Rules, in accordance with paragraph 34 of Schedule 2;
- (d) full recital of the text of the shareholding members' or borrowing members' resolution(s) or, if this is not practicable (e.g. because of space restrictions), a clear indication that the full text may be found in the notice of the meeting;
- (e) instructions as to the return of completed proxy forms, including the last effective date for receipt by the society or by the scrutineers. A pre-addressed and pre-paid envelope or other sealed means of return should be provided.

5.30 The 1986 Act does not require societies to send proxy voting forms to members with notices of meetings. However, the Authority believes that, on a matter as important as a transfer, and bearing in mind the 50% turnout (conversion) and 50% support (takeover) requirements on the shareholding members' resolutions, societies would be well advised to send a proxy voting form to members with the meeting notice. If a society decides, nevertheless, not to send proxy forms to members entitled to vote, then it should make clear to the members that proxy voting forms can be obtained on demand from its branches and/or by application to a central point.

5.31 The arrangements for the collection of the proxy forms should be such as to secure confidentiality and to avoid the risk of loss, whether accidental or deliberate. The Rules may provide for return of proxy forms to the scrutineers either directly or to the society's principal office. Where proxy forms are returned to the society's offices, the Authority recommends that the procedures should incorporate the following features:

- (a) the proxy form should be enveloped or otherwise sealed so that the members' voting instructions are concealed;
- (b) the envelope provided should be clearly marked so that the society can readily identify and separate it from other mail without the envelope being opened;



- (c) staff responsible for receiving and sorting mail should be given specific instructions about the handling of proxy forms and the overriding importance of security;
- (d) secure storage of proxy forms should be provided up to the point at which they are handed over to the scrutineers;
- (e) equivalent handling and security procedures should be applied to proxy forms handed in at branches.

5.32 The Authority suggests that proxy voting forms for shareholders and borrowers should be easily distinguishable, perhaps by colour coding, both as an aid to members who may be entitled to vote in each capacity, and as an aid to the scrutineers counting the votes.

5.33 Members may attend the meeting and vote in person. There must, therefore, be satisfactory systems in place in accordance with the Rules to identify and cancel any proxy votes they may previously have returned.

### **Scrutineers' Report**

5.34 The scrutineers are responsible for checking the validity of votes cast in person and by proxy. The scrutineers must be independent of the society and not have a direct interest in the result of the voting. For example, they should not be officers expecting to receive compensation or appointments under the terms of the transfer. It will usually be appropriate to appoint the society's auditors, and it is desirable that they should be appointed not just for the arithmetical count of votes but also to supervise the voting process as a whole so that they are in a position to confirm, after the vote, that all the requirements of the 1986 Act and the society's Rules have been complied with. This would include:

- (a) determining and validating member mailing lists for notices of the meeting and Transfer Statements or Transfer Summaries and for Trustee Account Holders (see paragraphs 3.15 and 5.4);
- (b) despatch procedures;
- (c) timing of notices and despatch of documents;

- (d) form and content of proxy voting forms;
- (e) receipt and custody of completed proxy voting forms;
- (f) validation of completed proxy voting forms to establish that members are qualified to vote and that forms are properly completed;
- (g) identification and validation of members attending and voting at the general meeting;
- (h) voting procedures at the meeting including casting of proxy votes, count of votes cast in person and aggregation of proxy and personal votes cast on the Transfer Resolutions, and on any special resolution required to authorise the payment of compensation to directors or other officers;
- (i) voting procedures at the meeting, or at another meeting, as the case may be, and the count of votes on any ordinary resolution to approved increased emoluments of directors or other officers (if required).

5.35 To fulfil the duties outlined above, it is suggested that the scrutineers would need to:

- (a) examine the systems and procedures to be employed by the society, before they are implemented, to ensure that they are satisfactory;
- (b) carry out such checks and tests as they consider necessary during the operation of the procedures as will enable them to be satisfied that the specified procedures are being carried out in practice;
- (c) provide that where validation functions are carried out by the society's staff this is done under the direction and supervision of the scrutineers;
- (d) direct and supervise the count of the votes cast both by proxy and personally at the meeting.

5.36 Validation checks during the counting of votes may be expected to include the following:

- (a) only proxy forms which comply with the 1986 Act and the society's Rules have been used;
- (b) the member is eligible to vote under the 1986 Act and under the society's Rules (**NB** a proxy vote may still be valid even though the member has ceased to be entitled to attend and vote at the meeting after the closing date for receipt of proxies - see paragraph 5.12 (a));
- (c) only one proxy form per member eligible to vote is included in the count (separate forms may be sent to and returned by a person eligible to vote on both the shareholding members' resolution and the borrowing members' resolution);
- (d) minors are excluded and that there is an explicit confirmation by each member voting by proxy that he is aged 18 or over;
- (e) the proxy form is completed and signed and is otherwise valid (where a proxy form lacks a signature but is otherwise valid, it is usual, if time permits, for the scrutineers to return the form to the member for signature and return in a pre-paid envelope).

5.37 The scrutineers' initial report will be made to the society at the meeting (which may be adjourned for this purpose). The Authority will require, in support of a society's application for confirmation under Sections 97(4)(d) and 98 of the 1986 Act, a report from the scrutineers on the result of the vote on each Resolution (distinguishing between votes cast in person and by proxy), the total number of members eligible to vote (and the proportion of that number that the votes cast represent), the numbers of invalid votes cast and also confirmation that, in the opinion of the scrutineers, the arrangements for the conduct of the voting were such as to ensure that:

- (a) notices of the meeting and Transfer Statements or Transfer Summaries were sent to all those entitled to receive them, in accordance with the 1986 Act and the Rules of the society having regard, *inter alia*, to the matters referred to in this chapter;
- (b) the periods of notice given complied with the requirements of the 1986 Act and of the society's Rules, taking into consideration established conventions for the counting of days;

- (c) there were satisfactory procedures to ensure the security of proxy voting forms and to minimise the risk of loss or unauthorised access;
- (d) there were satisfactory procedures to ensure that the count of votes cast personally at the meeting included only votes cast by members eligible to vote and who had not mandated, or had withdrawn, a proxy vote.

5.38 In relation to the notice of the meeting, the scrutineers' report may properly have regard to the provision of paragraph 22(3) of Schedule 2 to the 1986 Act that "accidental omission to give notice of a meeting to, or non-receipt of notice of a meeting by, any person entitled to receive notice of the meeting does not invalidate the proceedings at that meeting". It should be noted, however, that there is authority to the effect that "accidental" and "non-receipt" would not cover all cases of "error" on the part of the society, for example an erroneous decision of management not to send notices to particular persons or groups of persons.

5.39 The Authority would find it helpful if the scrutineers' report would also comment upon any procedural difficulties encountered and, if the numbers of invalid votes appear to be significant, give an analysis of the reasons why votes were found to be invalid (see also section 6).

## 6. CONFIRMATION

**No transfer can take effect until it has been confirmed by the Authority. This section first describes the form of application and public notice required. It then explains the Authority's view of how the statutory Confirmation Criteria should be interpreted. Finally, it gives guidance on the procedure customarily followed by the Authority when considering confirmation applications and hearing representations.**

### Application

- 6.1 Sections 97(4)(d) and 98(2) of, together with Part II of Schedule 17 to the 1986 Act, provide that when the necessary Transfer Resolutions have been passed the society must apply to the Authority for confirmation of the transfer in such manner as the Authority may direct. The society is also required, by paragraph 7 of Schedule 17, to publish notices of its application in one or more of the London, Edinburgh and Belfast Gazettes as the Authority directs and, if it so directs, in one or more newspapers. The choice of official Gazettes and national or local newspapers will, of course, have regard to the area in which the society's members live.
- 6.2 The application should specify the date on which the transfer is intended to take effect and should be accompanied by two authenticated copies of the Transfer Agreement. The scrutineers' report described in section 5, and a certified copy of the minutes of the general meeting at which the Transfer Resolutions were moved, together with a transcript of the meeting, must also be enclosed with the application, together with 10 copies each of the Transfer Document and the Transfer Summary (if sent), and copies of all other documents sent to members and any advertising material in connection with the proposed transfer. If a Transfer Summary was sent, the application should also be accompanied by a checklist of the information prescribed by Schedule 2 to the Transfer Regulations showing where each item may be found in the Transfer Summary.
- 6.3 A *pro forma* public notice of application, and *pro forma* letter of application are at Annex B. The appropriate fee is payable with the application, and a further fee is payable by the society if there is an oral hearing of the application, as prescribed by the Fees Rules.

## The Confirmation Criteria

### *Statutory Provisions*

6.4 Section 98(2) and (3) of the 1986 Act provides that the Authority must confirm a proposed transfer **unless** it considers that any one or more of the following four Confirmation Criteria apply:

- (a) some information material to the members' decision about the transfer was not made available to all the members eligible to vote; or
- (b) the vote on any resolution approving the transfer does not represent the views of the members eligible to vote; or
- (c) there is a substantial risk that the successor will not have -
  - (i) such permission (if any) under Part IV of the Act, or
  - (ii) such permission under paragraph 15 of Schedule 3 to that Act (as a result of qualifying for authorisation under paragraph 12 of that Schedule),as will enable it to carry on the business which it will have as a result of the transfer without being taken (by virtue of section 29 of the Act) to have contravened a requirement imposed on it by the Authority under the Act; or
- (d) some relevant requirement of the 1986 Act or of the Rules of the society was not fulfilled.

Section 98(4) of the 1986 Act then provides that the Authority shall not be precluded from confirming a transfer of business by virtue only of the non-fulfilment of some relevant requirement of the 1986 Act or the Rules (the Fourth Criterion in 6.4(d)) if it appears to the Authority that the failure could not have been material to the members' decision about the transfer, and the Authority gives a direction under that subsection that the failure is to be disregarded. Section 98(7) then provides that a failure to comply with a relevant requirement of the 1986 Act or the Rules shall not invalidate a transfer, once confirmed.

6.5 Where the Authority would be precluded from confirming a transfer by reason of any of the defects specified in the Confirmation Criteria, Section 98(5) and (6) of the 1986 Act provides that it may direct a society to remedy the defects. A direction under Section 98(5) may, amongst other things, require a society to:

- (a) call a further meeting; for example, to vote again in the light of a revised Transfer Statement containing material information previously omitted or after correction of defects in the systems for sending meeting notices and Transfer Statements or Transfer Summaries and validation of votes;
- (b) secure the variation of the Transfer Agreement; or
- (c) secure the alteration of the protective provisions in the articles of association of a specially formed successor company.

If the Authority is then satisfied, having considered evidence furnished by the society, that the defects have been substantially remedied, it must confirm the transfer. If not, then confirmation must be refused.

#### *Scope of the Authority's Powers*

- 6.6 The Authority's powers in connection with applications for confirmation of a transfer are confined to considerations of whether, in the light of the facts, any of the Confirmation Criteria apply. It is not for the Authority to consider, or make judgements about, the merits of a proposed transfer or the fairness of its terms; these matters are first for the board of a society, and then for its members, to decide. Once the members have approved the transfer and its terms, the Authority has no powers to require a society to make any changes to those terms, although it may direct a society to remedy any failure to comply with a relevant requirement of the 1986 Act as a condition of confirmation.
- 6.7 The Authority has no general power to determine disputes between a society and its members, nor to seek to enforce other legislation or the general law. Disputes concerning services provided by societies in the ordinary course of their business are generally a matter, in the first instance, for a society's internal complaints procedure. They may also fall within the jurisdiction of the Financial Services Ombudsman Scheme. Disputes between a building society and a member of the society, in his or her capacity as a member, in respect of any rights or obligations arising from the Rules of the society or the provisions of the 1986 Act, fall within the jurisdiction of the High Court or, in Scotland, the Court of Session (Section 85 of and Schedule 14 to the 1986 Act). However, the Authority does have power, on the written application of certain members, to direct that the member has the right to obtain names and addresses from the society's register of members. Before it gives such a direction, the Authority is required to be satisfied that the member requires that right for the purpose of communicating with

other members of the society on a subject relating to its affairs, and must have regard to the interests of the members as a whole and to all the other circumstances (paragraph 15 of Schedule 2 to the 1986 Act). A fee is payable by the applicant. Chapter 1 of this volume 2 of the IPSB gives guidance on applications for access to the register of members

### *Purpose of Confirmation*

- 6.8 The purpose of the confirmation process is to enable:
- (a) interested parties to make representations with regard to the Confirmation Criteria;
  - (b) the society to respond to those representations;
  - (c) the Authority to make such enquiry as it considers necessary to reach informed conclusions on each of the Confirmation Criteria.
- 6.9 The Authority, in reaching its view on each of the Confirmation Criteria, has not only to assess the points made to it in representations, and the society's responses, but also to make such further enquiries as it considers necessary. In deciding how far it should pursue such enquiries, the Authority has to have regard to the role and effect of confirmation, and to the mischiefs which it is intended to prevent. The Authority considers that one role of confirmation is to provide a protection to members against the provision to them by the society of information which is inadequate, obscure or misleading, and against voting irregularities: in other words to ensure that the vote represents the informed decision of the members. The Authority would hope that this safeguard would work in the majority of cases by causing the board of a society to take care during the preparation of the Transfer Statement **not** to put confirmation at risk on this account; otherwise the Authority might find that it had to withhold confirmation at the last stage. In considering the First Criterion, the Authority will have regard to the totality of the information provided to the members by the board of a society, and not exclusively to the Transfer Statement and Transfer Summary.
- 6.10 The task of the Authority is accordingly:
- (a) to reach a considered view on each of the Confirmation Criteria;
  - (b) if that view is that none applies, to confirm;



- (c) if one or more of the First Three Criteria apply, to direct the appropriate remedial action, or to refuse confirmation;
- (d) if the Fourth Criterion applies, to consider whether it is appropriate to direct that failure be disregarded; if not, to direct the appropriate remedial action or to refuse confirmation.

In considering the Confirmation Criteria, the Authority may well have to look again at the Transfer Statement, or at issues which were considered in connection with approving that Statement. It may also then have to consider the adequacy of the Transfer Summary. In doing so, it has a duty to consider information and arguments put to it by representers and by the society, which of their nature were not available earlier, as well as those arising from its own consideration of the Criteria. The Authority would clearly only change the view reached at the time of approval of the Transfer Statement if there were good reason to do so. But it is under a duty to examine the Statement and connected issues at the time of confirmation in the light of any new information and arguments which become available. Accordingly, the Authority cannot be bound at the confirmation stage to the view that was taken at the earlier stage as to whether further factual information should be included in the Transfer Statement or as to the accuracy of its contents or the view taken as to the legality of the scheme.

- 6.11 The task of considering each of the Confirmation Criteria would still be necessary even if there were no representations. Without such enquiry and consideration the confirmation process would not properly be carried out. The Authority's view of how the Confirmation Criteria should be interpreted and applied is given in the following paragraphs.

*The First Criterion*

- 6.12 This criterion requires the Authority to consider whether some material information was not made available to the members. The Authority's own view, in which it concurs with the view previously adopted by the Commission in its confirmation decisions, can be summarised as follows:

- (a) the words "**made available to all the members eligible to vote**" mean that the criterion is mainly, if not exclusively, directed to the information provided by a society to the generality of its members;

- (b) the extent of “**information .... not made available**” can reasonably be assessed by considering how far the totality of information made available falls short of what might be expected to be put to its members by a financial institution of standing and repute seeking to put sufficient information and a fair and balanced assessment of it, and the board’s conclusions, to the members to enable them to take an informed decision;
- (c) the words “**material to the members’ decision**” require the Authority then to focus on whether it is within the bounds of reasonable possibility that the members’ decision would have been different had any deficiency in the information been made good, i.e. whether it could have changed the decisions on voting of sufficient members to lead to a different conclusion. If it is within the bounds of reasonable possibility that the deficiency might have changed the outcome, it is not for the Authority to determine whether it would actually have done so - it should put the decision back to the members. This test requires the Authority to take account both of the size of the vote and of the size of the majority within it;
- (d) the relevance of a particular piece of information to an investor and to a borrower may well be different. Accordingly, it is necessary to consider materiality separately in relation to the shareholding members’ resolution and the borrowing members’ resolution.

6.13 The Authority’s approach to determining whether this criterion is met is accordingly:

- (a) to review the material put to members, in the light of the representations made and the society’s responses, but also taking points of its own accord;
- (b) to consider, on the basis of that review, what information relevant to the decision of shareholders, or of borrowers, or both, might reasonably have been expected to be put to members by the board of a society of repute considering its fiduciary duty, and the extent to which (if at all) the information actually put falls short of that;
- (c) to consider separately in relation to the shareholding members’ resolution and in relation to the borrowing members’ resolution, whether any deficiency so identified was sufficient to amount to “information material to the members’ decision”.

*The Second Criterion*

- 6.14 This criterion requires the Authority to consider whether the votes on the Transfer Resolutions do not represent the views of the members. The main mischief to which it appears to be directed is a resolution approved by a small and unrepresentative vote.

*The Third Criterion*

- 6.15 This criterion is concerned with a matter of fact, to be established by reference to the Banking Regulator if a different body.

*The Fourth Criterion*

- 6.16 This criterion requires the Authority to consider whether the relevant requirements of the 1986 Act and the Rules have been fulfilled. The phrase “**relevant requirement of this Act or the rules of the society**” appears explicitly three times in Section 98 of the 1986 Act:

- (a) sub-section (3)(d) in the specification of this criterion;
- (b) sub-section (4) which gives the Authority power to disregard certain non-fulfilments;
- (c) sub-section (7) which provides that a failure to meet such a relevant requirement shall not invalidate a transfer of business, although such failure by a society without a reasonable excuse is a criminal offence.

The interpretation of the phrase is also directly relevant to sub-section (5) - the power of the Authority to give the society a direction to remedy defects specified in paragraphs (a) to (d) of sub-section (3).

- 6.17 Sub-section (8) defines “relevant requirement”:

“(8) In this section “relevant requirement”, with reference to this Act or the rules of a society, means a requirement of the applicable provisions of this Act or of any rules prescribing the procedure to be followed by the society in approving the transfer and its terms.”

Section 97(2) in turn defines “the applicable provisions” other than Section 97 as:

“section 98, section 99, section 99A, section 100, section 101, section 102, sections 102B, 102C and 102D, paragraph 30 of Schedule 2 and Schedule 17.”

It will be noted that Section 102A (joint account holders) of the 1986 Act is not an applicable provision and, thus, not a relevant requirement.

- 6.18 The Authority considers that sub-section (8) of Section 98 should be read naturally. The words “prescribing the procedure to be followed by the society in approving the transfer and its terms” apply only to the Rules, in order to specify which of the Rules of the society are “relevant requirements”. They do not apply as a matter of normal construction of the sentence to the “applicable provisions of this Act”; nor is it necessary that they should do so, since those provisions are specified in Section 97(2).
- 6.19 In the Authority’s view, the above interpretation of “relevant requirement of the 1986 Act” stems from the natural construction of Sections 98(8) and 97(2) which, in turn, is necessary to give effect to Parliament’s intentions for Section 98(5), (6) and (7). The Authority recognises that this interpretation does not quite fit Section 98(4). The test which the Authority has to apply in the case of sub-section (4) to a non-fulfilment of a relevant requirement of the 1986 Act is:

“if it appears to the Authority that it could not have been material to the members’ decision about the transfer”.

That test clearly is designed to relate to a failure to meet a procedural requirement or to some other failure which might have an effect on the voting.

- 6.20 The wording of Section 98 is such that no construction of the phrase is entirely free from difficulty. The Authority’s view is that the wording, and the intentions of Parliament, are best met by following the natural construction of sub-section (8), as a result applying a wide interpretation in sub-sections (3), (5) and (7), and implicitly in (6), but only considering that it is open to the Authority to make a direction under sub-section (4) in relation to non-fulfilment of a procedural requirement or other failure to which the test in that sub-section is apposite.
- 6.21 The Authority accordingly considers that the relevant requirements are those in:
- (a) sections 97 to 102, and 102B to D of, together with paragraph 30 of Schedule 2 to and Schedule 17 to the 1986 Act;

- (b) the Transfer Regulations; and
- (c) the Rules which prescribe the procedure to be followed; that is, in particular, the Rules concerning: membership; special meetings; notice of meetings; procedure at meetings; entitlement of members to vote on resolutions; appointment of proxies; and joint shareholders and borrowers.

## **Procedure**

6.22 The procedure to be followed in confirmation proceedings is prescribed by Part II of Schedule 17 to the 1986 Act. Any interested party has the right to make written and/or oral representations to the Authority with respect to a society's application for confirmation. Written representations are to be copied to the society, which is to be afforded the opportunity to comment on them orally at the hearing of its application or in writing. (The FSA will in general be prepared to use electronic rather than paper-based communication if requested by the society or a prospective representer and some of the following procedures may have to be adapted accordingly.)

### *Representations*

- 6.23 Persons making representations should state why they claim to be interested parties, for example, their category of membership of the society, and the ground or grounds for their representations by reference to the Confirmation Criteria discussed above. Notice of a person's intention to make oral representations must be in writing. Such notices and written representations must reach the Authority at the address, and by the specified date customarily given in the Transfer Document issued to members and subsequently confirmed by notice published in the official Gazettes and newspapers as required by the 1986 Act. Persons who make written representations but subsequently decide also to make oral representations must, nevertheless, give notice of that intention in writing to the Authority by the same date. Representations received out of time will not be considered unless, exceptionally and at the sole discretion of the Authority, they appear to the Authority to raise matters of substance relevant to the Confirmation Criteria which are not already under consideration.
- 6.24 Representations or notices to the Authority will fall into one of the following three categories:
- (a) written representations only;
  - (b) written representations with notice of intention to make oral representations;

(c) notice of intention to make oral representations only.

- 6.25 The Authority will acknowledge the receipt of each representation or notice and will send a copy of the chapter of the IPSB on confirmation procedures to each representer. It will send copies of all written representations and notices to the society and will afford it an opportunity to comment on the written representations.
- 6.26 The Authority will consider the written representations in category 6.24(a) and the society's responses to them in advance of the date set for hearing oral representations. Copies of the society's comments on representations in category 6.24(b) will be sent to those who made the representations so that they may concentrate their oral representations on the points which they consider to remain at issue. A person making written representations who also wishes to see the society's response must, therefore, also give notice of intention to make oral representations. The society may, exceptionally, apply to put to the Authority in confidence documents which the society considers to be commercially sensitive: the Authority will decide on the merits of each case whether, and on what terms, to accept them as being confidential. Persons in category 6.24(c) will be asked to inform the Authority, in advance of the hearing, of the subject and general grounds of the representations they intend to make, and their responses will be copied to the Society.
- 6.27 Interested parties may join together in making collective representations and they may also appoint a person, either one of their number or another, to represent them at the hearing. They should notify the Authority in advance if this is what they intend to do.

#### *Conduct of the hearing*

- 6.28 The Authority will usually appoint one or more persons to hear and decide an application on its behalf. In the absence of notices of intention to make oral representations the Authority would expect to decide the application, having regard to the written representations, the society's responses and other information available to it, without the need for a public hearing. If there is a public hearing, an additional fee is payable by the society.
- 6.29 The Authority will notify the society and those making oral representations of the time and place of the hearing. If there are a significant number of persons wishing to make oral representations, then the hearing may extend beyond one day and may be adjourned from time to time and from place to place. The Authority will try to advise participants

of the day when they may expect to make their representations and of when the society's representatives may be expected to respond.

- 6.30 The Authority expects that hearings will be in public. Members of the general public and the press will be asked to wait outside at the outset of the hearing. The participants will then be asked if any of them has good reason to object to the admission of the general public and the press (such as, for example, the need to refer to personal financial affairs). The Authority may decide that parts of the hearing shall be in private if that appears to it to be desirable. If there are no reasonable objections, the general public and the press will then be admitted, within the limits of the space available. Only the representatives of the society and those who have given due notice of intention to make oral representations may address the Authority.
- 6.31 The procedure will be informal. While all participants will be invited to speak concisely and to avoid repetition, the Authority will be considerate towards those who are not professionally represented. The panel taking the hearing on behalf of the Authority may question the participants as the hearing proceeds. The sequence of events will be broadly as follows:
- (a) any preliminary matters (such as the admission of the public or other procedural questions) will be dealt with;
  - (b) the chairman of the Authority panel will introduce the proceedings;
  - (c) the representatives of the society will be invited to present the application for confirmation, including a description of the events at the meeting at which the Transfer Resolutions were put to the members, the voting on the Resolutions, and any other matters which they wish to introduce at that stage;
  - (d) the other participants will be invited to make their representations; where appropriate the Authority would expect to call them in a list marshalled, so far as possible, by subject matter;
  - (e) the representatives of the society will be invited to reply to, or comment on, the points made by the other participants;
  - (f) the other participants will be invited to comment on the society's replies insofar as those replies raised new issues.

- 6.32 This procedure may be varied according to the circumstances at the hearing, and is intended only as a guide to the probable order of events. The hearing may be adjourned if the Authority considers that necessary to enable facts to be checked or additional information to be obtained.

*The Authority's decision*

- 6.33 The Authority will not normally give an oral decision at the end of the hearing, but may be expected to reserve its decision to be issued later in writing, setting out its reasons. Copies of the written decision will be sent to the participants, and can be purchased by any other person. The Authority will ask the Central Office to place a copy on the public file of the society.





## 7. TRANSFERS UNDER DIRECTION

**This section describes the Authority’s powers to direct a society to transfer its business to a company, and to proceed by board resolution, and the modified transfer procedure consequently prescribed by the 1986 Act.**

- 7.1 Section 42B of the 1986 Act provides that, if the Authority considers it expedient to do so to protect the investments of shareholders or depositors, it may direct a society, *inter alia*, to transfer its business to a company within a specified time (subsection (1)(b)). In such a case, or where the Authority would have directed a transfer, but for the fact that negotiations were already under way, the Authority may also direct that the approval of the transfer shall be by board resolution rather than the Transfer Resolutions. In these circumstances, because neither a Transfer Statement nor Transfer Resolutions are required, the 1986 Act requires the society instead to send to every member entitled to notice of a meeting a statement (referred to below as a “**transfer notification statement**”) before it applies for confirmation of the transfer (paragraphs 9 and 10 of Schedule 8A to the 1986 Act). Finally, in these circumstances, the first two Confirmation Criteria concerning information made available to, and the views of, the members (see section 6) are replaced by a single criterion:

**“the members or a proportion of them would be unreasonably prejudiced by the transfer;”**

(paragraph 11 of Schedule 8A to the 1986 Act).

- 7.2 Where a society is proceeding under a Section 42B direction by board resolution, the Transfer Statement is replaced by a transfer notification statement and a general meeting of the society is not required. The contents of the transfer notification statement are prescribed by Schedule 3 to the Transfer Regulations. In brief, the members are to be informed that the statement is issued on the responsibility of the directors of the society and the successor company, and:
- (a) that the board, acting under direction of the Authority, has resolved to transfer the business;
  - (b) of the confirmation procedure, including the last date for receipt by the Authority of written representations and notices of intention to make oral representations and the expected date of the hearing of the society’s application;

- (c) of the name, address and nature of the successor company, and the proposed vesting date;
- (d) of the consequences for the members, including the loss of membership rights in the society, any changes in the terms and conditions of share and mortgage accounts, and deposit protection schemes;
- (e) the terms of any distribution of funds or shares in the successor company and of the Statutory Cash Bonus; and
- (f) of the interests of the directors and other officers of the society in the transfer, including any compensation or increase in emoluments to which the Authority has given its consent under paragraphs 7 and 8 of Schedule 8A to the 1986 Act.

7.3 The transfer notification statement must have been approved by the Authority before it is sent to the members. Applications for approval should, in general, follow the procedure described in paragraphs 4.11 to 4.17, and the final draft of the statement should be accompanied by the relevant documents listed in paragraph 4.15, but as appropriate to the particular case and the less extensive information the statement is required to contain.

7.4 Section 5 (General Meetings and Resolutions) does not apply, except that the directors will need to be satisfied that the society's register of members is correct to enable the society to send transfer notification statements, and notices under Section 102B (Trustee Account Holders) of the 1986 Act, to those to whom they must be sent if the society is to gain the protection of Section 102B(4).

7.5 When the board has resolved to transfer the business and transfer notification statements have been sent to its members, the society may apply to the Authority for confirmation of the transfer, but using an adaptation agreed with the Authority of the *pro forma* in Annex B2. The procedure described in section 6 is to be followed, including the publication of notices in the official Gazettes and newspapers and the form of application. However, the lapse of time between each stage of the procedure may be modified according to the particular circumstances of a case, and having regard to the need to protect the investments of shareholders or depositors. While a scrutineer's report will not be required, the Authority will require a report from the society's external auditors on the adequacy of the society's systems to fulfil the requirements of the 1986

Act and the Rules with regard to the sending of transfer notification statements and notices to Trustee Account Holders. This is, of course, relevant to the Authority's consideration of the Fourth Confirmation Criterion.

7.6 As is noted in paragraph 7.1, the First and Second Confirmation Criteria are replaced, in those circumstances, by a single criterion as to whether the members or a proportion of them "would be unreasonably prejudiced by the transfer". Whether this special criterion applies will be a matter of judgement for the Authority to make in the light of any representations made to it and its own enquiries in respect of the particular case. In making its judgement, the Authority will also have regard to the view it then takes as to whether it should exercise its discretion under Section 100(7) of the 1986 Act to direct that no Statutory Cash Bonus, or a reduced bonus, is to be paid "having regard to what is equitable between the members of the society". It follows also that, in considering the Fourth Criterion, the Authority will take account of the modified procedure.

7.7 The Fees Rules provide that fees are to be paid to the Authority:

- (a) with an application for approval of a transfer notification statement under paragraph 9(4) of Schedule 8A to the 1986 Act, and a further fee with any subsequent substantial revision;
- (b) with an application for confirmation under Section 97(4)(d) of, paragraph 6 of Schedule 17 and Schedule 8A to, the 1986 Act; and a further fee if oral representations are to be heard.

## **8. NOTIFICATION AND DISSOLUTION**

- 8.1 When the Authority has confirmed a transfer (whether voluntary or under direction) it will notify the Central Office and the society concerned.
- 8.2 Section 97(8) of the 1986 Act requires the society to notify the Authority of the vesting date, and it must do so no later than 7 days before that date, and, unless a notice is given under subsection (10), subsection (9) provides that the society shall be dissolved on that date. Subsection (10) provides that, if necessary for the purpose of facilitating the disposal of its shares in its successor, the society may include, in the notice of the vesting date, notice of a later date for the dissolution of the society, and it is on this later date that the society is dissolved. A society which gives such a notice must cease to transact any business as from the notified vesting date, except such as may be necessary to dispose of its shares in its successor.
- 8.3 Section 97(7) of the 1986 Act provides that, where a society continues to hold shares in its successor after the vesting date, the consideration for the disposal of those shares, together with any other property, rights or liabilities of the society acquired or incurred after that date, shall be transferred to and vested in the successor company on the date specified for the society's dissolution. All other property, rights and liabilities of the society are to be transferred to the successor company on the vesting date.
- 8.4 The Central Office will record the relevant date, or dates, notified to the Authority by the society.
- 8.5 The society will be dissolved on the vesting date or on the later date for dissolution referred to in paragraph 8.2, and its registration will subsequently be cancelled by the Central Office under the provisions of Section 103(1)(a) of the 1986 Act.

## 9. TIMETABLE

- 9.1 The society will need to draw up a project plan covering the key elements in the transfer process and the relationships between them, and specifying when it wishes to receive the necessary clearances from the Authority. The time needed for the process will depend, among other things, on the length of time it takes to settle the final terms of the distribution scheme, the complexity of those terms and whether the scheme raises new legal issues (perhaps requiring resolution by application to the High Court), and the time needed to verify the register of members and the record of Trustee Account Holders. It will also be affected by the facility with which the society and its advisers can develop satisfactory documents and respond to enquiries and representations. The plan and the timetable will, of course, need to cover all that will be required of the society, and the successor company, in relation to the requirements of the Banking Regulator, and of UKLA concerning the listing of any shares in the successor company.
- 9.2 It will be helpful for the society to discuss its plans with the Authority during their formative stages, when the Authority will be prepared to give a view on their feasibility. However, although the Authority may agree that a planned timetable appears to be manageable, it cannot undertake to meet any deadlines set by the society. In particular, the Authority cannot be constrained in the proper performance of its statutory functions by, for example, the society's wish to put the Transfer Resolutions to a SGM on or before the date of the AGM in that year, or the planned flotation date. The Authority will be mindful of the need to ensure that there is adequate time, compatible with its other business and commitments, to:
- (a) consider whether the proposed distribution scheme is in conformity with the 1986 Act;
  - (b) consider and approve the Transfer Statement, including time to deal with renewed applications if significant changes have to be made;
  - (c) give interested parties an opportunity to make considered representations at the confirmation stage, for the society to respond to those representations, and for the Authority to consider all the evidence and arguments, including making any necessary further enquiries of its own; and
  - (d) write a reasoned confirmation decision.

9.3 The likely sequence of events is as follows:

- Stage 1 Informal preliminary discussions with the Authority and, if different, the Banking Regulator on both substance and timing of the proposed transfer.
- Stage 2 Public announcement of the transfer proposals. The Authority will be ready to comment on drafts of the announcement and any supporting material, although the terms of the announcement are for the society to decide and the Authority is not required to approve them.
- Stage 3 Consultation with the Authority on the outline structure of, and main features to be contained in, the Transfer Statement, and on the full specification of the proposed cash and/or share distribution scheme.
- Stage 4 Submission to the Authority of the prudential information described in section 2.
- Stage 5 Initial application to the Authority, with the appropriate fee, for approval of a full draft of the Transfer Statement, contained within a draft Transfer Document, supported by the material described in paragraph 4.12.
- Stage 6 Consideration by the Authority, and discussion with the society and its advisers, of the draft documents, including submission by the society of revised drafts as necessary. At this stage, the Authority's staff will also be ready to comment informally on draft proxy forms and other material proposed to be sent to the members with, or in advance of, the Transfer Document. By this stage also, the society ought to have undertaken any mailing to members which it thinks necessary to verify its register of members (see paragraphs 5.14 to 5.17), and to notify them of the rights of Trustee Account Holders (See paragraph 3.18).
- Stage 7 **(if necessary)** Further application to the Authority, with a further fee, for approval of a significantly revised Transfer Statement (see paragraph 4.14).
- Stage 8 Production of printer's proofs of the draft documents. At this stage it will be advisable for the society to determine, perhaps by mailing to a

sufficient number of staff, whether the notice and Transfer Document pack (especially if it contains the Transfer Statement) is deliverable through domestic letter boxes.

- Stage 9      Informal indication by the Authority that it is satisfied with near-final proofs of the Transfer Statement, and the Transfer Agreement.
- Stage 10     Formal submission to the Authority of the final draft of the Transfer Statement, together with the supporting documents described in paragraph 4.15.
- Stage 11     Approval by the Authority of the Transfer Statement. One proof copy of the Statement, identified and signed on behalf of the Authority, will be returned to the society.
- Stage 12     Printing and distribution of meeting notice and Transfer Document to members of the society in time to be received by them **at least 21 days before the last date for receipt of proxy forms** for the meeting at which the Transfer Resolutions are to be moved. The Authority would appreciate being provided with a number (to be agreed) of copies of the final printed Transfer Document and any Transfer Summary and of the Transfer Statement if printed separately for distribution on request. Although not required by the 1986 Act, one copy of each will be passed to the Central Office to be placed on the public file of the society.
- Stage 13     The meeting at which the Transfer Resolutions are moved.
- Stage 14     If the Transfer Resolutions are passed, application to the Authority for confirmation and publication of notices of that application in the official Gazettes and newspapers. The application should be accompanied by the requisite fee and the material specified in paragraph 6.2.
- Stage 15     Last date for receipt by the Authority of representations with respect to the applications. A minimum of **four weeks should be allowed between Stages 14 and 15 and a further four weeks to Stage 16** (with extra time allowed for any public holidays which intervene). Representations will be copied to the society for its comments as and when they are received. The Authority will then require sufficient time



before the hearing to consider and assess all the representations and the society's responses, and to make any further enquiries which it may think necessary.

Stage 16      The confirmation hearing.

Stage 17      Notification to the society and representers, and publication, of the Authority's Decision. It is advisable to **allow a minimum of four weeks between Stages 16 and 17**, again allowing extra time for any public holidays.

Stage 18      Notification by the society to the Authority of the vesting date and, if later, the date of dissolution of the society.

Stage 19      Vesting date and, if later -

Stage 20      Dissolution of the society.

9.4      When considering the proposed vesting date, the society will no doubt consult its merchant bank advisers as to timing, particularly when shares are to be offered for subscription to raise new capital, having regard to other possible major share offers.

*Illustrative structure for a*  
**TRANSFER DOCUMENT**  
**containing a Transfer Statement**

Title page:

Should include a recommendation on the following lines:

“When considering what action you should take, you are recommended to obtain advice from your solicitor, accountant, or other professional financial adviser.”

**and the directors’ responsibility statement (short form with cross reference to item B9)**

## **PART A**

### **1. Summary of the Transfer procedure and Special General Meeting**

The Transfer procedure  
 Notice of the SGM  
 Directions to the SGM venue  
 Guidance on entitlement to vote

### **2. Background to, and rationale for, the proposals**

Merits of the proposed transfer  
 Conclusions and Recommendations

## **PART B: THE STATUTORY TRANSFER STATEMENT**

*Issued in accordance with Section 98 of and Schedule 17 to the Building Societies Act 1986*

**(Note:** If a Transfer Summary is issued it must include a statement that this Transfer Statement will be handed or sent to members forthwith free of charge and on request, and where and how it can be obtained.)

### **3. Review of Options and Value of Consideration**

Introduction - to explain that under the proposed terms of the transfer the business of the society will be transferred to an authorised bank and that approval of the terms of the transfer will include, if such is the case, the distribution of part of the consideration for the transfer to non-members. Should also explain that the transfer is subject to approval by the members, authorisation by the Banking Regulator and confirmation by the Authority, and include a brief explanation of the termination provisions of the Transfer Agreement  
 Factual statement of strategic options considered  
 Disclosure of any non-confidential proposals received

Reasons for choice and recommendation of proposed transfer  
Reasons for choice and recommendation of terms of the proposed distribution scheme  
Valuation of the business and methodology (takeover only)  
Estimated value of shares in successor  
Analysis of distribution of shares and/or cash as between members, Trustee Account Holders and non-members respectively  
Statement that approval of the Transfer Resolution includes approval of distributions to non-members

**4. Consequences for shareholders, borrowers and employees**

The distribution of shares and/or cash in the successor company  
The amount of the society's reserves and Statutory Cash Bonus  
Any changes in the terms and conditions of share and deposit accounts, mortgages and loans  
Changes in the factors relevant to determining retail interest rates (product pricing)  
Comparative average interest rates on retail deposits and loans of the society and the successor company over the previous 3 financial years (takeover only)  
Loss of membership rights in the society  
The statutory deposit protection scheme (summary of any differences)  
Arrangements for settlement of disputes  
Consequences for staff, including changes in terms of employment

**5. Interests of directors and other officers of the society and successor company**

Directors and other officers of the society  
Directors and other officers of the company  
Interests of directors, officers and employees in the share and/or cash distribution and the Statutory Cash Bonus  
Any compensation or increased emoluments under Sections 99 and 99A of the 1986 Act

**6. The management, activities and operations of the successor company following the transfer**

Management  
Activities and operations, including a comparison of their range and relative importance with those of the society and any intended change, together with, in the case of a takeover, comparative business indicators of the society and the successor company for each of the previous 3 financial years  
Structure and activities of any group to which the company belongs  
Ownership of the society's subsidiaries and interests in other associated bodies  
Particulars of any person having an interest in 3% or more of the successor company's equity share capital.  
Name, head office and principal objects of the company

The protective provisions in the articles of association in accordance with Section 101 of the 1986 Act (conversion only)  
The auditors of the society and of the company

**7. Financial information**

The consolidated financial position of the society and its subsidiaries at the most recent practicable date, and the Society's reserves at that date and the main features of the published annual group accounts for the last 3 years

In the case of a takeover, the consolidated financial position of the successor company/group at the most recent practicable date and the main features of the published annual group accounts for the last 3 years

The share capital of the successor company

Future financial prospects of the successor company

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Summary of the terms of the Transfer Agreement concerning conditions precedent and termination

Summary of principal rights which will attach to the ordinary shares in the successor company

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## 11. Statement of statutory approval by the Financial Services Authority

### STATEMENT OF STATUTORY APPROVAL BY THE FINANCIAL SERVICES AUTHORITY

#### **Building Societies Act 1986**

(c.53)

*Approval by the Financial Services Authority of the Transfer Statement of [ ] Building Society.*

The Financial Services Authority (“the Authority”) in exercise of the power conferred on the Authority by paragraph 4(3) of Schedule 17 to the Building Societies Act 1986 (“the 1986 Act”) and considering that the Transfer Statement of [ ] Building Society (“the Society”) is in conformity with the applicable provisions of the 1986 Act and the Building Societies (Transfer of Business) Regulations 1998 (SI 1998 No. 212) and appears to be factually consistent with the information provided to the Authority by the Society in connection with the Transfer Statement, which information includes the declarations of responsibility by the directors of the Society and of [ ] -

HEREBY APPROVES the above Transfer Statement so far as its contents concern the matters required to be approved by the said Schedule.

In this approval expressions used in the 1986 Act have the meanings which they bear in the 1986 Act and “the Transfer Statement” means the statement by the Society a draft of which is initialled for the purpose of identification “[ ]”.

[date ]

[Name ]

*For and on behalf of the Authority*

Notes:

This approval does not extend to any matters not forming part of the Transfer Statement as required by the 1986 Act and the Regulations, whether or not such matters are the subject of cross-reference in the statement as so required.

The giving of this approval is without prejudice to any issues which the Authority may have to consider on an application by the Society for confirmation of the transfer pursuant to Section 98 of the 1986 Act.

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- 1. Notice of Application**
- 2. Application to the Authority for confirmation**

*Publication of Notice of application to the Authority for confirmation of a transfer in the London, Edinburgh, or Belfast Gazettes and in any newspapers as directed by the Authority.*

-----  
**BUILDING SOCIETIES ACT 1986**

**Notice under paragraph 7 of Schedule 17 to the 1986 Act**

Notice is hereby given that ..... Building Society, Register No.....B, whose principal office is at ....., desires to transfer its business to ....., and that the society has applied to the Financial Services Authority to confirm the transfer.

Any interested party may make written representations to the Authority and/or give notice of intention to make oral representations to the Authority with respect to the application. Written representations and notices of intention to make oral representations should be received by the Authority at 25 The North Colonnade, Canary Wharf, London, E14 5HS by ..... 20....Oral representations will be heard by the Authority on .....20.. at a time and place to be determined by the Authority.



*Form of application to the Authority for confirmation of transfer of business to a company*

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To the Financial Services Authority

**BUILDING SOCIETIES ACT 1986**

**APPLICATION UNDER SECTIONS 97(4) AND 98(2) OF, AND PART II OF SCHEDULE 17 TO, THE 1986 ACT FOR CONFIRMATION OF A TRANSFER OF BUSINESS TO A COMPANY**

..... **BUILDING SOCIETY, REGISTER NO.....B**

The above-named society desires to transfer its business to ..... on .....20... [insert vesting date] and applies to the Authority to confirm the transfer.

In making this application the society declares that:

1. At a meeting of ..... Building Society held on .....20.. the following resolutions were passed:

A shareholding members' resolution, as required by paragraph 30 of Schedule 2 to the 1986 Act, passed in accordance with paragraph [30(2) or 30(3) as the case may be], that ..... Building Society do transfer its business to ..... in accordance with the terms of the transfer agreement, two copies of which, authenticated by the Secretary of the society, are enclosed with this application.

A borrowing members' resolution, as required by paragraph 30 of Schedule 2 to the 1986 Act that ..... Building Society do transfer its business to ..... in accordance with the terms of the above-mentioned transfer agreement.

2. A transfer statement, in accordance with Schedule 17 to the 1986 Act, approved by the Authority, so far as it concerned matters required by that Schedule to be so approved, was [sent] [made available] to each member of ..... Building Society who was entitled to receive it [, and a transfer summary was sent to those members] in accordance with Schedule 17 to the 1986 Act.

(Seal of the Society making the application)

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# **Interim Prudential Sourcebook for Building Societies**

## **4 MERGER CONFIRMATION PROCEDURES**

### **G**

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## **4.1 Introduction**

- 4.1.1 This note is for the guidance of those making written representations to the FSA and/or those participating in oral confirmation hearings. It sets out the procedures which the FSA will normally follow.
- 4.1.2 The 1986 Act provides that when the necessary merger resolutions have been passed the societies must obtain confirmation by the FSA of the merger in accordance with Section 93(2) (amalgamations) or Section 94(7) (transfers of engagements) of the 1986 Act. If the FSA confirms the merger it will issue a registration certificate.
- 4.1.3 References to the relevant provisions of the 1986 Act are given in parenthesis in this Note. The term “merger” means either an amalgamation or a transfer of engagements as provided by sections 93 and 94 of the 1986 Act.

## **4.2 The Role of Confirmation**

- 4.2.1 The role of the confirmation procedures is limited. Section 95(3) and (4) of the 1986 Act provide that the FSA must confirm a transfer unless it considers that:
- (1) some information material to the members’ decision about the merger was not made available to all the members eligible to vote; or,
  - (2) the vote on any resolution approving the merger does not represent the views of the members eligible to vote; or,
  - (3) some relevant requirement of the 1986 Act or the rules of any of the societies was not fulfilled.
- 4.2.2 These are the only grounds on which the FSA may refuse confirmation, or direct the society to remedy any defects. It is not the FSA’s function to make any judgement about the merits of the proposals which the members have approved.

- 4.2.3 If the FSA finds that there are defects, it may direct the society to take steps to remedy them. These include the calling of further meetings. If it is then satisfied that the defects have been substantially remedied, it must confirm the merger; if not, it must refuse confirmation (Section.95(6) of the 1986 Act).
- 4.2.4 The FSA may direct that non-fulfilment of some relevant requirement of the 1986 Act or of the rules of the society is to be disregarded, if it appears to the FSA that the failure could not have been material to the members' decision (Section.95(5)). "Relevant requirement" in this context means a requirement of section 93, 94 or 95 of or Schedule 16 to the 1986 Act or of any rules prescribing the procedure to be followed by the society in approving or effecting the merger (Section 95(11) of the 1986 Act).
- 4.2.5 The 1986 Act provides that any accidental failure to send the notice of meeting and merger statement to any person entitled to receive them does not invalidate the proceedings at the special general meeting (paragraph 22(3) of Schedule 2to the 1986 Act).

### **4.3 Representations to the FSA**

- 4.3.1 Any interested party has the right to make representations to the FSA with respect to the societies' applications for confirmation. They should state clearly why the person making the representations claims to be an interested party e.g. membership of the society and the matters to which the representations are directed.
- 4.3.2 Written representations, or notice of a person's intention to make oral representations, or both, must be in writing. They must reach the FSA at 25 The North Colonnade, Canary Wharf, London E14 5HS by the date quoted in the merger documentation issued to members and published in the official Gazettes and (usually) some newspapers. Persons who make written representations, but subsequently decide also to make oral representations must, nevertheless, give notice of that intention, in writing, to the FSA by the same date (paragraphs 8 and 9 of Schedule 16 to the 1986 Act). The FSA will in general be prepared to use electronic rather than paper-based

communication for notices and written representations if requested by the society or a prospective presenter. A specific electronic address will be provided for that purpose, and some of the relevant procedures may have to be adapted accordingly.

4.3.3 Representations or notices to the FSA will fall into one of the following three categories:

- (1) Written representations only.
- (2) Written representations with notice of intention to make oral representations.
- (3) Notice of intention to make oral representations only.

4.3.4 The FSA will send copies of all written representations to the society, and will afford it an opportunity to comment on them (paragraph 9 of Schedule 16 to the 1986 Act).

4.3.5 Copies of the society's comments on representations in category 4.3.3(2) will be sent to those who made the representations so that they may concentrate their representations at oral hearings on the points which they consider to remain at issue. Persons making written representations who wish to see the society's comments must, therefore, also give notice of intention to make oral representations. Any documents referred to in the society's comments will be made available by the society for inspection at a specified place which will be notified to those making oral representations. (The society may, exceptionally, apply to put to the FSA in confidence documents which the society considers to be commercially sensitive: the FSA will decide on hearing argument whether, and on what terms, to accept them as confidential). Persons in category 4.3.3(3) will be asked to inform the FSA, in advance of the hearing, of the subject and general grounds of the representations they intend to make. The FSA will pass this information to the society.

4.3.6 Interested parties may join together in making collective representations and they may also appoint a person, either one of their number or another, to represent them at the hearing. They should notify the FSA in advance if this is what they intend to do.

## **4.4 Purpose of the hearing**

IPSB Constitutional Chapter 4 Merger Confirmation Procedures

4.4.1 The purpose of the hearing is to enable interested parties to make representations, and to enable the FSA to make such enquiry as it considers necessary, both of the society and of those making representations, in order to reach an informed view on those aspects of the decision on confirmation to which the representations are directed. The FSA will examine all the representations, whether written or oral, in relation to the three statutory criteria described in paragraph 4.2.1. In the light of that examination, and consideration of all the representations and the society's response, the FSA will decide whether to confirm, or direct the society to correct any defects, or to refuse to confirm the merger. It is for the FSA to decide whether the matters discussed in representations are relevant to the statutory criteria.

## **4.5 Persons hearing the applications**

4.5.1 The hearing will be taken by a person or persons appointed by the FSA to hear and decide the applications on its behalf, and they will be assisted by staff of the FSA.

## **4.6 Time and place**

4.6.1 Hearings will normally start at about mid-morning on the day quoted in the merger documentation sent to members, and at a place which will be notified to the participants. If there are a significant number of persons wishing to make oral representations, then the hearing may extend beyond one day and may be adjourned from time to time and from place to place.

## **4.7 Procedure at the Hearing**

4.7.1 The FSA expects that oral hearings will be in public. Members of the general public and the Press will be asked to wait outside at the outset of the hearing. The participants will then be asked if any of them has good reason to object to the admission of the general public (including the Press). The Press and the general public will then be admitted, within the limits of the space available, unless an objection by a participant is upheld by the FSA. However, the FSA may decide that

parts of the hearing shall be in private if that appears to it to be desirable (for example, if representers feel it necessary to disclose their personal affairs).

4.7.2 The procedure will be informal. While all participants will be expected to speak concisely and to avoid repetition, the FSA will be considerate towards those who are not professionally represented. The persons appointed to hear the applications may question the participants as the hearing proceeds. The sequence of events will be broadly as follows:-

- (1) Any preliminary matters (such as the admission of the public or other procedural questions) will be dealt with.
- (2) The person chairing the hearing on behalf of the FSA will introduce the proceedings.
- (3) The representatives of the Societies will be invited to speak to their applications, including a description of the events at the meetings at which the transfer resolutions were put to the members, a statement of the voting on the resolutions, and any other matters which they wish to introduce at that stage.
- (4) The other participants will be invited to speak to their representations. Where appropriate the FSA would expect to call them in a list marshalled, so far as possible, by subject matter.
- (5) The representatives of the society will be invited to reply to, or comment on, the points made by the other participants.
- (6) The other participants will be invited to comment on the society's replies.

4.7.3 The above procedure may be varied according to the circumstances at the hearing, and is intended only as a guide to the probable order of events. The hearing may be adjourned if the FSA considers that necessary to enable facts to be checked or additional information to be obtained.

## **4.8 The FSA's decision**

4.8.1 The FSA will not normally give an oral decision at the end of the hearing. The FSA will subsequently issue a written decision, setting out its reasons. A copy of the written decision will be sent to each of the participants in the hearing and to those who made written representations and, on request, to any other person. The decision may also be published.

# Interim Prudential Sourcebook for Building Societies

## 5 TRANSFER CONFIRMATION PROCEDURES

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## 5.1 Introduction

5.1.1 This chapter is for the guidance of those making written representations to the FSA and/or those participating in oral confirmation hearings. It sets out the procedures which the FSA intends to follow.

5.1.2 The 1986 Act provides that when a society has approved the transfer of its business to a plc by passing the transfer resolutions, it must then obtain confirmation by the FSA of the transfer and its terms (Section 97(4) of the 1986 Act). If the FSA confirms the transfer, then all the property, rights and liabilities of the society, except any shares in its successor company, transfer on the vesting date to the successor company (Section 97(6) of the 1986 Act), which date is specified in or determined by the transfer agreement between the society and the successor company.

## 5.2 The role of confirmation

5.2.1 The criteria to which the FSA has to have regard are limited. It is **not** within the FSA's power to make any judgement about the merits or fairness of the proposals which the members have approved.

5.2.2 Section 98(2) and (3) of the 1986 Act provide that the FSA **must** confirm a transfer **unless** it considers that:

- (1) some information material to the members' decision about the transfer was not made available to all the members eligible to vote; or
- (2) the vote on any resolution approving the transfer does not represent the views of the members eligible to vote; or,
- (3) there is a substantial risk that the successor company will not have -
  - (i) such permission under Part IV of the Financial Services and Markets Act 2000, or
  - (ii) such permission under paragraph 15 of Schedule 3 to that Act (as a result of qualifying for authorisation under paragraph 12 of that Schedule), as will enable



it to carry on the business which it will have as a result of the transfer without being taken (by virtue of section 20 of that Act) to have contravened a requirement imposed on it by the Authority under that Act; or

- (4) some relevant requirement of the 1986 Act or the rules of the society was not fulfilled.

5.2.3 These are the **only** grounds on which the FSA may refuse confirmation, or direct the society to remedy any defects. If the FSA finds that there are defects it may direct the society to take steps to remedy them. If the FSA is then satisfied that the defects have been substantially remedied, it must confirm the transfer; if not, it must refuse confirmation (Section 98(5) and (6) of the 1986 Act).

5.2.4 In the case of the ground mentioned in paragraph 5.2.2(4), the FSA may direct that non-fulfillment of some relevant requirement of the 1986 Act or of the rules of the society is to be disregarded, if it appears to the FSA that the failure could not have been material to the members' decision (Section 98(4) of the 1986 Act). "Relevant requirement" in this context means a requirement of the provisions of the 1986 Act applicable to the transfer of a society's business (which are Sections 97 to 102 and 102B to D, paragraph 30 of Schedule 2, Schedule 17 and the Transfer Regulations made under the 1986 Act) and any Rules prescribing the procedure to be followed by the society in approving the transfer and its terms (that is, generally, the rules concerning: membership; special meetings; notice of meetings; procedure at meetings; entitlement of members to vote on resolutions; appointment of proxies; and joint shareholders and borrowers).

5.2.5 The 1986 Act provides that any accidental omission to give the notice of the meeting to, or non-receipt of the notice by, a person entitled to receive it does not invalidate the proceedings at the special general meeting (Schedule 2, paragraph 22(3)).

### **5.3 Purpose of the hearing**

and of those making representations, in order to reach an informed view. The FSA will examine all the representations, whether written or oral, in relation to the four statutory criteria described in paragraph 5.2.2. In the light of that examination, and consideration of all the representations and the society's response, the FSA will make its decision.

## **5.4 Making representations to the FSA**

5.4.1 Any interested party has the right to make written and oral representations to the FSA with respect to the society's application for confirmation. Those making written representations and those giving notice of intention to make oral representations should state clearly why they claim to be interested parties (e.g. the category of their membership of the society). Those making written representations should also identify the ground or grounds, in paragraph 5.2.2, to which their representations are directed and it will be helpful if those giving notice of intention to make oral representations will do likewise.

5.4.2 Written representations, or written notice of a person's intention to make oral representations, or both, must be addressed to the Financial Services Authority and must reach the FSA at 25 The North Colonnade, Canary Wharf, London E14 5HS by the date quoted in the transfer documentation issued to members. Unwritten representations and notice (for example by telephone) cannot be accepted. Persons who make written representations but subsequently decide also to make oral representations must, nevertheless, give notice of that intention, in writing, to the FSA at the above address by the same date (paragraph 7 of Schedule 17 to the 1986 Act). The FSA will in general be prepared to use electronic rather than paper-based communication for notices and written representations if requested by the society or a prospective representer. A specific electronic address will be provided for that purpose, and some of the relevant procedures may have to be adapted accordingly.

5.4.3 Representations or notices to the FSA will fall into one of the following three categories:

- (1) written representations only;

- (2) written representations with notice of intention to make oral representations;
- (3) notice of intention to make oral representations only.

5.4.4 The FSA will send copies of all written representations to the society, and will afford it an opportunity to comment on them (paragraph 8 of Schedule 17 to the 1986 Act). The FSA will consider the written representations in categories 5.4.3(1) and (2), and the society's responses to them. A synopsis of the representations (probably in the form of a summary of each of the main points made and the numbers of persons making each point) and the society's responses may be made available to those participating in the oral hearing. This is intended to inform those making oral representations of the points already under consideration by the FSA with a view to avoiding unnecessary repetition.

5.4.5 Copies of the society's comments on representations in category 5.4.3(2) will be sent to those who made the representations in time for the oral hearing so that they may concentrate their oral representations on the points which they consider to remain at issue. A person making written representations who wishes to see the society's comments must, therefore, also give notice of intention to make oral representations. Any documents referred to in the society's comments will be made available by the society for inspection at a specified place which will be notified to those making oral representations. (The society may, exceptionally, apply to put to the FSA in confidence documents which the society considers to be commercially sensitive: the FSA will decide on hearing argument whether, and on what terms, to accept them as being confidential). Persons in category 5.4.3(3) will be asked to inform the FSA, in advance of the oral hearing, of the subject and general grounds of the representations they intend to make; the FSA will copy any response to the society.

5.4.6 Interested parties may join together in making collective representations and they may also appoint a person, either one of their number or another, to represent them at the oral hearing. They should notify the FSA in advance if this is what they intend to do. The FSA will notify this to the society.

## **5.5 Panel taking the hearing**

5.5.1 A Panel will be appointed by the FSA to consider and decide the application on its behalf. The panel will conduct the oral hearing if one is required.

## **5.6 Time and place**

5.6.1 Oral hearings will normally start at about mid-morning on the date quoted in the transfer documentation sent to members and at a place which will be notified to the participants. If there is a significant number of persons wishing to make oral representations, then the hearing may extend beyond one day and may be adjourned from time to time and from place to place. The FSA will try to advise participants of the day when they may expect to make their representations, and of when the society's representatives may be expected to respond.

## **5.7 Procedure at the hearing**

5.7.1 The FSA expects that oral hearings will be held in public. Members of the general public and the press will be asked to wait outside at the commencement of the hearing. The participants will then be asked if any of them has good reason to object to the admission of the general public or the press (such as, for example, the need to refer to personal financial affairs). Unless an objection by a participant is upheld by the FSA, the press and the general public will then be admitted, within the limits of the space available. However, the FSA may decide that parts of the hearing shall be in private if that appears to it to be desirable.

5.7.2 The procedure will be informal. All participants will be expected to speak concisely and avoid repetition. The FSA will be considerate towards those who are not professionally represented. Members of the Panel taking the hearing may question the participants. The sequence of events will be broadly as follows:

- (1) any preliminary matters (such as the admission of the public or other procedural questions) will be dealt with;

- (2) the chairman of the Panel will introduce the proceedings;
- (3) the representatives of the society will be invited to speak to the application, including a description of the events at the meeting at which the transfer resolutions were put to the members, a statement of the voting on the resolutions, and any other matters which they wish to introduce at that stage;
- (4) the other participants will be invited to speak to their representations. The FSA expects to call them in a list marshalled, so far as possible, by subject matter;
- (5) the representatives of the society will be invited to reply to, or comment on, the points made by the other participants;
- (6) the other participants will be invited to comment on the society's replies.

5.7.3 This procedure may be varied according to the circumstances at the hearing, and is intended only as a guide to the probable order of events. The hearing may be adjourned if the FSA considers that necessary to enable facts to be checked or additional information to be obtained.

## **5.8 The FSA's decision**

5.8.1 At the end of the oral hearing, the FSA will reserve its decision. A copy of its written decision, including its findings on the points made in representations, will be published and copies will be sent to the society, and to those making written and/or oral representations.