

**EXPLANATORY MEMORANDUM TO THE  
BUILDING SOCIETIES ACT 1986 (MODIFICATION OF THE LENDING LIMIT  
AND FUNDING LIMIT CALCULATIONS) ORDER 2004**

**2004 No. 3200**

1. This Explanatory Memorandum has been prepared by Her Majesty's Treasury and is laid before Parliament by Command of Her Majesty.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. **Description**

- 2.1 This Statutory Instrument amends the Building Societies Act 1986 ("the 1986 Act") to keep the calculations of the "nature limits" for building societies operating on the same basis as currently used in relation to securitised assets. The nature limits are statutory restrictions on funding and lending activities that building societies can engage in. From 1<sup>st</sup> January 2005, some building societies will be obliged to prepare their accounts using International Accounting Standards ("IAS"), and others may choose to do so. Under IAS, the accounting treatment of securitised assets will change. If the nature limits provisions in the 1986 Act are not amended, the new accounting treatment of securitised assets will affect the way that the nature limits are calculated. This Order is therefore intended to preserve the status quo in terms of the nature limits.

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

- 3.1 Article 2(4) of the Order inserts a new subsection (17) into section 6 of the Building Societies Act 1986. The footnote states that subsection (16) has been inserted by the Building Societies Act 1986 (International Accounting Standards and Other Accounting Amendments) Order 2004 and no S.I. number is given for that order. This Order requires an affirmative resolution procedure and has been laid in draft before Parliament, awaiting debates on 8<sup>th</sup> and 16<sup>th</sup> December. At present, it therefore has no S.I. number.

4. **Legislative Background**

- 4.1 The EU Regulation on International Accounting Standards<sup>1</sup> (the "IAS Regulation") will come into force on 1<sup>st</sup> January 2005. Building societies that issue listed securities and which have subsidiaries for which consolidated accounts need to be produced will be required to use IAS for their consolidated accounts. Other building societies will be permitted to use International Accounting Standards if they wish to do so. A draft Order (the Building Societies Act 1986 (International Accounting Standards and Other Accounting Amendments) Order 2004) was laid before Parliament on the 11<sup>th</sup> October 2004 and amends the Building Societies Act 1986 to ensure building societies are able

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<sup>1</sup> Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002. OJ L243/1 of 11 September 2002.

to meet their requirements under the IAS Regulation and to allow societies to choose to use IAS if they wish.

- 4.2 One of the requirements of the standards adopted under the IAS Regulation is that securitised assets will be shown on the balance sheet at gross value. This creates an unintentional complication for building societies owing to the statutory restrictions on funding and lending activities that building societies are subject to. These restrictions are referred to as the “nature limits” (so called because the aim of these restrictions is to ensure that the mutual ‘nature’ and characteristics of building societies are preserved). The funding limit requires building societies to receive 50% of their funding in the form of member deposits and the lending limit requires that 75% of a society’s business assets must consist of loans secured on residential property.
- 4.3 Currently, calculations made to determine compliance with these nature limits are made using figures for assets and liabilities shown on the balance sheet. Thus, when securitised assets are shown on the balance sheet at their gross value, they will also be included in the nature limits calculations at their gross value. At present, securitised assets are shown net on the balance sheet and are thus included in the nature limits calculations at their net value. Therefore, the effect of this for some building societies will be serious. For example, in the funding limit calculation, some societies will see the proportion of their assets which consist of non-member deposits increase overnight, thus exposing building societies to the risk of being in breach of their statutory nature limit requirements.
- 4.4 This Statutory Instrument therefore modifies the amount taken into account in respect of securitised assets for the nature limits calculations, so that such assets and their related liabilities are included at net value, as now, regardless of how they are included in the accounts of the society. Therefore societies which use IAS to prepare their accounts will not be put at risk in terms of measuring compliance with the nature limits.
- 4.5 This Order is made under sections 6(7) and 7(7) of the Building Societies Act 1986 and is the first use of these powers. The powers were inserted when these sections were substituted by the Building Societies Act 1997 and enable the Treasury to modify how the assets and liabilities of subsidiary and associated undertakings of a building society are to be taken into account for the purposes of the nature limits. The securitised assets which are affected by this Order are held by subsidiaries of building societies and can therefore be dealt with by use of these powers.

## **5. Extent**

- 5.1 This instrument applies to all of the United Kingdom.

## **6. European Convention on Human Rights**

- 6.1 Not applicable.

## **7. Policy background**

- 7.1 Securitisation can be an effective way for building societies, as well as companies, to manage risk. In particular, the process by which assets can be isolated and transferred to a third party entity (known as the ‘special purchase vehicle’) in exchange for a cash sum enables building societies to address the risk of maturity mismatch (whereby

long-term activities are funded using short-term deposits). The Government believes that building societies should not be constrained in their future ability to securitise assets and that, where practical, a level playing field with other lenders (e.g. banks) should apply, especially as this is a constraint specific to building societies owing to the nature limits that building societies are subject to.

- 7.2 The Miles Review which looked at barriers to the provision of long-term mortgages at fixed-rates agreed that unless action was taken, building societies would be constrained in their ability to securitise assets and therefore less able to provide long-term mortgages at fixed-rates. This Statutory Instrument therefore implements one of the twenty recommendations of the Miles Review.
- 7.3 The Government considered whether this proposal had any implications for the mutual 'nature' of building societies and whether allowing securitised assets to be excluded from the nature limits calculations subverted the purpose of the nature limits. However, it was noted that the link between prevailing accounting standards and items included in the nature limits calculations was a link made out of policy expediency and that securitised assets have been disregarded from the nature limits calculations for many years. In addition, in securitising and establishing a 'clean break' between the society and the special purchase vehicle, the society no longer 'owns' the assets, even if it continues to play an administrative role over the assets. The Government therefore considers that no such implications are raised. Building societies will still be required to show securitised assets on the balance sheet, thus ensuring that the objectives of the IAS Regulation, particularly in terms of greater transparency, are achieved.
- 7.4 There is considerable interest and concern within the building society sector about whether they will be constrained in their ability to securitise assets, though there is little interest in the media. Her Majesty's Treasury informally consulted with the Financial Services Authority, the Building Societies Association (the trade body representing all 63 building societies), the Institute of Chartered Accountants and a number of individual building societies regarding the policy and the draft of the statutory instrument. All those consulted supported the proposals.

## **8. Impact**

- 8.1 A Regulatory Impact Assessment has not been produced. This Statutory Instrument aims to preserve the status quo and there are therefore no costs or benefits associated with this proposal.
- 8.2 There is no impact on the public sector as this Statutory Instrument only applies to building societies.

## **9. Contact**

- 9.1 Ian Noon at HM Treasury (Tel: 18002 020 7270 5897 or email: [ian.noon@hm-treasury.x.gsi.gov.uk](mailto:ian.noon@hm-treasury.x.gsi.gov.uk)) can answer any queries regarding the instrument.