

EXPLANATORY MEMORANDUM TO

THE BUILDING SOCIETIES (RESTRICTED TRANSACTIONS) (AMENDMENT TO THE PROHIBITION ON ENTERING INTO DERIVATIVES TRANSACTIONS) ORDER 2018

2018 No. [XXXX]

1. Introduction

- 1.1 This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

- 2.1 This instrument amends section 9A of the Building Societies Act 1986 in order to allow building societies to trade derivatives for the purpose of clearing house membership.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

- 3.1 None

Other matters of interest to the House of Commons

- 3.2 Disregarding minor or consequential changes, the territorial application of this instrument includes Scotland and Northern Ireland and is not a financial instrument that relates exclusively to England, Wales and Northern Ireland.

4. Legislative Context

- 4.1 Section 9A (restrictions on certain transactions) of the Building Societies Act 1986 was inserted by section 10 (restrictions on certain transactions) of the Building Societies Act 1997. Section 9A of the 1986 Act restricts the type of transactions that building societies and their subsidiaries can undertake. This instrument amends one of those restrictions.
- 4.2 The Building Societies Act (Restricted Transactions) (Amendment to the Limit on the Trade in Currencies) Order 2017, laid alongside this instrument, amends another of the restrictions in Section 9A of the 1986 Act.

5. Extent and Territorial Application

- 5.1 The extent of this instrument includes Scotland and Northern Ireland.
- 5.2 The territorial application of this instrument includes Scotland and Northern Ireland.

6. European Convention on Human Rights

- 6.1 The Economic Secretary to the Treasury has made the following statement regarding Human Rights:

“In my view the provisions of the Building Societies Act (Restricted Transactions) (Amendment to the Prohibition on Entering into Derivatives Transactions) Order 2017 are compatible with the Convention rights.”

7. Policy background

What is being done and why

- 7.1 This instrument makes an amendment to section 9A of the Building Societies Act 1986 which will help ensure that the restrictions in section 9A are reflective of the modern housing market and will help level the playing field between building societies and banks by reducing their reliance on third party providers, helping them provide the best quality services to their members, whilst maintaining the characteristics of the mutual model.
- 7.2 This instrument amends section 9A of the Building Societies Act to allow building societies to trade derivatives in order to become members of clearing houses.
- 7.3 Section 9A of the 1986 Act currently prevents building societies from trading derivatives, unless for the purpose of hedging against certain external factors, such as interest rates or exchange rates. Derivatives are essentially insurance products used by banks and building societies to protect themselves against interest rate risk. The use of derivatives is consequently essential for the provision of fixed rate products, such as mortgages. Whilst this restriction still enables building societies to offer fixed rate mortgages, it prevents them from engaging in more risky market making activities.
- 7.4 The European Market Infrastructure Regulation 2012 will make central clearing of derivatives mandatory for small institutions, such as building societies from 2018. This means that building societies will either need to be direct members of clearing houses or clear through third party members.
- 7.5 The membership rules of some clearing houses effectively prevent building societies becoming members. This is because the rules state that all direct members must participate in the default management process. This means that in the event of a member default, a direct member would be obliged to bid for a portion of the defaulted member’s derivatives portfolio. As this would involve the trading of derivatives that is not for the purpose of hedging balance sheet risk, it would be in breach of section 9A of the 1986 Act.
- 7.6 Amending legislation to allow building societies to become direct members of clearing houses would reduce the reliance that building societies currently have on third party providers and enable them to meet their regulatory requirements and compete on a level playing field with banks.
- 7.7 There is a further amendment to one of the prohibitions in section 9A of the 1986 Act, made by the Building Societies (Restricted Transactions) (Amendment to the Limit on the Trade in Currencies) Order 2017, subject to the negative resolution procedure, which is laid alongside this instrument.

Consolidation

- 7.8 HM Treasury does not propose to consolidate any legislation in consequence of amendments made to primary legislation in this Order.

8. Consultation outcome

- 8.1 The Government has consulted with the largest building societies that would stand to benefit from these changes, as well as the sector trade body. These discussions focused on how the change would benefit the sector and place building societies on a level playing field with banks.
- 8.2 The Government has also consulted with the Prudential Regulation Authority (PRA) in developing this proposal. They had no prudential concerns about the change.

9. Guidance

- 9.1 The PRA will be updating existing guidance once this change has been enacted.

10. Impact

- 10.1 The impact on business, charities or voluntary bodies will be positive. These changes will provide building societies with the increased flexibility to enter into certain transactions and arrangements that will benefit their members. There is no direct cost or benefit to the sector from this change as it will allow societies to make a commercial decision as to whether to become a member of a clearing house.
- 10.2 The impact on the public sector is minimal. There will be a small, short-term impact on public sector resources as the PRA will update their guidance and rulebook as a result of this change.
- 10.3 An Impact Assessment has not been prepared for this instrument.

11. Regulating small business

- 11.1 The legislation applies to activities that are undertaken by small businesses. However, it is expected that only the largest building societies will have the capacity to take advantage of these changes. Therefore, we do not expect this to impact on any small businesses.

12. Monitoring & review

- 12.1 This instrument does not provide for a review of the amendments it makes. This is because a review would be disproportionate taking into account the economic impact of the instruments.
- 12.2 While no specific review is planned for this instrument, the change will be reviewed as part of any future policy review regarding co-operatives and community benefit societies.
- 12.3 The Economic Secretary to the Treasury has made the following statement regarding the appropriateness of a legislative provision for review of this instrument:
“It is not appropriate to make legislative provision for review of the Building Societies (Restricted Transactions) (Amendment to the Prohibition on Entering into Derivatives Transactions) Order 2017. The Order does not impose any requirements, restriction, condition or standards in relation to business activity. The instrument amends one of the restrictions on the type of transactions that building societies and their subsidiaries can undertake. These restrictions are set in primary legislation, and the powers under which this Order is made do not provide for the restrictions to be reversed. It is more appropriate to review the effect of the amendment to the

restrictions as part of any future policy review regarding co-operatives and community benefit societies.”

13. Contact

- 13.1 Katharine Lyness at HM Treasury Telephone: 020 7270 2467 or email: katharine.lyness@hmtreasury.gsi.gov.uk can answer any queries regarding the instrument.