PO-CH/NL/0867
PART A

Chancellor

Lawson

PART A

CONFIDENTIAL

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PO -CH /NL/0139 0867

PART A

Begins: 9/12/85 DD: 25 years

Ends: 23/12/85 S/9/95

CHANCELLOR'S 1985 PAPERS ON BANKING SUPERVISION

PO -CH /NL/0139 0867 PART A

2383/048

CONFIDENTIAL

bf 16/12
bf 18/12

FROM: M NEILSON
DATE: 9 December 1985

PPS

cc: PS/Financial Secretary
Sir P Middleton
Mr Cassell
Mr Monger
Mr Scholar
Miss Sinclair
Mr Peretz
Mr Walsh
Mr Hall
Mr Wood

PS/IR
Mr Pitts - IR

Mr Plenderleith - BoE

C Agree and await X?

Rvo 23/12

DEEP DISCOUNT BONDS AND SHORT TERM CORPORATE BONDS

The Economic Secretary and the Financial Secretary discussed with officials the question of tax treatment of Deep Discount Bonds and Short Term Corporate Bonds on Thursday 5 December. The Chancellor had asked that this subject be looked at again (Mr Wynn Owen's minutes of 7 & 18 October refer). Mr Peretz's minute of 11 November covers the issues, and my minutes of 14 November and 22 November and Mr Williams minute of 19 November also refer.

Deep Discount Bonds

2. It was agreed that, for the reasons set out in Mr Peretz's minute there was no case for changing the tax treatment of Deep Discount Bonds.

Short Term Corporate Bonds

3. It was also agreed that no immediate action was appropriate on Short Term Corporate Bonds; the first priority was to establish a commercial paper market, in which it would be necessary to allow payment of interest gross. Once this had occurred it would be possible to reconsider the question of gross payment of interest on Short Term Corporate Bonds.

4. The argument was finely balanced; there was no conclusive case either way. Limiting gross payment to corporate bonds (rather than LA bonds and gilts) was not seen as a problem; the measure could be presented as specifically targetted at companies. Like the proposed commercial paper market the only practical ring fencing would be around UK companies. On this basis the measure would involve negligible cost. The arguments against immediate action were:

(i) It did not appear that payment of interest net was the most serious obstacle to development of a market in short-term corporate bonds, and thus gross payment was unlikely to be sufficient to get such a market going. But the evidence in this area was sparse. In a survey of corporate treasurers payment of interest net was seen as the eighth most important obstacle - out of eight - to the development of the short term corporate bond market. But this survey was out of date, having been carried out before earlier legislative changes which made short-term corporate bond issues practically possible. It would be useful to have better and more up-to-date information on the views both of corporate treasurers and of the specialists who would organise the bond issues.

(ii) It the market did get off the ground there might be pressure to extend gross treatment to corporate bonds with a maturity of more than 5 years. Though arguments relating to the need for liquidity in the short-term market could be deployed, such pressure might prove difficult to resist.

5. If the Chancellor agrees with this assessment the next step would appear to be consideration of Mr Walsh's forthcoming advice on the points raised in consultation about plans for a commercial paper market.

M NEILSON

1781/011

Pl type for C's sig (disc below)

Draft letter to Miss Deborah C. Adams of the Law Society of Scotland

BANKING SUPERVISION

1. Thank you for your letter and enclosed paper of 4 December, which raised a number of interesting and useful points.

2. Because of the tight publication timetable I have not been able to take account of your comments in the forthcoming White Paper on Banking Supervision. But they will be carefully considered in preparing subsequent legislation.

N.L.

3. The attached reply is self-explanatory. We do not consider that any substantive points need be picked up at this stage. The Bank are also replying non-committally to their separate copy of the paper.

M. EVERSHED

1781/011

From: M. EVERSHED
Date: 12 December 1985

1. MR HALL
2. CHANCELLOR

cc PS/Economic Secretary
Sir Peter Middleton
Mr Cassell
Mr Wilson
Mr Peretz
Mr Jones

LAW SOCIETY OF SCOTLAND LETTER OF 4 DECEMBER : BANKING SUPERVISION

1. The Law Society of Scotland's letter encloses a memorandum of observation on the Review Committee report which is supportive of the Government's position at a number of key points. These include:-

(i) Changes of Control and Ownership - where they endorse the proposals in the Bank's consultative paper (which are being carried forward in the White Paper);

(ii) Disclosure to Government Departments - where they express agreement with the Review Committee's proposal (again being carried forward in the White Paper) subject to a useful suggestion that the provision is framed so as to prevent information about identifiable individual clients of the authorised institution being distinguished. This may be a good way of easing any pressure that might develop on this issue without dropping the idea of disclosure to other departments altogether - we have salted it away for future consideration;

We can't give any guarantee on this.

(iii) Data received for Supervisory Purposes - where the society is robust, suggesting a statutory period after which failure to submit returns results in a requirement for an auditor's certificate explaining the reasons for delay.

2. On the negative side the Law Society are against meetings between the supervisor and auditor without the authorised institution having the opportunity to be present and worried about the universal use of banking names in a one-tier world (which worry will be answered in the White Paper) - but these points are not couched in a hostile manner and the general tone of the paper is helpful.

012/1949

CONFIDENTIAL

FROM: M A HALL

13 December 1985

1. SIR PETER MIDDLETON
(spare copy to keep)

2. CHANCELLOR

c c Economic Secretary
PS/Lord Belstead
Mr A Wilson
Mr Cassell
Mr Peretz
Mr Culpin
Mr Eversheed
Mr H Davies

STATEMENT ON BANKING WHITE PAPER

I attach a draft statement, and draft Q & A briefing by Derek Jones.

2. Background papers for the Statement are in the attached folder. This covers:-

*(1) Previous statments to the House;

*(2) White Paper (final proof);

*(3) Review Committee Report;

*(4) Bank's report on JMB (from 1985 Annual Report);

*(5) JMB briefing;

*(6) Dr Oonagh McDonald's recent speech (and brief analysis);

M A HALL

*Not copied

BANKING SUPERVISION

With permission, Mr Speaker, I should like to make a statement.

2. It is exactly a year since I announced to the House the establishment of a Committee to consider the system of banking supervision, under the chairmanship of the Governor of the Bank of England. I reported its conclusions on 20 June. Since then the Bank of England has conducted consultations, on the basis of papers drawing on the report of the Leigh-Pemberton Committee. The Government have carefully considered that report and the reactions to it, and are now putting forward important proposals, both statutory and non-statutory, designed to strengthen the system of banking supervision. These are set out in a White Paper, which I have arranged to be published as a Command paper, and have today laid before the House.

3. To take non-statutory changes first.

4. My earlier statement described the changes being made in the Banking Supervision Division of the Bank of England. The Governor is making good progress in implementing these. The White Paper announces further important steps. At the same time, the Bank

of England is increasing the frequency of supervisory visits to banks, both where the supervisors have prudential concerns, and on a routine basis.

5. I turn now to changes which will require legislation. The Government must move quickly to strengthen the statutory framework for banking supervision where it has been shown to be weak. I expect to be able to introduce legislation at the beginning of the next session.

6. The White Paper announces the formation of a new statutory Board of Banking Supervision within the Bank of England. This will bring independent outside expertise to bear at the highest level on the Bank of England's task of supervising banks. Its members will be appointed by the Governor with my agreement, and a report from the Board will be included in the Bank's annual report to me which will be laid before the House. The Board will help the development of an increasingly professional approach by the supervisors, under forceful direction from the top.

7. We also intend to implement the Leigh-Pemberton Committee's two main proposals.

8. First, the distinction between licensed deposit-takers and recognised banks will be abolished. This distinction has not in practice proved a reliable guide

to relative risk. All authorised institutions will in future be subject to the same criteria of authorisation - which will be tightened - and to the same supervisory regime.

9. Second, the Government intend to remove confidentiality restraints on both supervisors and auditors to the extent necessary to permit the communication between them that is essential to effective supervision. The importance of such communication was one of the key lessons the Leigh-Pemberton Committee drew from the Johnson Matthey Bankers affair. The changes proposed in the relationship between auditors and supervisors follow extensive consultation with the auditing profession and the banks. Normally, contacts between auditors and supervisors will take place with the full knowledge and participation of the client bank. We shall provide for direct contact between auditors and supervisors to take place in certain exceptional circumstances, without the knowledge of the supervised institution. I am hopeful that these changes can be achieved on the basis of agreed, professional guidelines, underpinned by minimal statutory provision. But if necessary, we shall not hesitate to legislate to ensure that the dialogue takes place.

10. The White Paper contains a range of further important proposals designed to strengthen the supervisory regime.

11. In particular, it is of the first importance that banks should supply to the supervisors information which is adequate, accurate and timely. The Bank's present statutory power to require specific information from licensed deposit-takers will accordingly be extended to all authorised institutions, and broadened to enable the bank to place routine submission of supervisory information on to a statutory basis. The Government further intend to make it a criminal offence knowingly or recklessly to provide misleading information to the supervisor.

12. Large exposures have also proved, in the past, to be a major source of banking problems. The Government therefore propose to provide in statute for the notification (to the supervisors) of large exposures.

13. Certain other statutory proposals, not directly related to supervision, are also set out in the White Paper. Financial Services legislation - to be introduced later this week - will empower the Government to take action against financial institutions, including banks, from countries which do not offer a reciprocal right of establishment.

14. The Leigh-Pemberton Committee pointed out that the growth of financial conglomerates poses problems for regulators. The White Paper sets out proposals enabling supervisors to exchange supervisory information,

whilst preserving a high degree of confidentiality for banking supervisory information.

15. The proposals in this White Paper are a swift but considered reaction to the Johnson Matthey Bankers affair. As I told the House in December 1984, events at that bank raised issues which extend far wider than the affairs of that institution itself. Changes in the conduct of supervision and its statutory framework were shown to be necessary. The proposals put forward today are designed to provide the effective system of banking supervision which is vital to confidence in Britain as the pre-eminent financial centre. These measures will also provide an important line of defence in the unceasing battle against the cancer of financial fraud.

16. Supervision will be firm, without being a strait-jacket. There would be great dangers in a rule-bound and legalistic system, where compliance necessarily tends towards the letter rather than the spirit of the law.

17. The proposals are further designed to avoid unnecessary administrative upheaval or the creation of new bureaucracy.

18. The approach we have taken is to build on the existing system of supervision. To reinforce its

strengths. And to right its weaknesses.

19. Together with the Building Societies Bill, to be read for the second time on Friday, and the Financial Services Bill, these proposals will provide a comprehensive statutory framework for the rapidly changing financial services sector.

20. I commend these proposals to the House.

013/1949

Q & A BRIEFING

POSITIVE

1. **Timely response to lessons of JMB:**
   Swift but well-considered proposals following wide consultation. Non-statutory aspects already in place or in hand. Legislation to be brought forward earliest practicable opportunity. [cf 5 year delay between 1974 secondary banking crisis and 1979 Banking Act.]

2. **Substance of proposals:**
   Important changes in both practice of supervision and legislative framework.

3. **Tougher:**
   Improving supervision and toughening-up powers and procedures of the supervisors. New offence of providing misleading information.

4. **New Board:**
   The Board of Banking supervision will be an independent new body, enshrined in statute, to ensure the quality of supervision. Outside expertise at highest level.

5. **Changes at Bank:**
   Strengthening supervisory effort. New procedures. More staff. Expertise. Secondments to and from Bank.

6. **Two-tier system to go:**
   Whole system of authorisation and supervision to be rationalised (abolition of two-tier system).

7. **Auditors**
   Vital role of communication between auditors and supervisors to be put on a new footing.

8. **Large exposures:**
   New statutory rules to control problem of large exposures.

9. **Reciprocity**
   New powers aimed at opening-up opportunities overseas for UK financial institutions.

014/1949

DEFENSIVE

1. **General**

Government's response too slow? Complacent

- Nonsense. Compare response of Labour Government to secondary banking crisis in 1974 - 5 year delay to Banking Act 1979.

- One year to the day since first statement to House. Six months since Leigh-Pemberton Committee reported.

- White Paper published today. Following extensive consultations. Swift but well-considered response.

Proposals do not go far enough? Need radically different system?

- True that serious shortcomings in Banking Act 1979 - Labour Government legislation.

- These are now being put right. Improvements in statutory powers and procedures for authorisation and supervision. Also in organisation of supervision - vital, but not addressed by Labour Banking Act.

- Not throw baby out with bathwater. System has generally worked well. Compare overseas.

Proposals soft on banks? Too much conceded in consultation?

- Purpose of consultation to determine what is workable. No question of an easy regime. Tougher than existing, Labour Government, system.

2. **JMB/Rescue Cases**

If these proposals had been in place, would they have prevented collapse of JMB/ Will they prevent further failures?

- Confident that they would have brought JMB's problems to light at an earlier stage. That is the key to avoiding

such collapses.

- But no system of banking supervision can guarantee against bank failures.

What proposals for handling future rescue cases?

- White Paper is about supervision not rescue cases. Should make such episodes less likely to occur.

Private sector should bear costs of rescues - not taxpayer. Establish fund for the purpose?

- Private sector did make substantial contribution and shareholders lost their investment. Nor has taxpayer made any contribution to bank rescues.

- Moral hazard in institutionalising expectation of rescue. Should be no presumption that banks will not be allowed to fail.

- Would hon Member's proposed fund have rescued JMB? Who would have decided?

Will proposals stop bank fraud?

- Weeding-out financial fraud a priority for Government.

- Good supervision important line of defence against fraud.

- Government's proposals mean better supervision and so reduce risk of fraud.

- But no system can eliminate fraud. Must therefore be vigilant at all times.

4. **Changes at Bank : Board of Banking Supervision**

Satisfied with improvements at Bank?

- Yes, but not complacent. No doubt, always room for improvement in supervision.

New Board just window-dressing? Should be independent of Bank?

- No. Majority of members will be independent, from outside Bank. Appointments to be agreed between Governor and myself.

- Board will provide independent report.

- Board members will be entitled to raise issues on own initiative.

- No point in upheaval and discontinuity to create new bureaucracy.

5. **Auditors**

Proposals do not go far enough. Should be a statutory audit commission for banks?

- Recognise important role of auditors. Government's proposals will establish full dialogue between auditors and supervisors.

- Proposals build on existing procedures, institutions and expertise.

- No point in new bureaucracy, removed from the supervised institutions. Better to employ expertise and knowledge of independent auditor 'on the spot'.

Is it true that auditors opposed to Government's proposals?

- No. Consultation continuing but hope for co-operation of profession in establishing role of auditors. Would be prepared to legislate if necessary, but professional guidelines probably better route.

- Profession unlikely to welcome hon Member's proposed commission.

Auditors as 'fraud squad' for banks?

- Auditors not detectives. But should report fraud to authorities.

6. Information/Reporting Requirements

JMB showed reporting requirements lax. Should be legal penalties?

- Prompt and accurate reporting to supervisors a basic requirement of good supervision. White Paper proposes firm, new regime.

- New offence of providing materially false or misleading information.

- Supervisors to be empowered to require information from any authorised institution. Legal sanctions for failure to comply.

- Should not of course impose legal sanctions on minor departures. But failure to meet requirements will be a signal to supervisors and will prompt further investigation.

7. Large Exposures

Main element in JMB collapse. Rules should be tighter?

- Recognise dangers of concentrations of lending.

- White Paper makes proposals for new statutory rules on notification of large exposures to supervisors, backed by criminal sanctions.

Bank are proposing to relax their requirements on large exposures?

- No. Proposals advocated by Review Committee and endorsed by Government will tighten controls. Bank is implementing.

Should be statutory limits, not just notification requirements?

- No. Review Committee advised that there should be flexibility to take account of circumstances of individual banks and customers. Such flexibility can be allowed within proper system of notification.

- Exposures over 25% of capital base will be notified in advance : allowing supervisors to consider individual cases.

- In some cases need flexibility to keep exposures even lower than 10%.

8. **Inspection System**

Other countries have a banking inspectorate; why not UK?

- Bank of England is increasing frequency of supervisory visits to banks. Will be routine, not just when problems arise. Also increased dialogue with auditors.

- Have considered possibility of full-scale inspectorate, but on balance believe such an inspectorate not necessary to achieve desired standards.

9. **Reciprocity**

Government prepared to legislate to protect City from unfair foreign competition. Why not steel industry, ships, cars etc?

- Purpose of proposals is to secure equal opportunities for UK firms to set-up overseas; not to protect the City of London - which is highly competitive.

- Barriers to entry in other countries particularly a problem in banking and financial services sector. Other countries e.g. Germany, Holland, have recently adopted powers similar to those proposed.

- Is hon member proposing greater investment overseas by UK manufacturing industry?

10. **Take-overs/Acquisition of banks**

Why special protection for banks? No shortgage of questionable acquisitions in other sectors?

- Proposals a natural extension of basic prudential controls for banks. To ensure that would-be controllers of banks will meet necessary requirements.

What about foreign take-overs?

- All acquisitions will be subject to the same prudential controls. But reciprocity powers will also be available.

11. **Two-tier System/Banking Names**

Abolition of two-tier system, and consequent widespread use of "bank" will mean public can be misled?

- Accept concern about use of banking names. White Paper contains proposals for reasonable restrictions on use; based on requirement for appropriate capital base.

- No distinction implied in terms of supervision.

Rules will not cover branches of overseas banks?

- Must comply with Community obligation in this area. Also technical difficulties in imposing capital requirements on banks incorporated overseas.

- But considering further the application of a general power to control misleading banking names.

12. **Deposit Protection Fund**

Review Committee recommended an increase in protection offered by Fund, at least to cover inflation since 1979. What action?

- Government do not at present propose to increase maximum payment from Fund.

- Purpose of Fund is to offer a 'safety-net' to prevent hardship to vulnerable smaller depositors. Fund covers 75% of a deposit, up to £10,000. Is hon Member concerned to provide guarantees to those with even larger bank accounts?

- Fund is made-up by contributions from the private sector banks.

A bank's contribution to the Fund should be related to the risks it undertakes?

- A reasonable principle, but would prove unacceptably complicated in practice.

(Disclosure to the Inst Department (see # 20/6)

Penalties / general criminal Acts.

	ERI	$/£	Dm/£
Friday close	75·0	1·7015	3·0984
Monday open	74·7	1·6890	3·0802
9 AM	74·8	1·6920	3·0824
10 AM	74·8	1·6910	3·0835

3 month IB 10 1/4%
1 month IB 9 3/4%.

FTSE −6
Gilts off 1/4 - 1/2 pt

NB: Paul says when you leave No 10, Lobby will be arriving. So probably better to go along upstairs landings & down side stairs, rather than along main hall.

016/1949

FROM: M A HALL

16 December 1985

CHANCELLOR

c c Financial Secretary
Economic Secretary
Sir Peter Middleton
Mr Wilson
Mr Cassell
Mr Peretz
Mr D Jones

Mr Shepherd IR
Mr Nicolle BE
Mr Bridgeman RFS

STATEMENT ON BANKING SUPERVISION WHITE PAPER : DISCLOSURE AND THE INLAND REVENUE

There is, as we discussed at your meeting this morning, a major presentational difficulty in trying to square rigorous pursuit of fraud cases with not obliging - or allowing - Inland Revenue to disclose information acquired from tax returns etc. There is also the narrower point of why supervisors of financial institutions are not to be permitted to disclose supervisory information to the Revenue departments.

2. There is no doubt that this complex of issues will come under scrutiny during the passage of the various supervisory legislation. It would be as well not to box ourselves into over-rigid positions on general policy. I suggest the following lines to take:-

Why no disclosure to the Revenue departments?

This would be a breach of traditional banking secrecy. And there would be a serious risk that the quality of supervisory information would be undermined.* [We do not recommend using the argument that this would deter business from the City of London - we understand, for instance, from the Inland Revenue that the American IRS does obtain such information, without serious deterrent effects.]

* But banking supervisory information can be disclosed to the relevant authorities with a view to criminal proceedings.

of in-house products with the provision of independent advice. Polarisation could deprive banks and building societies of the competitive advantage they gain from their retail networks, and might in effect force people into the hands of intermediaries whose prime motivation is to sell insurance policies to get commission. And under SIB rules company representatives cannot comment on the merits of an independent intermediary's advice, even where this was obviously foolish. Our main objective has therefore been to ensure that the polarisation rules operate as sensibly as possible in practice.

4. Early this year Treasury Ministers tried to persuade DTI Ministers to impose some major compromise upon SIB. However, DTI did not support Treasury and OFT views about the anti-competitive nature of the SIB polarisation rules. They argued that the SIB rules allowed advice to be channelled from independent brokers to the customer via bank branches, & that polarisation would not have a radical effect on the way banks currently operate.

5. In recent months institutions have been taking decisions about the future shape of their business on the basis of the SIB rules, which are substantially as they were last spring. These decisions are much as we had expected, with all the clearers save Nat West and Bank of Scotland opting to be company representatives, and most building societies taking the independent intermediary route. (As you know, the impact of polarisation on building societies has led the BSA to argue strongly, in the context of the review of Schedule 8 of the Building Societies Act, that societies should be permitted to own insurance companies which at present they cannot. You will be getting a note on the Schedule 8 review from FIM1 next week.)

LAUTRO Rules

6. On polarisation generally, however, the waters have been muddied and old passions revived by the drafting of the LAUTRO rule book (this being the SRO for the marketing of life assurance and unit trusts). LAUTRO take a significantly stricter line on polarisation than SIB. They claim that additional investor protection is needed. They have also extended polarisation to products not defined as investments in the FS Act (ie term insurance products, such as mortgage protection policies, and health insurance). Their rationale is to try and prevent their commission rules from being undermined where a broker provides a package of products, some within the F S Act and

some outside (commission could be loaded on the latter).

7. This would create problems for company representative banks in three main areas. First, on referrals to independent intermediaries, LAUTRO say that once a company representative starts to talk about particular types of investment all they are allowed to do is to sell their own products. They can give factual information, but before passing a client to an independent intermediary they are not allowed to say anything which takes account of the investors particular circumstances or the merits of particular types of products or companies. So, for example, a Midland Bank manager could not tell a customer that it was advisable to put no more than say half their £100,000 life savings in Midland Bank unit trusts (they would either have to advise investing it all in company products or send them off to the independent intermediary). Bad investment decisions would result.

8. Second, when advice is referred back from independent intermediaries, LAUTRO now allow the bank branch to get a copy of whatever is sent to the client, but will not allow information to be channelled via the company representative branch. This would mean that the independent intermediary could not have terminals in the bank branch (Lloyds Bank already have such terminals).

9. Finally, because of the extension of the scope of their roles, LAUTRO would prevent company representatives offering "pre-broked" term assurance products. So, for example, Midland Bank could not offer a mortgage protection policy which was not provided by its in-house insurance company (and at present many of the in-house insurance companies cannot offer every term insurance product). Customers who want repayment mortgages, as well as those who want endowment mortgages, would have to be referred to independent intermediaries for insurance quotes. The service all round would be slower, more cumbersome, and the client might lose the current benefit of group discounts obtained by the big financial institutions.

Deposit Takers Reactions

10. It seems pretty clear that the banks, and perhaps also building societies, are not prepared to put up with the LAUTRO rules. If the rule book is not substantially modified the banks have said that they, like the building societies, will opt for direct authorisation from SIB (building societies

may do so anyway so as not to become members of, and associated with, FIMBRA). Fortunately, there seems virtually no chance that SIB will tighten up its rules on polarisation. SIB now seem prepared to accept direct authorisation from banks etc, but they are worried that those who are considering going to SIB for authorisation for one function may decide to request authorisation for all functions (though so far the banks have not suggested this).

Recognition of LAUTRO Rules

11. LAUTRO have applied to SIB for recognition on the basis of their draft rules. LAUTRO are most unlikely to back down voluntarily on polarisation since that would alienate powerful life assurance interests (and would re-open some well concealed but serious conflicts, particularly between insurance companies with large in-house sales forces and those without). It seems quite likely that SIB will accept that the criteria in the FS Act are satisfied, in that the LAUTRO rules are at least equivalent to SIB's. SIB cannot overturn LAUTRO's rules because they are stricter. Therefore during the next two months SIB may notify DTI they wish to recognise LAUTRO.

12. But before SIB can recognise LAUTRO formally the Secretary of State has to give his consent. The SRO's rules have to pass the FS Act's competition tests (ie that the rules are either not significantly anti-competitive, or that, if they are anti-competitive, this is necessary for investor protection). The DGFT has to advise the Secretary of State on these competition points. It seems almost certain that the OFT will find the LAUTRO rules anti-competitive. But, as happened last spring over the SIB rules, DTI could still allow the rule book to proceed virtually unaltered.

13. A number of factors, some of them conflicting, will weigh with SIB and DTI. They will be concerned about the possible administrative problems SIB might face in handling direct authorisations. They will not want to threaten the viability of the SROs, particularly if it seemed that banks etc would seek SIB authorisation for all functions. And they may be sensitive to criticism that, by allowing the LAUTRO rule book to remain unchanged, they have in effect gone back on their public statements last spring when they defended the SIB rules.

14. Such arguments might favour overturning LAUTRO's rule book, but there may be stronger contrary factors. First, it is not yet clear that direct

authorisation by SIB will impose significant burdens upon either SIB or the bodies to be authorised by SIB (for example, at present institutions only get a six month delay in the application of Section 62 of the FS Act by going to an SRO rather than SIB; and though SIB's fees - to be published next year - could be considerably higher than an SRO's this would be a minor factor compared with the benefits from avoiding LAUTRO). Second, although the logical justification for some of the LAUTRO rules might well be undermined, LAUTRO's own viability should not be endangered by the absence of the deposit takers (the threat to IMRO if banks were authorised by SIB for all functions might be a more serious matter).

15. Third, and perhaps more importantly, there must be some doubt as to the practicability of forcing a major rules revision upon LAUTRO at this late stage. The stricter interpretation of polarisation runs throughout the rule book and it would require several weeks work to remove this. The FS Act timetable is now extremely tight, and all the SROs need to be recognised before DTI announce "P" day. Any major changes to LAUTRO's rules might endanger the chances of getting the FS Act in force on 1 April 1988. DTI are still trying hard to meet this timetable (we will provide next week a separate note on the increasing difficulties facing DTI in achieving this).

16. Finally, there is the attitude of the banks themselves. Although they are very annoyed about LAUTRO, I understand from the CLSB that the banks are likely to be reasonably content with SIB authorisation. SIB seem to accept that they will have to annoy the insurance industry interests and intermediaries by accepting direct authorisations. Establishing what LAUTRO and the insurance industry will do is more problematic. But it is not clear at the moment that they will do anything (for example, I doubt whether LAUTRO members could be forbidden from doing business with banks or banks' independent intermediary arms where the bank was authorised by SIB; among other things this would seriously infringe FIMBRA's responsibilities). There must also be a reasonable chance that if LAUTRO reacted foolishly Lord Young might take a much less favourable attitude towards recognition.

Treasury Action

17. As far as the Treasury is concerned, no FS regime involving polarisation would be entirely satisfactory and LAUTRO's interpretation is foolish. We recommend you to write to DTI Ministers expressing your concern about the

LAUTRO rules and urging them to encourage LAUTRO to change their rules before it is too late. As with the Chancellor's letter to the Governor, you will want to emphasise the need to make the FS regime simple, flexible, and above all practical. I attach a draft letter to Mr Maude in this vein.

18. Frankly, we doubt if this will produce results; but it seems advisable to register the point clearly now, to remind DTI Ministers of our interest, and to head off any possibility of still more unwelcome developments on this front - whether from LAUTRO or SIB.

P.S Hall

P S HALL

3373/19

DRAFT LETTER TO:

The Hon F Maude MP
Minister for Corporate and
Consumer Affairs
Department of Trade and Industry

POLARISATION AND LAUTRO RULES

I have been taking a close interest in developments on the LAUTRO polarisation rules. As you know Treasury Ministers have always had reservations about polarisation itself. However, earlier this year Paul Channon and Michael Howard gave a number of assurances that SIB's polarisation rules would be interpreted flexibly.

However, it now looks as if LAUTRO are trying to impose an interpretation of polarisation that was never intended last spring, and, indeed, to extend its scope. I appreciate that LAUTRO are still discussing draft rules with the banks and building societies. But I understand that as presently drafted they would prevent company representatives from:

- advising people on a reasonable distribution of their life savings (a company representative could either suggest it was all invested in the company products or send the person off to an independent intermediary);

- acting as a channel for information from independent intermediaries (directly contrary to what your predecessors told Parliament); and

- offering "pre-broked" term assurance products, such as mortgage protection policies.

All this conflicts with your emphasis on the need to make the Financial Services regime more flexible and to apply practical rules in a common sense way. The LAUTRO rules are so impractical that banks may be forced to seek authorisation direct from SIB for their life assurance and unit trust business (building societies might also wish to go to SIB for authorisation of their unit trust based personal pension business). This is a clear distortion of the intended supervisory framework.

The Director General of Fair Trading will, of course, also be taking a view on the competition aspects of the LAUTRO rulebook. There must be a good chance that he will find LAUTRO's polarisation rules anti-competitive to a significant extent.

In the circumstances, I hope you will feel able to warn LAUTRO that there is a real risk that consent will not be given to their recognition unless they change their rules. The SIB rules have been judged sufficient for investor protection, and there is no justification for LAUTRO being more restrictive.

PETER LILLEY

2565/11

CONFIDENTIAL

12/2.

From: D L C PERETZ
Date: 20 December 1985

PRINCIPAL PRIVATE SECRETARY

cc PS/Financial Secretary
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Monck
Mr Burgner
Mr Fitchew
Mr Shore
Mr Hall
Mr Walsh
Mr Wood
Mr Hannah
Ms Henderson

THE FINANCING OF CORPORATE ACQUISITIONS : LEVERAGED TAKEOVERS

You told me a little while ago that we were, after all, expected to provide a paper in response to the request in Mr Norgrove's letter of 20 November (copy attached).

2. I attach a paper prepared by Mr Walsh, with help from the Bank of England and DTI. I also enclose a short covering letter that you could send to David Norgrove. I understand the Prime Minister was particularly interested in any implications for the UK, and the covering letter is designed to bring these out.

3. The paper does not mention the work we are doing with a view to opening up a UK commercial paper market. That is merely because it will be new to the Prime Minister and this does not seem the right context in which first to mention the subject. We are confident that the rules and disclosure of requirements that will be set up will be sufficient to prevent the development of "Junk" commercial paper.

4. Nor does the paper go very far into calculating the possible impact of bank lending for takeover activity on the monetary aggregates. Making some quite simple assumptions it is possible to reach some rather large figures - for example that some 15 percent of the growth of £M3 this year might have been due to

takeover-related bank lending.

5. But I think one has to be very careful indeed with such calculations. First, it is not of course new. Although takeover activity has been going on at a very high rate recently, the figures in past years have also been substantial. A similar calculation for 1984 would suggest that over 20 percent of the growth of £M3 in that year was due to takeover-related bank lending. Second, to know the real effect of this one would have to trace the transactions through. Companies borrowing for this purpose might otherwise have been borrowing for other purposes. ~~All~~ The recipients of the takeover cash may use it to repay bank borrowing, or to avoid borrowing they would otherwise have had to do. Moreover, over time most bank borrowing for takeovers is likely to be repaid out of asset sales, or refinanced by new equity issues: at least that is the normal pattern.

6. Nevertheless, it would not be surprising if the current spate of takeover bids were having some effect, even if only a temporary one, on the rate of growth of bank lending.

DLCP

D L C PERETZ

f - corporate

CONFIDENTIAL

10 DOWNING STREET

20 November 1985

From the Private Secretary

Mr Wood 22/11

Dear Rachel,

JUNK BONDS

The Prime Minister has heard reports about the growth in the use of junk bonds in the US for financing of takeovers and more generally. She would be grateful for a note on this please.

I am copying this letter to John Bartlett (Bank of England).

Yours ever,

David.

(DAVID NORGROVE)

Mrs Rachel Lomax,
HM Treasury.

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THE FINANCING OF CORPORATE ACQUISITIONS : LEVERAGED TAKEOVERS

This note briefly sets out the latest state of play on attempts at regulating "junk bonds" in the US and the reasons why these bonds have not been emulated in the UK. Paragraphs 10-12 attempt to provide a broad estimate of the monetary effects of the recent level of takeovers in the UK. Attached is a copy of a recent Bank of England internal paper on takeovers and mergers.

Introduction

2. In the United States, a pattern of takeovers has emerged (often associated with the New York investment banking firm of Drexel Burnham Lambert Inc) under which takeovers are arranged by the would-be acquirer through the establishment of a "shell" company. The shell company issues bonds (called "junk" bonds because they are usually rated at Ba or lower by Moody's and BB or lower by Standard and Poor), secured against the stock it acquires in the target company, in order to buy the stock. This technique enables companies with a low capitalisation to take over companies with much larger ones, and has been one factor leading the latter to develop various devices, including "poison pills", to ward off hostile bids. These tactics represent a special type of leveraged takeover, which is any takeover where a high proportion of debt is used to purchase the target company. Junk bonds can of course be issued for other purposes than takeovers.

The Proposed Federal Reserve Regulation

3. The recent publicity about the intention of the Federal Reserve to impose margin requirements on shell companies relates to takeover financing using junk bonds. Under the Fed's proposal, they will be prevented from financing more than 50 per cent of a stock purchase with loans secured by the stock, and the Fed are accepting comments from the public on this proposal in the period up to 23 December. The Administration oppose what the

Fed intend, but it nonetheless appears as if Mr Volcker will proceed without Administration backing, as he is empowered to do. Drexel Burnham Lambert has protested about the proposed change, but are also ready to adopt new approaches to get around any new Fed regulation. The new regulation will not affect the many forms of leveraged takeovers in the US besides those financed by low-grade bonds issued through a shell corporation. It may not affect, for instance, the activities of T Boone Pickens of Mesa Petroleum who is one of the most famous practitioners of leveraged takeovers.

Junk Bonds in the UK

4. The particular leveraged takeover technique outlined above is not at present a major factor in the UK. There is no market for low-grade bonds in the UK as there is in the US, since the obligations on trustees and other provisions in our legislation, and our supervision arrangements for banks, building societies and insurance companies, discourage pension funds and financial institutions from investing in low-grade bonds. We also lack the equivalent of money market mutual funds, which are one of the main ways US individuals can participate in the high yield bond market while spreading their risks. Further, the UK does not have a universal tax provision for individuals similar to Individual Retirement Accounts, whereby Americans can invest up to $2,000 per annum in securities the income on which is tax-exempt until retirement.

5. Therefore the conditions do not exist here for a low-grade bond market equivalent to the one in the US, which has led to $35 billion in high yield debt having been issued there in the period 1977-1984. Nor have bidders for UK firms so far tapped the US junk bond market (at least on any scale) and switched the proceeds into sterling, ~~perhaps deterred by the high interest rates they would have to pay.~~

6. The takeover rules are also probably on balance more restrictive as they affect hostile bidders in the UK: in the

United States "two-tier" offers are possible under which one price is paid for the first 50 per cent of stock acquired and a lower one for the second 50 per cent. Short time limits for acceptance of offers can also be used as a tactic in the US, although to comply with the Williams Act the minimum offer period has to be more than twenty business days. It is hard to form a defence or counter-offer in so short a period.

7. But the fact that the particular method of effecting leveraged takeovers now being regulated against in the US is not at present a significant factor here (although Drexel Burnham Lambert would like to extend their operations to the UK) is not to deny that over the past two years UK takeovers have been accelerating in total value, and that some of them are highly leveraged. The net result of this may be to leave targeted companies saddled with large debts if bids are successful. As in the US, this in turn may lead to corporate raiders selling off the assets of the target company in order to pay off the debt incurred in purchase.

The Financing Pattern in the UK

8. It is not easy to assess the financial effects of takeovers. Even the presumption that bond or equity finance will have less effect on monetary growth than direct bank lending has to be examined in each case, since a large proportion of the securities concerned might, in principle, be taken up by the monetary sector. But aggregate data for even the primary financing arrangements for takeovers in the UK are not available in any great detail. The Office of Fair Trading, for instance, have very little relevant material. Any thorough investigation would therefore have to be a special exercise. The overall pattern can be only broadly estimated on the basis of DTI figures, which do not trace the ultimate source of cash used in takeover transactions.

9. There could of course be grounds for concern, aside from any effects on the monetary aggregates, in the growth of takeover finance in debt form. A series of takeovers financed by debt,

apart from their effects on industrial concentration and structure, could alter the balance between corporate debt and equity in an undesirable way. Effective banking supervision has an important role to play here, and should prevent unhealthy exposure by banks through involvement in leveraged takeovers and management buyouts.

10. It is known that direct bank finance has been a large element in such recent attempted takeovers as Elders/Allied (where a shell company, IXL, has been set up as an intermediary) and Argyll/Distillers. In the case of Elders/Allied foreign banks provided the finance and certain US banks such as Citibank now operating in London have a strong expertise in this general field. Other geared bids (Hanson/Imperial) have featured issues of loan stock convertible into equity later. (In both the Hanson/Imperial and GEC/Plessey cases, however, the acquirers have sufficient cash not to be seriously affected by the pressures of high gearing.) A large increase in gearing may be even more characteristic of management buyouts than of corporate takeovers. The Molins buyout, for instance, would have - if it had gone through - raised gearing from 9 per cent to over 90 per cent.

11. The overall position on financing takeovers in the UK (see Annex A) is that ~~from~~ 1980-84 about 55 per cent of the purchase price has been financed by cash, about 39 per cent by ~~transfer~~ of shares ~~(of the acquiring company)~~, and about 6 per cent by ~~transfers~~ of fixed-interest securities. It is unknown what proportion of the cash used in UK takeovers is raised by special issues of debt instruments. With the notable IXL exception, it is unusual here for a shell company to be set up to facilitate a takeover (although this seems to be more common in the case of management buyouts) and the total amount of fixed interest debt issues for all purposes is not large. The major source of credit in the UK is the banking system, and bank lending to finance merger activity takes place on a fairly large scale to borrowers that appear to loan managers to be creditworthy.

12. The total value of acquisitions and mergers within the UK in 1984 was about £5.5 billion; 54 per cent of it financed

in cash. The pace of takeover activity has accelerated this year, and in the first three quarters of 1985 the total value of takeovers was £6.1 billion, of which ~~however only about~~ perhaps 40 per cent ~~of~~ or £2.4 billion was in cash. A significant proportion of these cash figures could have been financed by bank lending, though the ultimate impact on aggregate bank lending and the money supply will depend on how quickly these loans are repaid, and what the recipients of cash offers do with the proceeds. Some will go to reduce bank borrowings; some to avoid the need for borrowing that would otherwise have taken place. And bank lending for this purpose will to some extent replace lending for other purposes.

13. ~~Recent and prospective~~ The progressive reductions in the rate of Corporation Tax (from 52% in 1983-84 to 35% in 1986-87) should tend to discourage the use of bank borrowing and other debt financing for takeovers as interest tax deductions become less valuable. But ~~the scale of the~~ until the current takeover boom~~, if it continues,~~ subsides is likely to outweigh this and other factors which might tend to reduce bank finance for takeovers.

PR

ANNEX A

CATEGORIES OF EXPENDITURE ON ACQUISITIONS AND MERGERS IN THE UK

PERCENTAGES OF TOTAL EXPENDITURE

		CASH	ISSUES OF ORDINARY SHARES	ISSUES OF FIXED INTEREST SECURITIES	TOTAL
	1969	28	52	21	100
	1970	22	53	25	100
	1971	31	48	21	100
	1972	19	58	23	100
	1973	53	36	11	100
	1974	68	22	9	100
	1975	59	32	9	100
	1976	72	27	2	100
	1977	62	37	1	100
	1978	57	41	2	100
	1979	56	31	13	100
	1980	52	45	3	100
	1981	68	30	3	100
	1982	58	32	10	100
	1983	44	54	2	100
	1984	54	34	13	100
1984:	1st Qtr	50	18	32	100
	2nd Qtr	65	34	1	100
	3rd Qtr	53	46	1	100
	4th Qtr	53	42	4	100
1985:	1st Qtr	41	41	17	100
	2nd Qtr	49	50	2	100
	3rd Qtr	30	65	4	100

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FROM: S N WOOD
DATE: 23 DECEMBER 1985

PS/CHANCELLOR

cc: Mr Peretz
Mr Walsh o.r.

FINANCING OF CORPORATE ACQUISITIONS : LEVERAGED TAKEOVERS

You passed on to me the Chancellor's comments on the paper attached to Mr Peretz's submission of 20 December.

... 2. I attach a clean copy of the paper, amended as the Chancellor requested.

S N Wood

S N WOOD

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THE FINANCING OF CORPORATE ACQUISITIONS : LEVERAGED TAKEOVERS

This note briefly sets out the latest state of play on attempts at regulating "junk bonds" in the US and the reasons why these bonds have not been emulated in the UK. Paragraphs 10-12 attempt to provide a broad estimate of the monetary effects of the recent level of takeovers in the UK. Attached is a copy of a recent Bank of England internal paper on takeovers and mergers.

Introduction

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The Proposed Federal Reserve Regulation

3. The recent publicity about the intention of the Federal Reserve to impose margin requirements on shell companies relates to takeover financing using junk bonds. Under the Fed's proposal,

they will be prevented from financing more than 50 per cent of a stock purchase with loans secured by the stock, and the Fed are accepting comments from the public on this proposal in the period up to 23 December. The Administration oppose what the Fed intend, but it nonetheless appears as if Mr Volcker will proceed without Administration backing, as he is empowered to do. Drexel Burnham Lambert has protested about the proposed change, but are also ready to adopt new approaches to get around any new Fed regulation. The new regulation will not affect the many forms of leveraged takeovers in the US besides those financed by low-grade bonds issued through a shell corporation. It may not affect, for instance, the activities of T Boone Pickens of Mesa Petroleum who is one of the most famous practitioners of leveraged takeovers.

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5. Therefore the conditions do not exist here for a low-grade bond market equivalent to the one in the US, which has led to $35 billion in high yield debt, yielding up to 4 per cent above those on "investment grade" bonds, having been issued there in

the period 1977-1984. Nor have bidders for UK firms so far tapped the US junk bond market (at least on any scale) and switched the proceeds into sterling.

6. The takeover rules are also probably on balance more restrictive as they affect hostile bidders in the UK: in the United States "two-tier" offers are possible under which one price is paid for the first 50 per cent of stock acquired and a lower one for the second 50 per cent. Short time limits for acceptance of offers can also be used as a tactic in the US, although to comply with the Williams Act the minimum offer period has to be more than twenty business days. It is hard to mount a defence or counter-offer in so short a period.

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estimated on the basis of DTI figures, which do not trace the ultimate source of cash used in takeover transactions.

9. There could of course be more substantial grounds for concern over the growth of takeover finance in debt form. A series of takeovers financed by debt, apart from their possible effects on industrial concentration and structure, which may not necessarily be at all harmful, could alter the balance between corporate debt and equity in an undesirable way. Effective banking supervision has an important role to play here, and should prevent unhealthy exposure by banks through involvement in leveraged takeovers and management buyouts.

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13. The progressive reduction in the rate of Corporation Tax from 52 per cent in 1983-84 to 35 per cent in 1986-87 should tend to discourage the use of bank borrowing and other debt financing for takeovers as interest tax deductions become less valuable. But until the current takeover boom subsides, it is likely to outweigh this and other factors which might tend to reduce bank finance for takeovers.

Conclusions

14. There are significant differences between the institutional conditions in the UK and the US, and between the tax laws of the two countries. The conditions which have encouraged the growth of a junk bond market in the US do not obtain in this country. In particular, the UK takeover rules would tend to prevent the use of junk bonds in leveraged takeovers in the UK. However, leveraged takeovers financed by bank borrowing rather

than bond issues have taken place in the UK for many years. There are implications in this for the wider monetary aggregates, but it is not easy to quantify the effects. More important is the prudential aspect. The banking supervisors need to maintain checks on banks' exposure to companies engaging in leveraged takeover bids. So far, there are no grounds for belief that this is a problem, but it is clearly important to keep this under review.