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Batiz-Lazo, Bernardo and Noguchi, Masayoshi

Bangor Business School, Tokyo Metropolitan University (Japan)

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# **Improving the System of Internal Control through Regulation: Cases of Small-Sized Building Societies, circa 1960**

By

Bernardo Batiz-Lazo, Bangor University

[b.batiz-lazo@bangor.ac.uk](mailto:b.batiz-lazo@bangor.ac.uk)

and

Masayoshi Noguchi, Tokyo Metropolitan University

[m-noguchi@center.tmu.ac.jp](mailto:m-noguchi@center.tmu.ac.jp)

## **Abstract**

Following the previous research conducted in Noguchi and Batiz-Lazo (2010), this study aims to analyze how the system of internal control entailing the effectiveness of the management and governance of building societies were improved within individual societies following the Building Societies Act, 1960 (BSA60). By specifically focusing on and comparing the process to reform the systems of internal control executed at two small-sized building societies, i.e. Lloyds Permanent and Eagle Building Societies, this study also purports to analyze how the improvement of the system of internal control affected the management and governance of both societies. The two cases examined in this study prove that an order, forbidding some activities by a building society, recognized to the CRFS under the regulation of BSA60 provided an important opportunity for the building societies to reform their systems of internal control and that the improvement of the system of internal control could have an important impact upon the management of the small-sized building societies in the UK, as a necessary condition for the withdrawal at an early stage of the order once made.

**Keywords:** the system of internal control; BSA60; the Chief Registrar of Friendly Societies (CRFS); the Treasury; building societies; supervision of retail financial intermediaries; delegated monitoring; UK

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## Introduction

In the seminal contributions by Benson and Smith (1976) and Diamond (1984) propose a framework in which financial intermediaries exist to solve informational asymmetries between borrowers and lenders. However, the intermediaries themselves are open to moral hazard problems and thus the need to regulate and supervise their operation as well as to introduce minimum capital requirements (e.g. Diamond and Dybvig, 1983; Townsen, 1979). It is beyond the scope of this paper to provide a full and detailed review to the broad literatures of the economics of information, the regulation of financial intermediaries and the role, analysis and interpretation of financial statement in that discourse. Instead, it is our purpose to look at the role of auditors in supporting the supervision of financial institutions. In this view, the production of financial information becomes yet another form of delegated monitoring while auditors themselves become agents of the state in the supervision of financial institutions.

Indeed, this idea has already found some empirical support (e.g. Guinnane, 2002 and 2003; Solvin *et al.*, 1990). Employing a rather different framework, that provided by corporatism, Noguchi and Bátiz-Lazo (2010) clarified why and how the enactment of the Building Societies Act 1960 (BSA60)<sup>1</sup> resulted in auditors of the societies being required to report on, and the directors of the societies to establish, a system of internal control. This work documented evidence in which auditors' sectoral interests, as represented by the Institute of Chartered Accountants of England and Wales (ICAEW), wielded a great deal of influence. This influence was based on their refusal to provide the state with essential information, specialised skills, and knowledge that the state needed to supervise effectively the performance of building societies (see further Cawson 1985). The auditors forced the state to enter into negotiations with them and, indeed, compelled the state to make concessions to its policy formulation (see further Williamson 1989).

Specifically, the state introduced the 'true and fair' requirement for building societies but in exchange introduced sections 38<sup>2</sup> and 45<sup>3</sup> of BSA60 which imposed the duty on

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<sup>1</sup> Reference to BSA60 is often substituted for the reference to the Building Societies Act 1962 (BSA62) because BSA60 experienced minor revisions and was reintroduced in 1962 as BSA62.

<sup>2</sup> The importance of testing the effectiveness of internal control in conducting audit of accounts had been recognised in the early 20th century, as demonstrated in the preface to the first edition of Spicer and Pegler's *Audit Programmes* (1908: 4). Concerning the widespread adoption after World War II of the systems-based approach in auditing, the ICAS (1954: 72) stated that '[t]here is little doubt that these demands [on manpower during World War II] resulted in some relaxation of standards of auditing work,

their auditors to determine whether the directors of a society complied with BSA60's specific requirement to establish and maintain a system of internal control and, if not, to report thereon.

Research in this article thus adds to accounting history literature by looking at the long-term effects of the requirements introduced by BSA60. Our aim is to analyze how the system of internal control entailing the effectiveness of the management and governance of building societies were improved within individual societies following BSA60 and what impact it had on the management of those societies. With this aim in mind, it should be noted that BSA60 also gave the Chief Registrar of Friendly Societies (CRFS), in conjunction with HM Treasury, new powers to sanction and even intervene in the running of the societies. But as the cases below suggest, effective supervision by the CRFS relied on auditors' skills as well as auditors fully implementing their new duties. In this connection, the following editorial in *The Times* (12 October, 1978 p. 27), entitled 'Stricter checks pose audit problems for small building societies', is suggestive:

An extended search of public sources resulted in no record of a major threat for building societies accounts' being qualified before October 1978. On the face of it, then, the framework for disclosure and internal control emanating from the early 1960s not only brought societies under the same regime as other corporate bodies but seemed fit for purpose. However, the failure of the otherwise small Grays Building Society questioned the established wisdom. In this context Mr Keith Branding, Chief Registrar, and Mr Eric Sayers, President of the 'English Institute', wrote a joint letter to all societies and their auditors warning them of the lax application of the 1962 Act while reminding them of Section 38(2), which made specific provision for individual societies to keep (and auditor's to examine) a system of control, inspection and supervision. Both Mr Branding and Mr Sayers were of the view that there was an impending need to reappraise those systems – particularly at small societies.

It should also be noted that there were no cases of intervention by the CRFS prior to the passing of BSA60. This was an industry where fraud and the manipulation of financial statements was a rare occurrence (see further Bátiz-Lazo, 2006; Bátiz-Lazo and Billings, 2009). Societies in distressed were typically amalgamated with other larger-sized societies either at the initiative of the larger societies, the CRFS or the Building Societies Association (hereafter 'the Association').<sup>4</sup> In the twenty years that followed

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but in so far as this merely eliminated repetitive checks and led to a greater reliance on proper sampling and to emphasis on the importance of adequate internal control, the changes may well have been beneficial'.

<sup>3</sup> The ICAEW commented on BSA60 that: 'Subsection (4) of Section 45 places a positive duty on the auditors to carry out such investigations as will enable them to form an opinion on certain matters which they are not required to refer to in their report unless they form an adverse opinion. The absence of any comment in their report is therefore equivalent to a positive statement by the auditors that they have investigated and satisfied themselves on all the...matters' (ICAEW, 1960: 5).

<sup>4</sup> Note there is no systematic and detailed record of the 'population ecology' of building societies.

the passing of BSA60, orders were issued to intervene six societies<sup>5</sup> and fraudulent activities were found in two<sup>6</sup>. These were a tiny fraction of the 755 societies in existence in 1958 (with a sum of total assets equal to £2,407,956,000).<sup>7</sup> As exemplars of these processes we focus on and compare two cases of intervention: Lloyds Permanent and Eagle societies. Through the examination of their processes to reform the system of internal control following BSA60, this study purports to analyze how the improvement of the system of internal control affected the management and governance of these two societies.

The research is based on the examination of surviving records, including minutes, correspondence and other historical records of the individual building societies, HM Treasury, Chief Registrar of Friendly Societies (CRFS), Board of Trade, Institute of Chartered Accountants of England and Wales (ICAEW) and Building Societies Association (BSA), which also allows us to use the history of BSA60 to inform the current debate on the regulation of asset management (including internal control) of retail financial institutions by enriching our understanding of the systems of internal control of building societies. To assess the validity and reliability of the source materials, a heuristic method of qualitative research, i.e., data triangulation (the use of a variety of data sources for studying the same phenomenon) is adopted to minimize the bias introduced by a single source.

The remainder of the article proceeds as follows: the next section contextualizes this study by offering a brief history of building societies and reviews the background of the establishment of BSA60 by specifically focusing on the introduction of the regulation of the auditors in reporting on, and the directors in establishing, the systems of internal control. The subsequent two sections examine the process in which Lloyds Permanent and Eagle societies tried to reform their own systems of internal control following the regulations of BSA60. The final section offers a summary and some concluding remarks.

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<sup>5</sup> Lloyds Permanent (1960-1), Leeds Permanent (1962-4), London & Midland (1965-8), Eagle (1961-9), Law Mutual (1963-9), and West Bromwich (1968-70).

<sup>6</sup> Grays and Wakefield (both in 1976).

<sup>7</sup> Building Society Association Circular 664, page 4, table II. Also note that between 1952 and 1979 the number of societies consolidated from 796 to 287 (Davies, 1981: 27).

## **Building Societies and BSA60**

Building societies are *mutual* financial organisations owned by long term depositors and mortgage borrowers while specialising in liquidity creation by turning retail deposits into mortgage loans. The first society was formed in Birmingham in 1774, and societies soon began to spread out across the Midlands and the North of England in the second half of the 18th century to enable working and lower-middle class people to purchase or build their own homes. By 1825 there were at least 69 societies (Jeremy, 1998: 299). Their growth accelerated from the mid-19th century, following their transition from ‘terminating societies’ (that were disbanded after their original members had all made house purchases, the last of which was wound up in 1980) to permanent societies. By 1895, their number had grown to 3,642 (Jeremy, 1998: 299). But the number soon started to decline and this trend continued throughout the 20th century. By the end of 2003, only 63 remained (Coles, 2004).

In spite of the reduction in number, their asset size grew substantially. This was particularly the case during the interwar period (see further Humphries, 1987; Scott, 2008; Scott and Newton, forthcoming). Specifically, the share of building society advances had grown from 27 percent of total mortgage transactions in 1920, to 38 percent in 1936, and to 50 percent in 1958 (Cleary, 1965: 282). But the distribution of this growth within the individual business portfolio was unevenly distributed. For instance, by 1958 there were 755 societies, with a sum of total assets of £2,407,956,000.<sup>8</sup> The top five societies (0.66 percent of the total number of societies) held £1,029,108,000 in assets altogether, or 43 percent of the overall total for all societies.<sup>9</sup> Although most building societies remained small, provincial and deeply embedded in their local community during the 20th century, some became large and national, as represented by the formation of the Halifax in 1937, Abbey National and the Woolwich in 1948 and the Co-operative Permanent Building Society in 1952 (Davies, 1981: 87-8).

The development of building societies in the UK economy had, however, at intervals been plagued with fraud and scandals. Indeed, important regulatory innovations (including those dealing with financial disclosure) had been introduced following the demise of a building society (Drake, 1989: 90). For instance, the 1894 Act followed the collapse of the Liberator Building Society in 1892,<sup>10</sup> whereas the 1939 Act emerged

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<sup>8</sup> Building Societies Association Circular 664, page 4, table II.

<sup>9</sup> Building Societies Association Circular 664, page 4, table II.

<sup>10</sup> Accounting and auditing requirements for building societies dated to the Building Societies Act 1874,

from the publicity given to the 'Borders case'.<sup>11</sup> There was thus a long held view that the building society 'industry' was largely managed reactively rather than pro-actively. According to Vinten and Greening (2001: 205),

the features common to all the considered cases are the dominance of an individual over the building society's systems, and poor systems of internal control and supervision. In each case the auditors had failed to recognise the significance of these factors sufficiently. The external auditors could have used their influence far more effectively both to set up systems to prevent the possibility of fraud and also enforce systems and prevent individuals overriding controls.<sup>12</sup>

There were of course disclosure requirements for building societies to prevent the occurrence of such frauds and scandals: the origin of these regulations dated back to the Building Society Act 1894, which gave the CRFS powers to intervene in the affairs of societies and required full accounting disclosure and professional audits (Phillips, 1983: 4). There were also amendments in subsequent legislation (notably in the Building Societies Act 1940), but the 1894 Act remained the main statute regulating disclosure until changes were introduced through BSA60.

In June 1959, the State Building Society collapsed as a result of its directors making mortgage advances, without proper security, for bridging finance in take-over bids to a company in which the same directors also held board positions. This episode became known as the 'Jasper affair' and led to the expansion of the disclosure requirements in BSA60.<sup>13</sup> Indeed, the need for a response following the demise of the State Building Society reached the top echelons of British government, as revealed in the following report in *The Times* (28 September 1959: 14):

The Prime Minister has confirmed the appointment of a committee to review the Companies Act and the Chancellor of the Exchequer has said that good progress has been made in preparing new building society legislation. The Jasper affair has certainly underlined the importance of both moves.

Specifically referring to the case of the State Building Society, not only the Treasury and the CRFS but also the ICAEW, intending to bring building societies legislation 'up-to-date' (BT58/831) and taking 'similar lines to improvements made in company

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which required individual societies to specify the appointment of auditors and make audited financial statements available to members.

<sup>11</sup> 'Building Societies Bill', *Building Societies Gazette* (June, 1960: 452-3).

<sup>12</sup> Vinten and Greening (2001, 205) adds that '[t]here were also problems with their effective management...These problems were caused by a total lack of independent inspection, poor supervision and ineffective auditing'.

<sup>13</sup> Details of which were published in the Building Societies (Accounts) Regulations 1960 (S.I. 1960 No. 1826) and the Building Societies (Annual Return and Auditors' Report) Regulations 1960 (S.I. 1960 No. 1827).

law' (BT58/831),<sup>14</sup> stressed the need for 'adequate disclosure of the use made of [individual society's] funds and the state of its affairs'.<sup>15</sup> As a result, the 'true and fair requirement' was introduced to be applied to building societies as well as companies.<sup>16</sup> The auditors' report was also now required to contain statement whether in the auditors' opinion the annual accounts gave the true and fair view required by the Act.

In a parallel development, the ICAEW also attempted to modernise the societies' audit procedure by emphasising that '[they] should be required by statute to keep proper books of account...including the need to maintain proper records of and control over the mortgage deeds and other assets'.<sup>17</sup> In particular, they regarded the original requirement for annual inspection of *each and every* mortgage deed by the auditors, rather than directors, as 'totally out of accord with modern methods of auditing' and 'not in fact properly carried out at present' (T233/1652). For them, 'the correct method was for the Directors to be required to establish a proper system of control over the mortgage deeds, and for the auditors to have to examine that control to see that it was effective and to carry out *sample* checks' (T233/1652, *emphasis added*).

The state authorities, represented by the Treasury and the CRFS, were on the other hand keen to maintain the *status quo* and attached a greater importance to the auditors' 'paternalistic' duty to safeguard the financial assets of building societies on behalf of depositors and savers. Although they, though reluctantly, conceded to the accountants' position, it was not a unilateral concession: in exchange for abandoning the requirement to inspect *each and every* mortgage deed by the auditors, the state authorities insisted that the auditors should perform the alternative duty of reporting on the nature and quality of internal control of building societies.

A further important novelty introduced by BSA60 were sections 6 and 7 (later sections 48 and 51 of the Building Societies Act 1962). These enabled the CRFS to influence the running of individual societies by limiting the marketing and/or acceptance of any new deposits as well as advancing any new loans. As indicated in the case studies below,

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<sup>14</sup> Representing the views of building societies, R. Cowling, Director and Deputy General Manager of Leeds Permanent Society, a member of the Association's Council, and Chairman of the Yorkshire County Association of Building Societies, stated that '[t]he draftsmen of the Bill, no doubt receiving their brief from Government's advisors, seem to have been determined that as far as possible the provisions of the Companies Acts should apply to building societies'. He added that 'It was not easy to convince the negotiations, or Parliament, that the operations of a building society were in many respects far removed from those of a limited liability company' (*Building Societies Gazette*, December 1960: 996).

<sup>15</sup> P&L Committee Minutes Book: I: 25.

<sup>16</sup> P&L Committee Minutes Book: I: 26.

<sup>17</sup> P&L Committee Minutes Book: I: 27.

these new powers played an important role in shaping the societies' system of internal control when authorities moved to intervene based on limited information and doubts about the adequacy of internal controls at society already having some financial difficulties while, as a result, they exposed frauds and scandals.

### **Lloyds Permanent Building Society**

The investigation concerning Lloyds Permanent Building Society<sup>18</sup> started with the following letter dated 24 October 1960 from the CRFS, Sir Cecil Crabbe, to E. W. Maude at the Treasury:

My attention has been drawn by various parties to circulars issued by the above society to prospective investors in reference to investment facilities in an associated company – Freehold Land Finance Company Limited. As you know, an order was made in respect of this society under section 11 of the Prevention of Fraud (Investments) Act, 1958,<sup>19</sup> on 6th April last forbidding the society or anyone on its behalf from inviting subscriptions to the society's capital. I am at present having further enquiries made under section 8 of the Building Societies Act, 1960,<sup>20</sup> for the purpose of enabling me to consider whether an order forbidding the acceptance of any share or loan money by the society should now be made under section 6 of that Act. (T326/17)

According to the Crabbe, 'the directors of this society have found a way round the restrictive provisions relating to building societies whilst at the same time continuing to take advantage of the "building society" appeal to the general public' (T326/17) by utilizing the disguise of a private finance company called 'Freehold Land Finance Company Limited'. Indeed, in the circular issued in September 1960 to the general public, Robert Jones, the common director of both Lloyds Permanent Building Society and Freehold Land Finance Co. Ltd., stated that '[a]lthough the basis of the Company's

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<sup>18</sup> The society was incorporated in 1954 and its assets totaled over £4 million in 1960.

<sup>19</sup> Subsection (1) of Section 11 of the Prevention of Fraud (Investments) Act, 1958 provided that '[i]f, with respect to any building society, the registrar to building considers it expedient so to do in the interests of persons who have invested or deposited or may invest or deposit money with the society, he may by an order made with the approval of the Treasury direct that, unless and until the order is revoked, no invitation to subscribe for, or to acquire or offer to acquire, securities or to lend or deposit money shall be made by or on behalf of the society'. The CRFS had made an Order under Section 11 prohibiting Lloyds Permanent Building Society from advertising for further investments. The principal grounds on which the decision to make the Order was done included: (1) The unsatisfactory reserve position in relation to the total assets of the society and (2) Inadequacy of security for the advances in respect of the 'Oak Farm' properties, resulting in a position of potential loss which would jeopardise the society's solvency.

<sup>20</sup> Subsection (1) of Section 8 of the Building Societies Act, 1960 provided that '[t]he Chief Registrar may at any time serve a notice on a building society, or any person who has in his possession or under his control any books, accounts, deeds or other documents relating to the business of the building society, requiring the building society or other person to produce to the Chief Registrar such of them as he considers necessary for the exercise of the powers which he has under the two last foregoing sections'.

policy is investment in Freehold property, thus enabling the maximum possible security, its constitution permits it to invest on more favourable basis than those enjoyed by a Building Society, and this advantage is transacted in the more attractive rates of interest secured to depositors' (T326/17). As to the association of the finance company with the building society, Crabbe in his letter dated 2 November 1960 addressed to Maude further added that '[t]his is a most disturbing development of which...we had been aware for some time' (T326/17).<sup>21</sup>

Since the date of the order under section 11 of the Prevention of Fraud (Investments) Act, 1958, Lloyds Permanent had received withdrawal notices for shares totalling £982,227; the repayments totalled £612,944, leaving £369,283 still to be repaid.<sup>22</sup> Nevertheless, the society had continued to receive substantial amounts as new investments. Crabbe's letter dated 2 November 1960 described the activities of the Lloyds Permanent along the lines of a 'ponzi scheme', namely that '...current investments are being used to repay prior applications for withdrawals and the new investments will be subject to a long delay, which would not be anticipated from reading the brochure, if application for withdrawal is made.' (T326/17). Crabbe followed on by requesting permission to intervene and proposing to take immediate action by issuing a formal notice under subsection 2, section 6 of BSA60. Maude's reply, after the consultation of J. M. Bridgeman at Treasury, expressed in his letter dated 11 November 1960 to Crabbe, was that he 'would be prepared to recommend in due course that Treasury consent should be given to such order' (T326/17).

Accordingly, a notice dated 17 November 1960 was issued by Crabbe to the Lloyds Permanent. Besides raising concerns regarding new investments and repayments above mentioned, Crabbe's notice also mentioned the following relevant points which, in turn, go on to show a wider range of concerns at the CRFS with the running of this society:

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3. Advances on mortgage by the society to the Chairman of the Board of Directors whilst applications for withdrawals of shares were still outstanding.

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<sup>21</sup> According to a note of a meeting held on 31 January 1961 within the Board of Trade, concerning the connection between Lloyds Permanent Building Society and Freehold Land Finance Co., Ltd., the Board itself recognised that '[t]he relationship between the Building Society and the Freehold Land Finance Co., Ltd. ('the company') appears to have been that when it became clear to Jones that the Building Society could no longer operate he decided to carry on by means of the Company' (BT58/1130).

<sup>22</sup> The society maintained a rota for repayment in order of date of application of withdrawal, to which, however, there were exceptions in certain 'hardship' cases (T326/17). Furthermore, the society in its casual explanation provided to prospective investors stated that it was the normal practice to pay withdrawals on demand, but under the society's formal rules, it was entitled to require six months notice of withdrawal. This rule had been made clear in its prospectuses for 'investment' and 'term' shares but not in the prospectuses for 'contract' and 'savings' shares.

4. Use of the society's premise and office facilities by Freehold Land Finance Company Limited without definite and satisfactory financial arrangements.
5. Inattention to the affairs of the society by the Board of Directors whose meetings have been held only quarterly since an order was made under section 11 of the Prevention of Fraud (Investments) Act, 1958.
6. Unauthorised disbursement of £6,530 purporting to be director's fees to the Chairman of the Board of Directors.
7. Low ratio of the reserves to the total assets of the society.
8. Adverse result of the society's operations during the current year resulting in an estimated loss of £20,000 for the period 1st January 1960 to the 30th June 1960 with an estimated further loss since that date. (T326/17)

The society was allowed fourteen days to respond but in fact did not submitted any communication (either orally or in writing), with the result that Crabbe asked for the Treasury's approval to make a formal order. Based on this request, Maude prepared a memorandum dated 6 December 1960, to press the approval of the Treasury, in which he pointed out that the society was 'almost entirely under the personal control of one man – Mr. Jones':

Mr. Jones has done his best to escape the consequences of the Chief Registrar's Order by developing a company called the Freehold Land Finance Company. This operates under the same management and in the same premises as Lloyds Permanent Building Society, and solicits deposits from the public, offering a high rate of interest (7% tax paid, equivalent to 11½% grossed up at the standard rate). Despite warning to investors in the press, Mr. Jones has had some success in persuading shareholders who withdraw funds from the building society to re-invest them in the finance company...There can be no shadow of doubt that this is not a Society which can properly be allowed to receive funds from the public... (T326/17)

The Treasury approved for the CRFS to issue a formal order on 12 December 1960. Crabbe then attended an interview with Mr. Roe, Assistant Secretary of Lloyds Permanent, on 10 January 1961. During the meeting Roe intimated that 'Mr. Jones...had...intended to "run down" the society and replace it by the Freehold Land Finance Company' (T326/17) and 'in pursuance of this object it was Jones's declared intention to transfer the capital assets (office premises, equipment etc.) to the finance company' (T326/17). It is also recorded that Roe's suggested that 'the only remedy for the present state of affairs would be to call a meeting of the members with a view to the replacement of Jones and the other members of the Board of Directors' (T326/17).

The interview seems to have had some effect on Crabbe as in his letter dated 17 January 1961 to Lloyds Permanent, he proposed not only to appoint an inspector to examine and report on the affairs of the society but also to call a special meeting.<sup>23</sup> But later in his letter dated 3 February 1961 to Maude, Crabbe clarified his intention to 'defer calling

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<sup>23</sup> Under section 5 of the Building Societies Act, 1894 and section 13 of BSA60, where the CRFS is of opinion that an investigation should be made into the affairs of a building society the Registrar may, with the consent of the Treasury, appoint an Inspector to examine and report on the affairs of the society. Lloyds Permanent Building Society had failed to hold a general meeting since the end of 1959.

the special meeting for a week or two in order to enable the inspector as a matter of urgency to make an interim report which could be available to members before the meeting is held' (T326/17). Accordingly, he appointed as inspector the CRFS's Executive Registrar, Dennis Leigh, O.B.E.

Shortly after, in a letter dated 26 January 1961 to the CRFS, two directors of Lloyds Permanent, J. I. Jones and B. M. Jones, informed that at a meeting of the society's directors held on 25 January, it was decided to remove Robert Jones from his office as Chairman, Director and Secretary of the society on the grounds of his refusal and neglect to act (T326/17). The letter continued to add the directors' aim to reconstruct the Board (subject to approval of the CRFS and a general meeting of members) and the following administrative measures:

- a. To impose an immediate freeze of the funds of the Society.
- b. Reduction of the staff to a minimum necessary to carry on the routine business.
- c. Disposal of the Society's Branch premises.
- d. Negotiation for the transfer of some of the Mortgages, subject to the Registrar's approval. These latter two in order to meet the current withdrawal position.
- e. Subject to the revision of the financial position and to further discussions with the Auditors, to come to a satisfactory arrangement with the Members regarding the interest commitment in June 1961. (T326/17)

The disposal of retail branches was noteworthy at a time of heighten expansion by most societies (see further Batiz-Lazo, 2006; Batiz-Lazo and Billings, 2009; Davies, 1980). The proposed reduction of staff was surprising and practically unheard-of as rarely did a society engaged in such a practice, even after amalgamation there was an attempt to preserve members and staff.

In an additional letter dated 31 January 1961, the two directors reinstated the decision to dismiss Robert Jones but also that Ernest Partridge, C.B.E., M.P., had accepted to join their Board (T326/17). Crabbe and Leigh then interviewed Partridge on 1 February 1961. In the record of this meeting Partridge confirmed that a Board meeting had been called for 6 February as a result of which Robert Jones would be removed while he and 'two other persons of good standing' were to be appointed with '[t]he ultimate aim ... to put the society in such a position that it would confidently apply to the Chief Registrar to revoke the order under section 6 of the building Societies Act, 1960...' (T326/17). Partridge also stated that 'he and his colleagues on the Board would apply themselves assiduously to the task of restoring administrative order in the society' (T326/17).<sup>24</sup>

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<sup>24</sup> Indeed, in an announcement made by Partridge to the members of the society dated 17 February 1961, he stated that '[t]he new Board has decided that in its future policies and practices it will faithfully follow the regulations and recommendations laid down by the Building Societies Association, although the Society is not yet a member of that body' (T326/17).

The appointment of Partridge as the new Chairman of Lloyds Permanent was a revelation to the Treasury. This became evident in a note Maude sent to the Economic Secretary dated 23 February 1961:

It was perhaps rather surprising that Mr. Partridge should have thought it appropriate to involve himself with this unsavoury institution at a moment when he knew an Inspector was to be appointed, particularly as he can claim no experience of building society affairs...My personal view is that Mr. Partridge would be well advised to remain on the Board long enough to find some independent and reputable people to take over and then to clear out. But it sounds as if he may have visions of carrying out a rescue operation on the same sort of lines as Lord Reith in the State Building Society. (T326/17)

Nevertheless, a special meeting was held on 28 March upon which Partridge, Air Chief Marshall Sir Hugh Lloyd, G.B.E., K.C.B., M.C., D.F.C., Victor Brooks and William W. Harris, O.B.E., J.P. were appointed as directors with the full support of the society's membership. Later on the Board appointed M. K. Simons, a former official of the Co-operative Permanent Building Society, as assistant secretary 'with the special task of mortgage administration'.<sup>25</sup> During this meeting Partridge made no secret of his criticisms towards the administrative policy of the previous management team:

There was little or no control of the borrowers' accounts in the latter part of 1960 owing to a complete lack of direction by the former management, and the arrears situation was, for this reason, not receiving the careful and constant attention which such a matter demands. (T326/17)

Statutory capital and liquidity requirements were first imposed on the societies (and indeed in any UK financial intermediary) in 1959 (see further Bátiz-Lazo, 2006; Bátiz-Lazo and Billings, 2009). Thus the bad administration leading to weak reserves would be a concern to the new directors and officials at the CFRS and the Treasury. According to estimates by the CRFS, the total general reserves at the end of 1960 for all of the British building societies were equivalent to 5 per cent of mortgage assets (T326/17). However, the total reserves (including the 'Mortgage Reserve' of £10,000) at Lloyds Permanent Building Society as shown in the audited balance sheet as at 31 December 1960, amounted to only £21,370 or 0.65 per cent of the mortgage assets (T326/17).

As noted by Partridge, there were two important factors affecting capital adequacy at the Lloyds Permanent, first, the ability of the borrower to repay their mortgages and, second, the poor valuation of assets set as collateral.

The interim Inspector's Report by Leigh also noted that little or no attempt was made under the direction of the previous board to monitor or confirm the financial position of borrowers. The assessment of the borrowers' ability to repay the mortgage was, in his

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<sup>25</sup> Prior to Simmons taking office a part-time appointment was made of the assistant general manager of the Abbey National Building Society.

view, based solely on the particulars given in the initial application, without any further verification. At the end of 1960, of the 1,181 mortgages outstanding, repayments were in arrear in no less than 223 (19%) cases, of which 150 were more than two months in arrears. For the results, Leigh concluded that '[t]here is little doubt that many of the arrears cases would not have arisen if prompt action had been taken to remind borrowers of their obligations' (T326/17). The same interim report also pointed to the fairly generous valuation of dwellings as collateral for loans. The report expected a significant amount of time would be required to build up the amount of reserves from income to a reasonable level.

The report of the Lloyds Permanent's auditors, Calder-Marshall, Ibotson & Bound, dated 2 June 1961 for the period ending on 31 December 1960, also noted the generosity in the advances with the regard to the value of the property, the poor investigation as to the financial circumstances of borrowers prior to making the loan and specifically pointed out that 'the Society did not maintain a satisfactory system of control over its transactions and records', which led them to and concluded that 'it failed to maintain a system of control and inspection of its books of account' (T326/17).

The final report by Leigh was dated 18 October 1961. Based on it, J. Macpherson at the Treasury wrote to the Economic Secretary on 23 February 1961, and commented that 'the new board have taken steps to improve the financial position of the society, selling most of the offices, and reducing retrospectively the rate of interest on shares..' (T326/17).

Indeed, the final report by Leigh noted that 'Mr. Partridge's stated aim is to keep the Society in existence and to build it up until it can achieve trustee status<sup>26</sup>...' (T326/17). However, state authorities were not convinced on the desirability of keeping the Lloyds Permanent as a going concern. This was evident in the same communication by Macpherson, who noted his reservation as in spite of actions by the new directors 'there still might be an eventual loss to shareholders' (T326/17). It was also similar evidence in the final report by Leigh, where he stated that '...investors would probably be able to

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<sup>26</sup> Following the enactment of the Housing and House Purchase Act 1959 (HHPA59), societies gained two forms of government recognition: their deposits became authorized 'trustee investments' and building societies became entitled, for the first time in their long history, to borrow from H. M. Government. 'Trustee investment status' was first sought by societies for investments in their 'shares' and deposits in the mid-1920s (Humphries, 1987, p. 335). Without it, trustees, including executors of estates of the deceased, were unable to invest in building societies in the absence of specific directions. Societies believed that this status would give them a competitive advantage and increase their loanable resources but it rapidly turned into 'a seal of respectability' (Boléat, 1981, p. 32). See further Bátiz-Lazo (2006) and Bátiz-Lazo and Billings (forthcoming).

get their money back earlier if it were built up to the stage at which a major society was prepared to accept a transfer of engagements' (T326/17).

To continue trading the Lloyds Permanent first had to deal with the orders issued by the CRFS. To revoke them it was necessary to demonstrate that assets were fully secured and reserves were adequate. This had to be to the satisfaction of the CRFS. To this end, the society's mortgage and investment policies, including the system of control, had to conform to the 'generally recognised standards' as set by practice in the larger and well-established societies. Hence the appointment of officers with experience in the management of larger societies (namely Simons).

The new management team led by Partridge then set to the task of improving the system of control of the borrowers' accounts and, according to his assessment, it was anticipated that the number of cases in arrear would be reduced by the stricter control (T326/17). In a letter dated 7 May 1962, Partridge wrote to the CRFS arguing progress had been made and hoping the CRFS would entertain the revocation of the orders:

...during the period of lax control under the previous direction, especially 1958/60, a number of borrowers had acquired the habit of missing, from time to time, a monthly payment and in a subsequent month making a double payment. From February 1961 the administration was progressively tightened and as a result of the continuous systematic mortgage administration from 1st September 1961 the area in which this disconcerting habit amongst borrowers is practised, has been materially lessened.

A memorandum attached to the letter, further emphasised the progress made in the systems for mortgage control (which had been implemented by himself and Simons). Under the heading of 'Proper control', Partridge stated that:

On the 1st September he initiated a complete overhaul of the mortgage department and thereafter systematic administration has been carried out in the manner practised by all sound building societies. [As a] result, the ratio of accounts more than one month in arrear has been reduced [from 13% in August 1961] to a figure of 9%, and is improving monthly' (T326/17).<sup>27</sup>

The reserve ratio also increased rapidly, reaching £86,675 or 3% of mortgage assets. This improvement was highlighted in the Directors' Report dated 23 March 1962 (for the accounts of the period ending on 31 December 1961):

By introducing a policy of strict supervision of the mortgage accounts steady progress is being maintained in reducing the amount of arrears on mortgage repayments. The Directors confidently believe that with a continuance of careful and constant administration the mortgages generally will prove to be as secure as those of any other reputable building society. (T326/17)

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<sup>27</sup> Partridge added that '[t]he Board has consistently expressed the view that the mortgage securities are fundamentally sound and nine months' close contact and detailed supervision by an expert has served to confirm that view. The Board contends that, so long as normal systematic mortgage administration is continued, and it is intended that it shall be, the Society's mortgages will prove as satisfactory as those of any other sound building society' (T326/17).

The improvement in the system of internal control also led the auditors, Calder-Marshall, Ibotson & Bound, to remove all of the comments made in the previous period regarding the internal control system of the society.

Crabbe also recognised significant improvements in reducing losses and enhancing the solvency of the society. However, against Partridge's expectation, the CRFS decline to revoke the order '... until those members who wished to withdraw their share monies had been fully satisfied' (T326/17). Crabbe continued to think of the desirability of transferring the engagements of Lloyds Permanent to other society, as recommended by Leigh in his final report. This was clearly stated in Crabbe's letter dated 23 May 1962 addressed to Macpherson at the Treasury:

'My own feelings about this society have tended to favour the solution towards which the Inspector leaned in his final report, viz. a transfer of engagements...I discussed this question with Mr. Partridge who told me that he had sounded three other building societies through Parliamentary colleagues with regard to the prospects of a take-over, namely the Temperance (Sir Cyril Black, M.P.), the Abbey National (Sir Herbert Butcher, M.P.) and the Portman (Sir Wavell Wakefield, M.P.). As he understood the response, Mr. Partridge said, none of these societies was prepared to give favourable consideration to such a proposition in present circumstances, all of them taking the view that in the present excessive demand for mortgage advances it would not be fair to divert moneys intended to be lent out to prospective house purchasers to meeting the claims of investing members of Lloyds Permanent Building Society...[but] I could not believe that societies of the standing of those mentioned by Mr. Partridge seriously contemplated that they would be faced with a demand for the withdrawal of more than a small proportion of the investments of Lloyds shareholders... (T326/17).

Crabbe's scepticism was somewhat well founded as it was common practice for larger, more liquid societies to rescue those in distress. At the same time, Crabbe's chief reason to keep the order in place was that he was not entirely convinced that 'the present direction of the society has sufficient experience to run a society of this size successfully in circumstances where appeals for public investment might well be made on a large scale' (T326/17). Accordingly, in his letter dated 5 June 1962 addressed to Partridge, Crabbe informed him that he came 'to the conclusion that it would be premature to revoke the orders at the present time' (T326/17).

Partridge tried once more to persuade the CRFS to revoke the orders in October 1962. But, even though recognising that 'much has been done towards putting the affairs of the society on a proper basis and to improving its financial position' (T326/227), Crabbe again refused to revoke the orders. In his letter dated 13 November 1962 addressed to Partridge, the CRFS continued to question the liquidity of the society as to allow investors freely to withdraw their investments; and 'whether losses to the investors would not arise as a result of possible future arrears and subsequent forced sales of properties in mortgage to the society' (T326/227).

The request for revocation of the orders was finally accepted on April 1963. As Crabbe explained in his letter dated 1 April 1963 addressed to J. I. Mck. Rhodes at the Treasury was that '[t]he overall control of the society is in a board whose members have a reputation to loose and who though not widely experienced in building society matters have shown ability to deal with the problems facing it' (T326/227). Crabbe continued and summarized the improvements made at Lloyds Permanent Building Society as follows:

...the Society's administration was overhauled and effective control of its affairs set up; steps were taken to obtain repayment of advances secured on speculative property...and investors, many of whom had unsuccessfully applied for the return of their investments, were given a regular supply of information about the Society's progress...Mr. Partridge's undoubted energy in the Society's interest has operated to its advantages with the result that the Society's financial soundness is now no longer open to question. (T326/227)

Accordingly, J. I. Mck. Rhodes at the Treasury reported in his notice to the Economic Secretary dated 4 April 1963 that '[t]he Chief Registrar is satisfied that under the present Chairman and board this satisfactory position will continue, that investors' funds are now adequately secured and that the society will continue to be able to meet any withdrawals from its liquid funds' (T326/227). The two orders made on Lloyds Permanent Building Society were finally revoked on 9 April 1963.

### **Eagle and Law Mutual Building Societies**

The investigation concerning Eagle Building Society started with the following letter dated 24 January 1961 from Crabbe to Maude at the Treasury:

This society has caused me concern ever since it was registered. It has conducted a widespread press and postal publicity campaign paid for to a large extent by the chairman, who is himself a dealer in the property market. He also has a criminal record as you will see from the report. It would have been very difficult in the earlier years of the society's experience to have established evidence of insolvency or potential insolvency but the whole 'set-up' has been and is very unsavoury and could lead to an alarming situation if the Chairman discontinues his subsidies to the society. (T326/849)

Crabbe expressed his intention to make an order to the society under section 7 (1) of BSA60 and proposed to issue an appropriate notice under subsection (3)<sup>28</sup> based on the following considerations:

1. Inadequate reserve ratio;

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<sup>28</sup> Subsection (3) (a) of Section 7 of BSA60 provided that '[n]ot less than one week before giving a direction under this section...with respect to any building society, the Chief Registrar shall serve on the building society a notice stating that he proposes to give the direction and specifying the considerations which have led him to conclude that it would be in the interests of persons who may invest or deposit money with the building society to give the direction'.

2. Dependence of the society for defrayment of a large part of its management expenses on subsidies from the Chairman of the Board of Directors;
3. Virtual control of the society by the Chairman, who is associated with companies to which large advances have been made and who has himself received substantial advances;
4. Unsatisfactory financial arrangements for the provision of staff and office services by a company with which the Chairman is associated;
5. Arrangement of mortgages on terms that have avoided disclosure of total amounts advanced on single properties or to single mortgagors;
6. Doubtful adequacy of security in respect of certain advances. (T326/849)

The ‘set-up’ that Crabbe referred to was explained in a note dated 14 February 1961 prepared by A. Guthrie at the Treasury as the mortgager policy in which the advances were ‘made not to a large number of comparatively modest owner occupiers but to limited liability companies planning to develop the properties concerned as hotels or flats’ (T326/849). This policy was regarded as objectionable because ‘it represents speculative investment rather than the comparatively secure business of helping people to pay for their homes’ (T326/849). Indeed, until reforms passed on in 1896, both the spirit and the letter of the law limited building societies to deal with personal customers and home dwellings, while other institutions (such as insurance companies) helped to finance the purchases for commercial purposes (see further Scott, 2008).

The case of the Eagle was further complicated because the directorships of various companies, including S. A. Halsall, the chairman of the society, ‘were interlocked too closely’ (T326/849). The situation was explained more in detail in the note under the heading of ‘Control of Society by Chairman and involvement with his other companies’ as follows:

It seems clear the Society is in effect run by Mr. S.A. Halsall for the benefit of his personal transactions and those of the other property companies with which he is associated...a large part of the Society’s dealings are with companies directly controlled by Halsall or else controlled by his associates...The Eagle has also had dealings with companies whose directors were either on the Board of the Eagle, or were co-directors with Halsall on some other Boards. In another case Halsall and a co-director of his replaced the previous directors of a company the year after the Eagle had made substantial advances to it... (T326/849)<sup>29</sup>

In this situation the security of mortgages was regarded as doubtful because ‘most of them are in the hands of individuals and companies who interconnect a great deal too closely’ (T326/849) and because ‘its mortgages are too large, too few and concentrated in too few hands’ (T326/849). The society was further accused of ‘lending money to speculative builders, providing mortgages in order that people could buy property that the directors were interested in, lending on tenant occupied terrace

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<sup>29</sup> According to J. M. Bridgeman at the Treasury, the case of Eagle Building Society was regarded as that: ‘[t]his is another case where a Building Society has become closely involved with a Finance Company. I fear that there is a definite risk in this case of the position going sour and there being a repetition of Lloyds case’ (T326/849).

accommodation...lending without proper mortgages, grossly overestimating the value of properties, exorbitant administrative expenses and so on' (T326/849).

In his letter dated 23 February 1961 addressed to Crabbe, Maude agreed that 'the position of this Society [was] most unsatisfactory' (T326/849) and that the Treasury 'would certainly concur in your issuing notice of your intention to make a discretion' (T326/849).<sup>30</sup> However, on 2 March 1961 Crabbe informed Maude that the directors of the Law Mutual Building Society were in the process of negotiating a merger with the Eagle and as a result replacing the Eagle's Board with their own (T326/849).

The CRFS disregarded the negotiation and issued to the Eagle a notice to give an order under section 7 (1) of the BSA60 on 10 March 1961. In responding to the notice, Halsall in his letter dated 15 March 1961, reminded Crabbe of ensuing negotiating and pleaded for the Eagle to continue advertising. This plea was once again disregarded. The CRFS pressed on and issued the order, with the consent from the Treasury, on 23 March 1961.

Shortly after and as planned, the directors of the Law Mutual took over the Board of the Eagle. Formally, the two societies existed as separate entities but in fact they were run as one. Little distinction was made between them for management purposes and thus 'expenses were adjusted not so much in relation to who incurred them as to who can best bear them' (T326/849). However, even with this merger, the order made by Crabbe to Eagle remained effective.

The situation worsened for the amalgamated societies on 10 December 1963, when the new CRFS, S. D. Mussen, wrote to J. I. McK. Rhodes at the Treasury asking for permission to issue an order for the Law Mutual under section 48 of the Building Societies Act 1962 (previously section 6 of BSA60) 'so as to stop the society from taking further investments.' (T326/849). The main considerations which led Mussen to this conclusion were: (1) insufficient reserves on mortgage assets and (2) insufficient liquid funds. In particular, Mussen described the poor mortgage administration policy as follows:

...The reality of this risk is further to be judged by reference to (1) the arrears of repayments which the society is already experiencing (19 out of 182), (2) the general absence of personal security factor, in so far as that society has not thought fit to enquire into the borrower's income and appears to rely for repayments in some cases on accommodation in the mortgaged properties being let, and (3) the fact that the numerous properties which are either wholly or partly let will not necessarily maintain their value. (T326/849)

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<sup>30</sup> Maude added that 'this society was potentially in a very dangerous position and...the situation might well degenerate very rapidly as it has done in the case of Lloyds Permanent Building Society' (T326/849).

The society was also accused as follows: '[s]ince 1960 not less than one-seventh and perhaps as much as one half of all the society's advances have been made either to finance sales of properties by certain companies whose directors are directly or indirectly associated with the directors of the society or to those companies or their depositors themselves' (T326/850).

Rhodes confirmed Mussen's request in a letter dated 24 December 1963, but he also suggested for Mussen to apply section 51 (equivalent to section 7 of BSA60) rather than section 48, because the Treasury considered that an order prohibiting the acceptance of investment 'would be justified only if there was a real risk of the Society's insolvency' (T326/850). In this connection, the Treasury wanted it to be sure that 'the 39 properties valued by the District Valuer should have been a true sample of the Society's 182 mortgaged properties, rather than merely a selection of the bad causes' (T326/850). Mussen agreed to the suggestion and accordingly issued a notice of intention to make a direction under section 51 was issued to Law Mutual Building Society on 14 April 1964, quoting with the following grounds for the action:

- (1) the affairs of the society have been conducted without due regard to the interests of investors;
- (2) mortgage debts owing to the society are inadequately secured;
- (3) reserves of the society are substantially lower than the interests of investors demand;
- (4) insufficient liquid funds are and have been maintained by the society;
- (5) liquid funds were deliberately increased for a brief period at the end of June and December 1962 so that the society's accounts for the period ending on the 30th June and 31st December 1962 could conceal the insufficient liquid funds normally maintained;
- (6) advertisements issued by the society contain false statements as to (i) the properties taken as security for advances and (ii) borrowers... (T326/850)

In responding to the notice, A. T. Pepperell, Executive Director of Law Mutual, made the following allegations in his letter dated 16 April 1964 to Mussen:

Every property in mortgage to the Society has been, or is in course of inspection...It is the Society's policy to re-inspect every property in mortgage every two years...The Society makes an initial status enquiry upon receipt of an application for mortgage when it considers this to be necessary. After a mortgage has been granted, it has not been policy to make further periodic status enquiries but, in the case of arrears, positive action is taken...During the twelve months that the current investigation has been taking place, the Directors would, at any time, have been glad to have amended or improved the administrative policy of the Society on receiving guidance from you. The future of the Society is gravely prejudiced by the action which is contemplated and the Directors will do everything possible to conform to the standards required. (T326/850)

In his letter dated 1 May 1964 to Mussen, Pepperell informed him that the following actions had been taken by the board of the society:

1. Except where commitments have already been entered into, no advances will be made until liquidity has reached a minimum of 10%;
2. Thereafter, no advance will be made which would have the effect of reducing liquidity below 10%;

3. Advances will only be made to borrowers who intend to occupy the property;
4. On no account whatsoever will advances be made to builders or developers ever on a temporary basis; and
5. Programmed inspections will be speeded up as much as possible. (T326/850)

However, Mussen was not satisfied. An investigation by the CRFS's staff found no evidence in support of the society's alleged practice regarding the inspection of mortgaged properties and thus, Mussen considered that the society's statement conflicted with the information elicited by the investigation (T326/850). He made his feelings clear when writing to Rhodes on 4 May 1964 while requesting the Treasury's consent to make the order:

There was no doubt in my mind that advances on a considerable scale were being made continually to property speculators and builders in South Wales. It is possibly true that the money was being turned over again and again on different property and the total amounts became exaggerated. It was really in the nature of temporary finance as and when required, but from the point of view of the society's investors it could not be regarded as proper security or orthodox building society lending. The running of the society was kept very much in the hands of Mr. Pepperell who I felt was entirely out for himself, a man of small ability and with very few principles. (T326/850)

The Treasury's consent came on 7 May 1964. The society was not only prohibited from 'issuing advertisements in any medium inviting business or making known the activities of the society' (T326/850) but also required 'to take all practical steps to withdraw any advertisement inviting business or making known the activities of the society which is on display in any place' (T326/850). The CRFS then kept close watch on the society's affairs and even interviewed the directors on a number of occasions.

However, the situation further deteriorated. In a letter dated 18 July 1967 from Mussen to R. T. Armstrong at the Treasury, the CRFS asked for consent to serve a notice of intention under section 48 (1) of BSA62 to both of Law Mutual and Eagle building societies. Mussen now regarded the two societies as 'indistinguishable administratively having the same directors, staff and office' (T326/849). But of greater concern and in the absence of any guidelines in BSA60 for a 'lender of last resort' for building societies, was the potential for financial losses:

As with the Eagle, the essence of the case against this society is that a large proportion of its outstanding advances are secured on properties of less value than the advance, the total difference in those cases being £41,932. At 31st December 1966 the society had reserves of £8,664 and a provision for anticipated losses of £1,800. Taking this into account the net total possible losses on these mortgages against which there is no reserve is £31,000, involving a possible loss of 6% of shareholders funds.....It seems inevitable therefore that in the course of time and even if the debts outside South Wales are fully recovered losses will turn out to be in excess of the society's reserves and the investors will suffer some loss. In these circumstances the society should clearly be stopped from taking further investments. (T326/849)

The Treasury agreed on 21 July 1967 and the notice of intention was issued by the CRFS to the two societies on 25 July 1967. The two societies then made oral

representations to the CRFS on 15 August and again on 5 October 1967. On 24 October 1967, Mussen informed Armstrong of these meetings and that the societies had promised to stop taking deposits and making new advances. For Mussen these actions were equivalent to the effects of the proposed order and in light of them the CRFS had decided to postpone implementing the order for six months (T326/849).

Mussen was of the view that, if kept to their promises, 'the societies will gradually run down' (T326/849). He aimed '...to get rid of these two societies with as little publicity as possible as they have never been a credit to the Building Society movement' (T326/849). For the same reason, he also entertained a transfer of the engagements of the two societies to a third (undisclosed) society. The Treasury agreed to the CRFS' plan on 30 October 1967.

By the end of 1967, the chairman and the board of director of both societies had resigned. The new directors accepted to maintain the course of action previously agreed with the CRFS. Under new management both societies made some progress by disposing of the mortgaged properties whose valuations had given rise to concerns about the security of the members' investments.

But, as far as its discernible from his letter dated 27 May 1969 to Armstrong, Mussen was still not satisfied with the progress made. In the letter he stated that: '[j]udging by results so far the new directors of the societies have performed a useful service, but I have never been entirely happy about the circumstances in which they took over or their motives for so doing' (T326/849).

The Treasury's assessment of the situation was more critical than that of the CRFS. A note prepared by D. M. Thompson dated 25 June 1969, pointed to the need of a more thorough examination of the business of the two societies as soon as possible (T326/849). R. J. Painter informed the CRFS of the Treasury's views in a letter dated 27 June 1969. This view seems to have prevailed. Ultimately the orders were not lifted until the 1970's while the societies were run down 'with as little publicity as possible'.

## **Discussion and Conclusion**

This article documents evidence of how the system of internal control was improved within individual societies following BSA60 and how the introduction of this new regulation affected the management of two societies. By so doing this study purports to enrich our understanding of the systems of internal control of building societies so that the history of BSA60 heralded in this study contributes to inform the current debate on

the regulation of asset management (including internal control) of retail financial institutions.

There were important common features in the two cases examined in this study. Both cases started with the investigations by the CRFS under section 11 of the Prevention of Fraud (Investments) Act, 1958 and then proceeded to the CRFS making orders under the regulation of BSA60, i.e. the order under section 6 forbidding the acceptance of any share or loan money given to Lloyds Permanent Building Society in December 1960 and the one under section 7 prohibiting the issue of any advertisements inviting business given to Eagle Building Society in March 1961. In the latter case, the CRFS had at the stage of July 1967 intended to further proceed to make an order under section 48 of BSA62, equivalent to section 6 of BSA60, with its sister society, Law Mutual Building Society, which had also been given in May 1964 an order under section 51 of BSA 62, equivalent to section 7 of BSA60. But, the execution of the orders under section 48 was reserved by the CRFS subject to both societies' observing some financial undertakings including taking no further investments.

The two cases have a definite difference, however. The order given to Lloyds was withdrawn in April 1963 whereas the ones and undertakings given to Eagle and Law Mutual were never lifted during the 1960's. One obvious reason for the difference was the degree of the executive director's commitment to, and the actual achievement of, the improvement of the system of internal control in both societies. As indicated in the case of Lloyds, it was necessary for a society to demonstrate that the mortgage assets were fully secured and its reserves were fully adequate to revoke the order once made. To this end, the mortgage and investment policies, including the system of control, should have been tightened to conform to the generally recognized standards.

In this connection, the ability of the borrower to repay the instalments and the value of the mortgaged security were two principal administrative factors. It would be possible to not only ensure the collection of advances but also reduce the risks of bad debts and arrears by establishing the proper system to continuously, rather than only initially, assess and monitor the borrower's ability to repay the mortgage. Moreover, the possible amount of losses caused by the disposal of house properties in mortgage would have been minimized and the necessary amount of reserves to cover the losses concerned would have been identified by improving the system of internal control to continuously monitor the value of the mortgaged properties, rather than only the initial assessment.

In the case of Lloyds, the new management team led by E. Partridge seriously worked on the improvement of the system of internal control, with the result that the amount of

arrears was reduced whereas the amount of reserves was dramatically increased during the short time period in which the order was given. This effort and the resultant improvement in the financial position were then recognized by the CRFS, which finally led to the withdrawal at the early stage of the order given to the society.

On the other hand, in the case of Eagle, A. T. Pepperell, the new Executive Director who succeeded the management of the society from S. A. Halsall, promised to improve the inspection of the house properties in mortgage in May 1964 when the CRFS was examining the possibility to make the order under section 51 of BSA 62 to its related society, Law Mutual. But there identified no evidence to indicate that it had been actually executed. Instead, Pepperell simply attempted evading the orders about to be given by the CRFS by making difficult promises severely limiting the ability of the society to make advances and take investments. Rather, such actions were hoped by the CRFS and the Treasury who clearly planned to drive the financially unhealthy small-sized building societies to dismantlement gradually and to transfer their engagements to other healthier larger-sized societies.

The two cases of small-sized building societies examined in this study have proven that powers to make an order recognized to the CRFS under the regulation of BSA60, often attended with an alternation of the executive management of the subjected society, became an important opportunity to reform the system of internal control in the building society. When the alternated manager committed to take positive actions towards the improvement, the financial position was expected to be resultantly improved, through a stricter administration of arrears and reserves, and it finally led to the withdrawal of the order made at an early stage. However, when it was not so, the effect of the order was prolonged, with the result that the managerial power of the building society, largely on the financial aspects, was seriously restricted and driven to be gradually dismantled.

The two cases examined in this study also suggest that when the order was once given, the withdrawal at an early stage was not easy under the condition with the bias of the CRFS and the Treasury who rather hoped for the dismantlement, rather than the continuous existence, of the financially unhealthy small-sized building societies. Under the circumstance, a vicious circle was caused, in which free managerial power of the management of the building society was limited by the order made and the withdrawal of the order became more and more difficult for that restriction. The case of Eagle and Law Mutual endorsed the point. In fact, during the time in which the order was given, both societies were deprived by the authority of autonomous management and opened

under the strict watch of the CRFS. In this sense, the improvement of the system of internal control, a necessary condition for the lift of the order once made, could exert significant influence on the management of the small-sized building societies in the UK.

The scope of this study is limited to the examination of only two cases having become the subject of an order made by the CRFS under the provisions of BSA60. Therefore, the cases examined here might be regarded as the special one having already some financial difficulties and, for this reason, revealed the doubt of frauds and scandals. To more precisely analyze how the system of internal control was improved within individual societies following BSA60, further research based on a more comprehensive sample, including both small and large-sized building societies, is undoubtedly needed.

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