The future of building societies: a central banker's view

*The **Governor**[1] notes the greatly increased competition that building societies have faced in the last five years and the ways they have successfully responded to it. He considers some implications of these responses, and of various new ideas for further development, particularly as they affect societies' capital and management resources.*

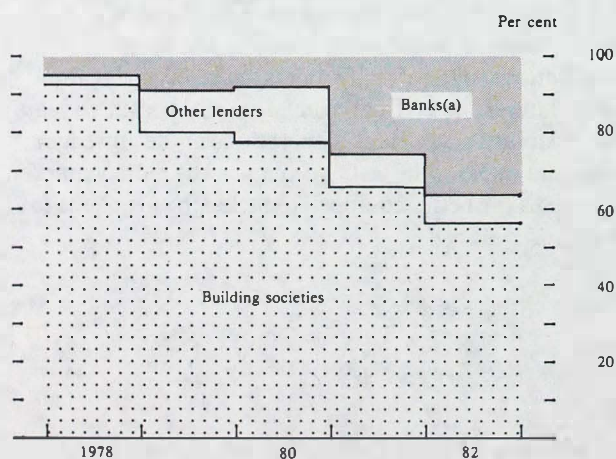
Some ideas for further innovation would require legislation. A measure of greater flexibility would be appropriate, but the societies should consider fully the consequences of these changes that might bear on their public image, legal status, fiscal treatment and arrangements for prudential supervision.

Events of the last quinquennium

... [When I spoke to your annual conference in 1978] I gave my address the title 'The building societies in a changing financial environment'. And, indeed, the situation now is very different from what it was five years ago. The building societies were then on the threshold of major changes. Though there had been a long period of expansion within the framework of existing legislation and practices, this seemed unlikely to go on much longer; and my endeavour then was to suggest those areas where you needed to look afresh at your position.

Since then, you have faced greatly increased competition, both from within and from outside the building societies' movement. In part as a result of this, there has been a spring tide of new ideas and already much commendable innovation. I am sure you will agree that what is now needed is a critical scrutiny of the ideas that are afloat and I shall, if I may, offer some remarks on these ideas, from the perspective of a central banker. In the process, I shall seek to look at possible developments in your role, not so much from your vantage point, but in the light of some general developments, as I see them, in the provision of retail financial services. My observations will include some thoughts about the need for change in your governing legislation and about the appropriate direction of that change. But these thoughts should not be taken as a preview of any proposals which the Government may wish to put forward on the future of building societies.

Chart 1
Shares of net mortgage advances



(a) Includes trustee savings banks.

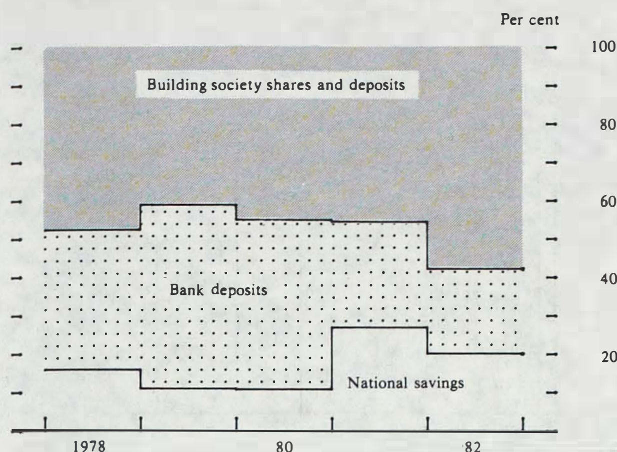
The last five years have seen profound changes in the general financial environment. In part these have followed the change of emphasis in economic policy. Exchange control, the 'corset' restraint on the size of banks' balance sheets, hire purchase controls and statutory control of prices and dividends have all gone. At the same time business conditions, both international and domestic, have often been difficult. These factors have intensified competition throughout the economy. Your movement has both felt this and contributed to it.

Chief among competitive developments in your own industry since 1978 has been the penetration of the mortgage market by banks, especially the clearing banks. In the first half of last year they were undertaking nearly 40 per cent of all net new mortgage lending, against just over 5 per cent on average in the 1970s; although their current share is perhaps only 20 per cent, there is, I think, no doubt that the banks mean to stay in this market. Besides their lending in competition with yourselves, the banks have also begun to compete harder for personal savings, thereby seeking to reverse a long-evident decline—caused largely by effective building society competition—in their share of these funds. A number of banks have introduced a form of interest-bearing current account, and pay close to wholesale money rates for large personal deposits. Some have also launched savings schemes aimed at particular groups—such as the elderly, or younger people saving for a first house—that typically maintain sizable balances with building societies. I see no reason for supposing that the banks will soon move away from trying to attract such balances.

A factor scarcely less important for you has been the thrust of government policy aimed at reducing inflation. Monetary

(1) In a speech to the annual conference of the Building Societies Association in Bournemouth on 5 May.

Chart 2
Personal sector acquisition of liquid assets: shares by instrument



policy has played a prominent part in this and it has been necessary to maintain heavy and regular sales of central government debt to the general public, in order to restrain the growth of the money supply. To this end, national savings instruments have once more been given an important role in the Goverment's funding programme, after some years of relative passivity. Inevitably this has meant competing more strongly and more directly with the building societies for personal savings. By a combination of new instruments and keen pricing, national savings have averaged over £3 billion (net) a year in the last three financial years, against £1$\frac{1}{4}$ billion (net) in the three previous years. In recent months, this competition has eased a little. Nevertheless, in the Budget this March the Chancellor set the same target for national savings in the present financial year as he did last year. All in all, this market clearly seems set to remain highly competitive.

The building societies' response

There is no need for me to tell you in detail of the ways in which you have responded to these pressures. Many of you introduced new forms of high interest account, and increased the attractiveness of term shares by raising the premia offered over the ordinary share rate and by reducing the effective term for which such funds had to be held. Early last year a premium of 2 per cent could be obtained on some shares requiring just three months' notice of withdrawal. This was not tenable. The funds attracted were not only very expensive in themselves but often represented switching, within societies, from lower-yielding accounts. The premia were later cut back as interest rates fell generally. But in the very competitive conditions that I have described, it will no doubt remain a temptation to offer 'loss-leaders' of this kind. In that too much of the business may well lead to losses, the term is perhaps apt.

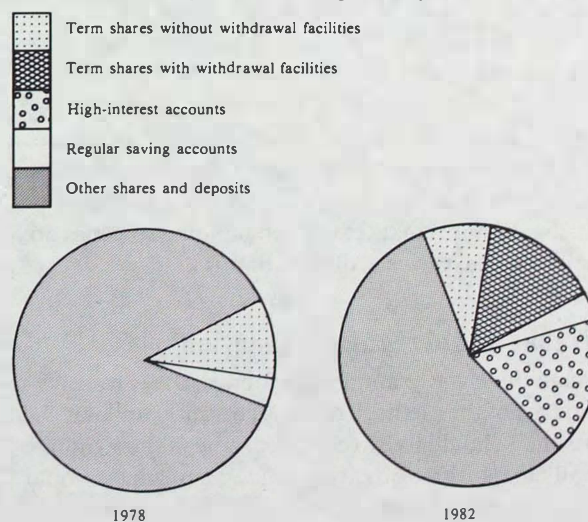
A number of you also responded to competition by extending the range of services offered to those who save with you. Several large societies, I believe, have introduced or extended an interest-bearing chequing account. Under present legislation such accounts, if offered directly by societies, cannot be as versatile as those offered by a bank because a society cannot offer a facility, such as a cheque guarantee card, with which the depositor could go into overdraft unless it is secured by a mortgage. Nevertheless, money on these accounts attracts an explicit rate of interest, even on relatively modest transactions balances. This is still a comparative rarity. Several other societies have linked with a bank or credit card company to enable their depositors to take out a credit card and settle monthly accounts by transfer from their accounts with the society. Several have also begun introducing automated teller machines, the potential of which extends far beyond the dispensing of cash. Another society, in partnership with a bank, is launching the first electronic home banking service in the United Kingdom, attaching to it a range of other facilities including home shopping.

Yet another response has been to seek funds from the wholesale markets. Six societies currently have a total of over £400 million outstanding in the yearling bond market. This year's Finance Bill contains provisions enabling societies to issue certificates of deposit on which interest can be paid gross; and this will open up another source of wholesale funds, at least for the largest societies.

Some of these responses have involved using new electronic technology, the further development of which seems likely to intensify the competitive pressures to which I have already referred. Foreseeing the pace of technological change of this kind, or even its particular direction, is hazardous, particularly as some of the applications are still fairly close to the drawing board. But electronic money transmission is now technically feasible. Provided it is acceptable to the public and is found to be commercially viable, radical changes could well follow.

Automated teller machines can already provide some of the services required by the individual investor; and they are being widely introduced both by banks and by building societies. The development of electronic funds transfer at point of retail sale is under close discussion and could also be in operation in a few years' time. As I have mentioned,

Chart 3
Innovation in types of building society accounts



the first step into electronic home banking is also already being taken.

Implications for capital and management

What will this imply for you? It clearly implies a change in the services offered to investors and an increase in their range. It is also likely to alter the economics of money transmission in a way that calls into question the present degree of specialisation between banks and building societies in the provision of retail deposit services.

Societies have hitherto managed to retain a share of new personal sector savings sufficient for them to continue as the dominant lenders in the mortgage market. But this has been achieved only at the cost of a potentially lower underlying operating surplus, which was hidden in 1982 by the exceptional capital gains made by most societies on their investment in gilt-edged.

It is important here to recognise that building societies are not as highly capitalised as banks. This is because societies operate within a statute which debars them from high risk activities, so that their need for capital—and indeed actual capital—has been relatively low. In the financial environment that I have described, demands on your resources of capital and, indeed, of management can only increase. Societies' managements have concentrated upon a particular range of business—which they have shown they can do very well. But how well and how quickly building societies could adapt to higher risk business raises new sorts of question.

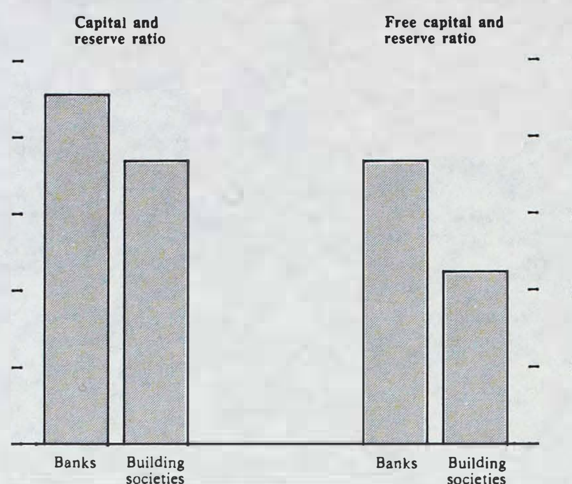
Two illustrations may make this clear. First, take the automated teller machines which some societies are introducing and which they and others may eventually share. However justifiable or necessary these machines may be, their general introduction—at branches, places of work, or various other useful locations—will add to capital costs, at least in the short run.

Second, take the issuance of negotiable certificates of deposit. It will need to be kept in mind by those who enter this market that there can be no guarantee that a given amount of money can be raised or rolled-over on a particular day on particular terms. The interest rate risk could perhaps at least in principle be limited by hedging in the financial futures market. But reduction of risk in this way brings with it extra risks of another kind; management control systems have to be tight indeed for any institution to allow its staff to commit it in the fast moving and highly professional futures market. As yet, building societies do not have much experience of risks of this kind.

Ideas that would require legislation

Although these two examples are topical, they are only a small part of the plethora of ideas currently under discussion. I should like to consider some of these more generally under three broad headings, all of which would imply legislative change.

Chart 4
Capitalisation of banks and building societies: 1981



First, there are suggestions for innovation in the forms and range of housing finance that societies might offer—suggestions which, in cases such as the provision of shared equity mortgages, were probably not considered when the present legislation was drafted. It is not surprising that, as specialists in the field, societies should wish to innovate in this way and, provided that any risks involved are fully appreciated, it would seem appropriate for present legislative curbs in this area to be relaxed.

Second, there are suggestions for legislative change aimed at maintaining the ability of societies to attract deposits. The impetus behind such proposals no doubt owes much to the keen financial environment that I have described. So far, a good deal has been achieved within the present legislation. For example, individual societies have negotiated arrangements with banks, to the mutual benefit of both. Moreover, many of these joint ventures might well have been undertaken even if societies had had the same operational freedom as banks; it must seldom be economic these days to start a credit card company in order to make such a facility available to one's depositors.

Nevertheless, the limitations on the ways in which a society may compete for deposits are potentially important. In particular, there is the prohibition upon unsecured lending. This effectively rules out the provision by a building society of a comprehensive money transmission service that permits the possibility of an overdraft with current accounts operated by customers in the ordinary way, whether by cheque or electronically. Here, too, legislative change allowing societies some flexibility would seem appropriate.

Many of the ideas now under discussion—and these form my third group—could, however, go very much further. The recent report issued by your Council considers that societies should be enabled to compete more effectively by offering a more comprehensive service to investors and borrowers. To that end, it recommends—*inter alia*—that you should be allowed to set up or buy banks, licensed deposit-takers and insurance companies, and run these as subsidiaries of the parent society. I am no opponent of

change. But, before accepting that this would be wise, there are a number of important questions on which I would like to be allowed to comment.

Some questions to be faced

The first question, which I am sure is widely appreciated, is how to make sure that the pace and direction of change does not undermine the very special confidence that the general public places in you. Here the particular difficulty is that a rapid and wide-ranging diversification by only a few societies could affect the public image of the whole movement.

A second, and equally important, consideration is that wider diversification would, in all probability, bring into even sharper focus the questions now being asked about the accountability of your boards of directors. There is considerable discussion about the interests of borrowers and staff on the one hand, who are largely tied to the one society, and those of the shareholders on the other, who can take their money somewhere else as they choose. There is debate, too, about the difficulty of accommodating the mutual principle of 'one shareholder one vote' with the practical reality that, while many shareholders have no inclination to participate in essentially managerial decisions, a handful take a different view. It is necessary to observe also that wider diversification would imply wider discretionary power and responsibilities for the board of directors. This would certainly call for clearer accountability to shareholders.

A third and, especially from my vantage point, critical question is that wider diversification would call for wider-ranging and rather different forms of prudential control, both within each society and by the Registry. No doubt changes are already underway. But our experience of supervision in the banking sector strongly suggests that, as societies broadened their activities, the prudential supervision to which they were subject would need to become increasingly positive: and there would have to be greater discretion for the Registrar to judge what was appropriate for each individual society, in the context particularly of its capital and managerial resources. As I have said already, societies currently operate on capital ratios which are low by the standards of banking. Their management, too, has yet to demonstrate how rapidly it can take on new functions. The greater the range of services that societies come to provide, the more pressing might these restraints become.

Prudential, fiscal and legal implications

Some of the recommendations of your Council's report especially raise prudential implications of this sort. For, if adopted, they would bring societies—albeit through subsidiaries—into new activities of higher risk. They would also involve societies, through these subsidiaries, in activities governed by statutes other than the Building Societies Act, and by supervisors other than the Chief Registrar of Friendly Societies. In particular, if a society were to own a bank or licensed deposit-taker, that subsidiary would fall within the Banking Act and be supervised by the Bank of England along with its banking competitors.

Acquisition of such subsidiaries would carry wider implications, which are perhaps not fully set out in the Report. The important point is that the Bank would require the parent, in the interests of the subsidiary's depositors, to support the subsidiary in case of need more fully than is required by the law of limited liability. But even apart from our requirement, no parent which itself took deposits and depended upon a credit-worthy name could expect to walk away from a subsidiary in trouble, without risking a loss of confidence on the part of its own depositors.

Given time, developments in the prudential controls on societies can contain the prudential risks of even quite wide diversification to an acceptable level. On that premise, I would myself accept an appropriate relaxation of the present legal constraints upon your activities. But there must clearly be limits to what any of you can do, especially in the diversification of your assets, while continuing to call yourselves building societies and to retain the public goodwill now attaching to that name; and a full debate will, no doubt, be necessary to reach agreement on where these limits should be drawn. For any society wishing to go beyond these limits, consideration could be given to provisions which might enable it to convert more easily to company status and thus, in effect, cease to be part of the building society movement.

For the great majority of you who would not, I judge, be interested in company status, there remains one question with which the Report does not deal and which I will leave as a question. When will the area of common activity in the operations of building societies and banks expand to the point where the present differential fiscal treatment, in a number of areas, becomes seriously inequitable and creates an inequality of competition that misallocates resources?

It is already clear that banks and the larger societies are now more like each other than when I spoke to you in 1978. If societies, in future, obtain greater operational freedom in banking services—whether or not exercised through subsidiaries—the extent of common ground between at least some societies and banks would continue to grow. This would throw into sharper relief the differences of fiscal treatment between these institutions. In one respect the increasing common ground has already been recognised by government. A monetary aggregate (PSL_2) which includes many building society deposits is one of three for which a target range is now set for purposes of monetary policy.

Conclusions

Mr President, it is time for me to conclude. The last few years have been difficult ones for building societies, even though you have responded with vigour and considerable success. It would be wise to plan ahead on the assumption that competition is likely to remain fierce and that earning

an operating margin sufficient to sustain the growth of your business is likely to remain challenging. This environment suggests the need for some modification in the restraints of your governing legislation. Also, there is a conceptually distinct case for reviewing the legal constraints upon the forms in which societies can provide housing finance.

Whatever changes are considered, I have sought to identify two questions of particular importance that will need to be addressed. First, what will be the impact upon the public image of building societies? Second, what prudential risks will be involved and how can these best be allowed for in a system of prudential controls which is already evolving rapidly to keep pace with change? In particular, the costs and risks of any new ventures, in terms of capital and of managerial load, must be assessed fully and objectively. In a long experience I have seen some instances of shrewd—and many of unwise—diversification.

What is at issue in the present debate is how best to build on your movement's solid record of success and achievement and, to that end, how best to bring up to date legislation which is in substance more than a century old. New legislation is unlikely to last anything like as long. But if it provides as good a framework for sustained progress, we should be able to regard the time involved in deliberation as well spent indeed. Mr President, I hope that my remarks will prove of some help in your future deliberations.