Building societies: a changing role

*The **Governor** reviews[1] the changes that are taking place in the nature of the mortgage market and in the markets for deposits and points up the implications of these changes—particularly the prudential implications—for profitability, risk and capital adequacy. He goes on to consider some of the opportunities opened up for the societies through diversification, but notes that this too has its risks as well as making new demands on capital and on management skills and resources.*

It is a great honour to be asked to address this conference. The invitation came, I recall, just after my speech at the International Building Societies conference in Vienna last September, when I urged upon all those engaged in housing finance the virtues of caution and restraint. I was greatly struck by your apparent readiness to risk exposure to more of the same.

I am particularly pleased to have this opportunity to address the societies, for I have a sense that this year is in many ways a watershed for your industry, just as last year was for so much of the City. Much has changed since my predecessor spoke at your conference four years ago. We have new legislation, not only for the building societies themselves, but also for the banks and the financial services industry more generally. In all of the markets in which you are engaged, competition has continued to intensify; and your activities have increasingly converged with those of the banks. This has, of course, implications for the monetary policy context, with which the Bank of England is centrally concerned. Shifts in the market shares of the two groups of institutions have complicated the interpretation of £M3 in recent years. Only this month, in an article in our *Quarterly Bulletin,* we introduced a new aggregate, to be known as M4, which is very similar to the old £M3 except that it treats the public's holdings of building society deposits in exactly the same way as their bank deposits. This well illustrates the immediate concern to us of your activities: and if I may be permitted a brief commercial, it does emphasise the importance we attach to timely and accurate returns from the building societies. I know that these are irksome to you, but I can assure you that we are most appreciative of your efforts in this direction.

But I am not here to harangue you about statistics, or even to discuss our monetary policy concerns. My subject today will, I hope, be of more direct concern to you. The nature of the mortgage market is changing in a number of ways as the extent of home-ownership evolves, and as other players, whether banks or special financial vehicles, enter the game. There are changes too in the markets for retail and wholesale deposits. All these changes have implications both for the profitability of mainstream mortgage lending and for the risks involved: and hence the need for, and supply of, capital. At the same time other and possibly more rewarding lines of business, many offering the prospect of fee income, have been opened up by the recent legislation. But some of these, too, may be demanding of capital; so that the process of diversification, however compelling its logic, will need to be followed with care. My greatest concern in all these matters is with the prudential aspects of the flexible and competitive financial system that is now evolving. This is the general theme that I propose to develop in greater detail today.

The demand for mortgages

Even if the degree of diversification permitted by last year's Building Societies Act were to be exploited to the full, not only would the bulk of societies' funds continue to be taken from the retail market, but also perhaps as much as three quarters of their total assets would be in the form of loans secured on residential property. Their prospects do therefore remain intimately bound up with the growth, profitability and risk of the mortgage business. When the building societies' cartel was in existence, and other institutions did not offer such keen competition, building up mortgage lending scarcely called for a great marketing effort! The clear financial and social attractions of home-ownership meant that demand for the product was high: and, as virtually the sole suppliers, the societies were hard-pressed to meet that demand. Even in more recent years, when competition has become more intense, building societies have still managed to grow at a rate which would be the envy of many an industrial company.

Can this continue? In the short term, the demand for mortgages is dependent on the movement in real incomes, interest rates and house prices; but in the longer term a number of structural influences on the market are also important. One of these is the spread of home-ownership. The current rate of owner-occupation of around two thirds is still some way from its likely maximum level. One reason is that not all those who would wish to do so have yet moved from the rented sector to their own properties. Another is that the broad social trend towards smaller households seems likely to continue. But I would doubt whether the *increase* in the rate of

(1) At the annual conference of the Building Societies Association in Harrogate, on 21 May.

owner-occupation can continue as strongly as in the decades since the war. The demand for smaller units partly reflects demographic changes which also affect patterns of wealth-holding and people's need to borrow to buy their homes. The members of the first wave of post-war home-buyers are now leaving property to their children, who are, in many cases, already home-owners. Growth in mortgage lending may in future come less from spreading owner-occupancy than from increased borrowing against the security of residential property, in part associated with a lengthening of mortgages and an increasing use of mortgage-backed annuities.

In the years when the building societies' cartel was in operation, it was by no means unusual for the supply of mortgage lending by the societies to fall short of demand. Individuals wishing to raise the funds necessary to buy a house had to run down their holdings of financial assets, such as bank and building society deposits, in order to supplement the mortgage loans that were available. As a result, their holdings of both mortgage debt and financial assets came to fall below the levels which would have prevailed in the absence of rationing in the mortgage market. The more flexible market which has characterised recent years has allowed individuals to adjust their financial positions, and raise the levels of both debt and assets relative to their income. For example, relative to personal disposable income, mortgage debt rose from about 30% in 1980 to over 55% last year; while individuals' liquid financial assets increased from some 65% to more than 85% of incomes over the same period. This adjustment of personal balance sheets is continuing, and in the process mortgage debt outstanding is rising relative to the value of the stock of housing. Even so, at about 25%, this ratio is still quite low.

The movement of house prices relative to other prices is also relevant to the growth of mortgage lending, although the direction in which the influences work is not always clear. With the demise of mortgage rationing, however, it is the terms on which finance is available rather than the quantity of lending which, together with movements in real incomes and expectations of house price changes, affect the demand for housing and hence its price. House prices have risen strongly in recent years, but neither buyers nor lenders should rely on this trend continuing indefinitely. There have been falls in prices—not only in particular regions, but, as recently as 1981–82, in the country as a whole.

Credit risk

The risk of a fall in house prices tends to increase as house prices rise relative to earnings. As the service of the mortgage pre-empts an increasing proportion of a household's income, the risks to all lenders multiply. While remaining at a low level, the number of societies' loans in default and in arrears has tended to rise in recent years. There were some signs of improvement in the latter part of last year; but the question of risk does take on a heightened importance at a time when competitive pressures have led to easier lending standards and narrower margins. Moreover, societies are no longer in a position to offer as much protection to borrowers as used to be the case against a sharp upward movement in the general level of interest rates. At the same time, it has to be recognised that the spread of home-ownership means that many people whose jobs may be less secure than those of the traditional mortgage borrower are now among your debtors.

With an ever-wider range of borrowers, each of whom has access to credit finance from a growing range of sources, credit assessment is becoming increasingly difficult. It must make sense for lenders, whether their claims are secured or unsecured, to check on a potential borrower's other obligations; and it follows that all must be willing to play a full part in the exchanges of information necessary to achieve this. Standards in consumer credit have become an important public issue. There are a number of instances of individuals who have incurred what appear to be inordinate amounts of debt from a number of different lenders, and concern has rightly been voiced as to the prudential and indeed social implications of such cases—quite apart from the consequences of higher personal sector borrowing more generally. Some banks have now begun to investigate the possibilities of participating in arrangements for a centralised database which would pool the details of borrowers' debts to a number of different institutions, with this information then being made available to all the contributors. I welcome this initiative. The building societies are in a position both to support and to benefit from participating in a scheme of this type, and I hope that with your historical association with issues of a broad social nature you will be ready to do so.

Building societies' funds

I turn now to the deposit market. Here too, competition has increased in recent years, both from banks and from the government—pressure in the latter case coming initially through national savings, but more recently as a result of sales of public sector assets. Moreover, the strong stock market has increased the relative attractiveness of unit trusts. I think that a number of you now perceive retail funds not only to be more sensitive to changes in interest rates, but also to have become more volatile as the range of assets in personal investors' portfolios has widened. In response to these pressures, societies have introduced a range of new deposit accounts for the retail investor. These have offered an array of special features, but almost invariably the key attraction has been a higher rate than on the ordinary share and deposit accounts, whose relative importance has declined considerably. Consequently, the cost of your funds has increased. Indeed, it now appears to be by no means unusual for the gross cost of some accounts actually to exceed the rate obtained on a mortgage loan, or at least to leave only a very small margin to cover other expenses. I understand the pressures to introduce such 'loss-leaders': but the

competitive process is one which must make it increasingly hard to subsidise the losses from other areas of business.

Some relief from the challenges in the retail market has been provided by the powers enabling the larger building societies to obtain wholesale funds—indeed it is difficult to see how last year's large increase in the societies' mortgage lending would have been possible had this source of funds not been available. The process by which wholesale money has come to represent, for some societies, a highly significant proportion of total inflows, has been managed without major difficulties. Greater reliance on such borrowing may have its attractions, and I well understand your wish to increase it. But wholesale markets are qualitatively different from retail markets: experience shows that on occasions it may not be possible for a given amount of money to be raised or rolled over on a particular day on particular terms. Widespread volatile market conditions are something you have yet to contend with, and it is important that the efficiency of your treasury systems matches your ambitions to enter and maintain a presence in the newer markets in which you raise funds.

Margins and capital adequacy

I have already mentioned the effect of increased competition in narrowing the margin between the cost of funds and the return on mortgage lending. In 1985 the difference between the average cost of retail funds and the mortgage rate was over $1\frac{1}{2}$ percentage points. This declined to $1\frac{1}{3}$ percentage points last year, and, until the latest adjustment to the structure of your interest rates, it had fallen even further in the first few months of this year. Profitability is an important consideration at any time, but is particularly so at the present. For the moment, generating surpluses is the only way in which societies can increase their reserves in order to improve their capital ratios; and higher capital ratios are desirable not only in view of the heightened risks in the mortgage market, but also because of the societies' entry into new areas of business of which their experience is very limited. Higher ratios also serve to retain the confidence of increasingly sophisticated retail investors, as well as ensuring the continued good name of societies in the wholesale markets. Last year many societies managed to increase their reserve ratios, despite a squeeze on mortgage profitability. This probably reflected increased earnings from fees and commissions, and also capital gains on gilts in the portfolio of liquid assets. This last contribution must be regarded as rather exceptional.

In the more controlled and less competitive era now behind us, the prudential concerns I have raised were less important than they have now become—not only to supervisors but, I would urge, to managers. Some of you may initially have viewed the Building Societies Commission's new capital adequacy rules as a hindrance, coming as they did at a time when you were working hard to maintain your current position in the mortgage market and to diversify. But in the intensely competitive world in which you operate, questions of profitability and asset quality acquire a new importance; and the capital adequacy system now governing your activities should, I suggest, be seen as a sound platform enabling the building societies movement to meet the challenges which lie ahead—not as an obstacle holding it back. In particular, the Commission's standards leave a positive margin between the actual level of capital and the required level of about 1% on average, which ought to allow adequate scope for carefully planned diversification; though of course, once this margin is used up, further expansion will be possible only to the extent that you can generate surpluses. I would also say that we have in recent years urged your major competitors, the banks, to look more closely at the adequacy of their capital in the light of their exposure to LDCs and of the more competitive financial environment. I doubt you will find many bankers who believe that the capital requirements on their own mortgage lending are unduly light, or give them a competitive edge over building societies.

Diversification

Turning now to the process of diversification itself, I have to say that I sympathised with the general case for the societies undertaking a range of new activities. Putting some of your eggs into different baskets reduces your exposure to possible adverse developments in the mortgage market; now that you can offer a very wide range of products to the personal sector you are in a stronger position to meet your customers' demands. However, the area of diversification open to you is of a particular form. It is best regarded as enabling building societies to serve their *existing* customers *better*—rather than permitting them to strike out into completely new markets.

One effect of the new powers is likely to be that building societies will become a rather less homogeneous group. The larger among you will almost certainly undertake a wider range of new activities than the smaller societies. Those who do diversify may develop along various lines, by specialising to different degrees in areas such as the provision of banking services, or the sale of investment products—or by moving closer to the housing market. In time, it may be that some societies come to feel constrained even by the powers available under the current legislation, and may attempt to change status by becoming public companies and moving into the banking world.

It is frequently suggested that, because of their greater resources, the larger societies are likely to be the chief beneficiaries of deregulation: and that concentration in the industry will therefore increase. While this argument has something to justify it, it does not of necessity mean that big is so beautiful that the smaller societies will cease to be as viable in their own right as at present. I am thinking here in particular of certain aspects of societies' agency roles which it might become possible to develop.

For example, as a result of their extensive branch networks and long experience of operating in the housing market, building societies have a comparative advantage in originating and administering mortgage loans, but the smaller societies especially may not have the same advantage in raising funds. By contrast, there may be a number of other financial institutions, particularly foreign banks, for whom the reverse is true. If so, this might provide an opportunity for mutually beneficial collaboration, with the financial institution raising funds and receiving the payments of interest and principal, and the building society receiving a fee for its administrative endeavours. Provided all the relevant risks could be passed on, this business might, as in the case of banks, be carried on independently of balance sheet lending, and would not therefore impinge heavily on capital requirements. In other fields, financial innovation has involved 'unbundling' an array of services previously provided as a package. There seems to me no reason why building societies might not benefit from an extension of this process.

Your new powers will in some ways change the manner in which you generate the bulk of your surpluses. Many of the new activities, though by no means all, do not provide a return associated with the margin between the cost of funds and the return on a loan, but instead generate fees and commission. This development, similar to the experience of the banks, is not in itself new to you, since the fees earned from life insurance brokerage have in recent years made a significant contribution to your receipts. But I would suggest that fee income may become an even more important means by which you can enhance profitability, helping to offset any squeeze on your interest margins.

I suggested earlier that the resources you devoted to the mortgage market would need to remain sizable. Many of the new products which you are now empowered to provide are demanded by the consumer at the time of house purchase. This opens up, for example, the possibility of developing your estate agency business, acting as a broker to provide life assurance or contents insurance, or offering an unsecured loan to finance the consumer goods usually purchased on these occasions. And of course, once the prospective borrower has come into your branch, he can be shown the whole wider range of services which you now provide. Continued success in the mortgage market could, from this perspective, be deemed a necessary condition for success in selling your more recently-acquired products and services. Indeed, looking somewhat further ahead, to the extent that mortgage lending comes to act as a means of attracting potential customers, as well as a venture in its own right, you may feel that you would benefit from participating in a market in mortgage-backed securities. This would allow mortgages originated by a society to be on-sold subsequently, thereby providing the finance for further new lending. One should note, however, that banks may be tempted to follow a similar path.

Risks of diversification

Your new powers open up the possibility of undertaking a number of potentially profitable ventures. At the same time, however, they expose you to a new set of risks. Deregulation is best regarded as a challenge, not a panacea, and it introduces new problems which must be faced if the opportunities are successfully to be exploited.

In the past, building societies have been relatively specialised institutions. However, the skills acquired in providing mortgages and outlets for personal savers will now need to be augmented with new talents. In the brave new world, the successful corporate cultures may be those geared more to adapting to a rapidly changing environment, rather than to a continued extension of the existing one. A wider range of qualities will be demanded of societies' directors, management and staff: indeed, many of you have shown that this challenge is being met. Such qualities will be at a premium, for some of the areas into which you are moving may prove to be scarcely less competitive than the mortgage market, and you will find yourselves up against institutions whose experience in offering a broad range of financial products is that much greater than your own. There may also be some temptation, in order to attain market share at an early stage, to set prices below the perceived true economic value of the product. Such practices do of course carry the risk of a later, uncomfortable adjustment of margins.

There is also the question of costs. The expenses involved in acquiring the technology necessary to compete successfully can be great, as can those related to training existing staff, purchasing new skills from outside and co-ordinating the different activities of a more broadly-based institution. I discussed earlier the possibility of a capital constraint on building societies' future activities. To this could be added what might be termed a 'resource constraint' which would manifest itself most clearly in upward pressure on your costs.

Conclusions

The past few years have seen a radical transformation of the framework within which building societies operate; and the process of change is by no means complete. I have stressed the increase in the risks of your traditional business relative to its rewards. This makes diversification attractive, but this too has its risks as well as making demands on capital which can no longer be so easily generated from balance sheet operations. Thus the societies continue to face new and demanding challenges. In doing so they do enjoy a considerable asset in their public image. At present they are, I would judge, held in particularly high esteem by the general public in this country. In part this reflects their mutual status—although this has its disadvantages in limiting their access to the capital market—but also the fact that the societies have had a well-defined function which has been carried out efficiently. It will be an achievement if, in the future, you can keep this reputation wholly intact as the nature of your business evolves.