Building societies: the changing environment

*The **Governor** reviews[1] the regulatory changes affecting building societies in the United Kingdom over the past two years and comments on the impact on the societies of the stock market collapse—noting that one consequence of the sharp improvement in their retail inflows since the crash has been a welcome reduction in the likelihood of an unbalanced assessment of the benefits of conversion into banks.*

*On international aspects of housing finance, the **Governor** welcomes the opening up of markets that would form part of the European Community's move to a single internal market, but stresses that two important corollaries must be fulfilled: there must be total clarity of responsibility for the prudential supervision of credit institutions in the Community, and they must be subjected to similar tests of capital adequacy; and the opening up of markets must be more than in form only, even if in practice exploitation of the opportunities created may prove a slow process.*

It is a little over two years since I spoke at your Association's Congress in Vienna. I spoke then about the implications for housing finance of deregulation, of greater volatility in markets and of technological change. I know that those topics, perhaps with added immediacy and focus, figure prominently on your agenda for this week. But there is now a further ingredient, barely touched on in my Vienna remarks; and that is the growing international dimension to housing finance, especially in the context of the 1992 objective for a single internal market within the EEC. What I have to say tonight falls into two parts: first, I shall look again at my earlier themes in relation to developments in the United Kingdom; and second, I propose to look at some international aspects of housing finance.

The implementation of the 1986 Building Societies Act has created a radically new statutory and regulatory environment for our building societies. The purpose of the Act was to remove the disabilities that prevented building societies from competing effectively in activities reasonably closely related to their mainstream functions of providing finance for house purchase and a secure home for the savings of the public. The Act provided a definitive statement of how far that diversification might go without changing the fundamental nature of a building society. A mechanism was also set out for any society wishing to go beyond that point, so as to become a more general purpose financial institution. It could do so by incorporating as a company, establishing share capital, and obtaining authorisation as a bank.

Not all of these enlarged powers were immediately made available to the building societies. This hesitation no doubt reflected a concern that the societies should not overstretch themselves in new types of business, of which they had little experience. But delay was quickly seen to have two undesirable consequences. First, it provided too little incentive for societies wishing to diversify to assemble the resources, and gain the experience, necessary to do so effectively. Second, it created uncertainty over how to assess the relative benefits of converting to banking status, and probably gave an exaggerated impression of their extent. So it was quickly decided to make available virtually all of the greater freedoms which the Act permitted, with the task of restraining any unjustified enthusiasm for exploiting them falling to the Building Societies Commission. In this respect I may add that the societies do still need to exercise great care in developing their unsecured lending.

The other major development affecting building societies in these past two years has been the stock market collapse of a year ago. Until then, 1987 had been a very difficult year for them. Loss of share in the market for personal sector savings had led both to loss of share in the mortgage lending market and to lending margins being held in check. Black Monday changed all that. There was an immediate and sharp revival in retail deposit inflows, which has continued through this year.

That development prompts me to offer two observations. First, last year's flows illustrate the extent to which savers and investors are now prepared to switch between financial markets that were until recently regarded as separate. What the building societies gained—or perhaps I should say regained—was the flow of retail savings which had, for a period, been going into the equity section of the capital market through the medium of unit trusts. The resources which building societies use have to be won in competition not just with other takers of deposits, such as banks, but with the wider capital market.

My second observation on the episode is perhaps something of a digression, because it concerns the implications of the stock market crash for macroeconomic

(1) In a speech at the IUBSSA International Housing Finance Conference, on 21 November.

management. The universal fear was that there would be a sharp decline in spending as individuals adjusted their outlays to a lower level of wealth. What we all missed at the time was the extent to which any such depressive effect would be compensated for—if not overcompensated—through enhanced activity in the housing market. The increased flow of savings to finance house purchase not only sustained housing activity and price levels, but helped to generate boom conditions which became, in turn, the engine which drove excessively rapid growth in consumption and activity in the economy generally.

Interest rates have been raised to deal with this, and inevitably a cooling-off in the housing market has become an explicit objective of policy.

Being close to the sharp end of cyclical adjustment is, of course, no new experience for the building societies. I am confident of their ability to respond to the new situation—indeed, much more confident than I might have been a little over a year ago. Morale undoubtedly suffered through most of 1987, but has been marvellously restored since. What I find especially welcome about this is that it will have removed a state of mind that had begun to develop, the belief that the grass must be very much greener on the other side of the fence. I would have been concerned had societies approached the decision to convert into banks with a mistaken assessment of the benefits of doing so. As it is, I extend a welcome to any who choose to become subject to supervision by the Bank of England. But I shall not be offended if they are few in number.

Let me move now to the international dimension. Foreign competitors are no strangers in the UK mortgage market. Over 5% of net new mortgage lending in 1987 was provided by some 25 foreign banks which have made a significant entry into the market. But the present focus of attention, rightly, is the European Community's objective of creating a single, Community-wide market in financial services by 1992. The basic passport to Europe for all credit institutions, including those involved in housing finance, is the Second Banking Directive. From 1992, banks and other credit institutions authorised in one Community country will be permitted to operate throughout the Community on the strength of their home country authorisation.

This opening up of financial markets is entirely in accord with the philosophy long pursued by the Bank of England and the UK government. There are, however, certain important corollaries which are worth restating as the 1992 initiative comes closer to fruition. The first, relating to prudential supervision, is well on the way to being met through the Second Directive; there must be total clarity of responsibility for the prudential supervision of credit institutions in the Community, and they must be subjected to similar tests of capital adequacy.

The second corollary is more difficult. If markets are opened up only in form, and not in reality, then that contributes nothing to realising the European objective; and it is unfair to the domestic institutions of countries whose openness is totally real. There are difficult issues here for some member states, because the absence of real openness is likely to be associated with the existence of rather specialised providers of mortgage finance, using regulated techniques that have the effect of creating a sheltered market. It is not clear how this difficult area will be resolved. The vehicle for doing so might be the Second Banking Directive, or it might be a more specific Mortgage Credit Directive aimed at mutual recognition of financial techniques.

However this particular problem is resolved, there will undoubtedly be a considerable widening of opportunity for entry into the housing finance markets of other Community countries, and for a corresponding influx of competition into one's own domestic market. But we may all of us, even so, find exploiting those opportunities to be a slow process. Housing markets across Europe are very different from one another—different in terms of the mortgage product and methods of funding, but also in terms of cultural and political attitudes to owner occupation, social policy on housing, taxation and historical experience particularly in relation to house prices. No one here will be surprised to hear me say that the best way to hasten into these new market opportunities may well be to do so slowly. There is a parallel here with the widening of opportunities in domestic markets, including that of conversion to banking status: the fact of creating the opportunity to diversify internationally may in practice be much more important to the health of financial markets than the number of institutions which in the event exploit it, or the extent to which they do so.