ANDREW BAILEY

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It is a great pleasure to be here today, at what is my first BSA Annual Conference. It might help if I begin by explaining my current role, because it is not entirely straightforward. Up until the end of March I was an Executive Director at the Bank of England, responsible for Banking Operations and the resolution of problem banks, the latter including leading the resolution of the Dunfermline Building Society - the only use to date of the resolution powers given to the Bank of England in 2009. It was all change for me at the end of March, and since then I have been responsible for the supervision of deposit takers at the FSA and Deputy Head of prudential regulation there. This new role will, with the passage into legislation of the Government's reforms of financial regulation, mean that I will be the Deputy Chief Executive of the Prudential Regulation Authority. Our current expectation is that the PRA will come into existence around the beginning of 2013. Just to add a twist to the end, I am still attached to the Bank of England, with responsibility for the programme of work to create the PRA as a subsidiary of the Bank. Anyway, enough of me as they say.

The last four years have taught me a lot of things as we have gone through the problems of the financial crisis. One of the things that I have enjoyed has been learning a lot more about building societies. Occasionally, but mainly not so, the process has been painful, as with Dunfermline, but always I have felt that it has left me better educated. I have learned a great deal from many people in the societies themselves, and from my colleagues, one of whom sent me an extract from the 1870 edition of the Building Societies Gazette, in which the author set out his views on the sorts of people to avoid having on the board of a building society, namely:-

"men who have no experience in matters of business …. crotchety men … men who cannot open their minds to any view of a matter that does not originate with themselves … men who love discussion for discussion's sake … who love to show off in the committee room …. "

On the other hand, the qualifications of the Executive were listed as to be:

" a man thoroughly versed in some of the higher walks of commercial arithmetic, and especially in the laws of compound interest. It will often happen that his superior knowledge must guide his committee or board, but such guidance should be exercised to leave upon their minds the satisfactory impression that the action has been their own."

Nothing changes, I hear you say, except perhaps doing compound interest in the head?

I want to talk today about the impact of the crisis on the business of building societies and retail banking more generally, and what it means for the future. Let me start with the big question that I am asked most frequently about building societies, namely what is my attitude towards promoting diversity in the banking industry, and specifically mutuals? I am in favour of promoting competition in the banking industry, and with that greater diversity in the types of organisations that provide banking services to the public. But, as I will explain later, we need to be very careful what we mean by promoting competition and diversity because both need to be sustainable.

As far as mutuals are concerned, neither the FSA nor the Bank of England can promote a particular model of doing business. Our job is to promote the stability of the financial system, which is the bedrock and the foundation of a healthy financial sector, including mutuals. We can facilitate different business models, and we should not put up unnecessary regulatory barriers. I would also go a step further, as Hector Sant's did earlier this year in evidence to Parliament, and agree that mutuals make an important contribution to the fabric of society, including of course the provision of affordable housing through lending that is priced appropriately for the risk. This last point is perhaps obvious, but nonetheless important. My job is to achieve and maintain the stability of the financial system, but I am doing so in order to help to realise on a sustainable basis, and I emphasise sustainable, other important objectives of public policy such as enabling people to afford housing.

Digging into these issues some more, I want to start on competition in banking. This is of course the territory of the Independent Commission on Banking chaired by Sir John Vickers, and if you have not yet read their interim report, I strongly recommend it. Competition in banking needs careful assessment to understand the nuances. It is true that the UK has a highly concentrated banking industry. At the end of last year, the largest six banks in this country accounted for 69% of lending to UK households, 68% of lending to UK companies, and 78% of UK household deposits. The lending numbers are more concentrated still looking at the flow of lending to households last year. Those are the sort of headline figures that are used to tell a story of lack of competition in the industry, and in important respects that story is correct. However, we need to reconcile that evidence with the causes of the financial crisis, which in critical areas was a sorry tale of reckless competition. One way to make this reconciliation is with the rather obvious point that the crisis has left the banking industry more concentrated than it was before 2007. Beyond that, my assessment is that the crisis was fuelled by unsustainable competition in important parts of the banking industry, one of which was the provision of mortgages. There is no doubt that in the years leading up to 2007, lending margins were squeezed heavily in new mortgage provision, and the volume of lending increased rapidly, supported in part by the churning of re-mortgaging activity. For a while this competition in the supply of mortgages looked good for borrowers, but it was an unsustainable loss leader for the lenders and it fuelled the rapid growth of household indebtedness. Northern Rock was in many ways the extreme bad example of this trend, with a business model that squeezed margins, thus mispricing credit risk, and therefore depended on taking a larger and larger share of new mortgage lending to offset those low margins, and that volume was in turn dependant on the continued openness of the securitisation market. Two other fatal weaknesses were: first a dependence on avoiding the trigger of the hard credit rating limit embodied in the business model, which; second, was at odds with the flow of lending at ever higher LTVs to sustain the volume of activity.

This was competition of an unwanted sort. The consequences could, and in the past would, have been a lot worse than they have been an important reason for which is that the establishment of monetary stability over the last two decades has substantially attenuated the impact of the recession, a very different story to the early 1990s and before.

But there are a number of important lessons from this experience of what I would frankly call unstable competition which are important for understanding the future diversity of the industry, and the role of mutuals. First, I think that demutualisation, as it developed, was a failed and very costly experiment. It is a striking fact that no demutualised building society exists today as an independent entity under private ownership, and as we know a number lost their independence in very costly ways which damaged the stability of the financial system. At root, I think this outcome happened because of their failure to adapt and create business models in the PLC sector which fostered sustainable competition:

The second important lesson from this failed experiment was the impact it had on the remaining building societies. Demutualisation changed the profile of UK mortgage lending radically. From 1997 – the peak of demutualisation – the bulk of outstanding mortgages lay outside the mutual sector, for the first time. This, perhaps inevitably, prompted a response from the remaining building societies, which took the form of more aggressive pricing of mortgage lending rates and deposit account rates, thus squeezing net interest margins and rates of return (which societies were happy to badge as "mutual pricing"). It was a change in the ethos of societies. It would have been good competition if it had been sustainable. For some societies it was sustainable, a point I will come back to later. But the result very much depended on how the change in business model was managed and whether it was compatible with the three critical constraints of any bank: the level of capital that is truly loss bearing in the going concern sense of the term, and the ease with which that capital can be supplemented; the sustainability of funding; and the quality of governance and management for the changed business model.

Two developments were important here. First, the squeezing of lending margins was more difficult for building societies because of their greater reliance on retained earnings to build up Core Tier One, true loss bearing capital. This was a critical weakness for those societies that took on more risk in their lending portfolios. Second, squeezing margins meant that there was pressure to expand balance sheets, and this expansion had to be funded. This is the pressure generated by greater leverage that was evident across the banking industry. After 1997, in common with the rest of the mortgage market, societies began to lean more heavily on the wholesale market for funding. The wholesale funding stock of building societies was around 20% in the first half of the 1990s , but had risen to over 30% by 2000. The traditional building society model of retail deposits funding overwhelmingly prime mortgage lending had changed. For many societies the transition was handled well, but for others if was not. Dunfermline was unfortunately a very difficult case in point, where an expansion into commercial property lending and acquired mortgages originated outside the traditional lending sector was frankly incompatible with the constraints that existed on their business model.

What does this mean for the future of building societies? I do not see that the developments of the last fifteen years make the model unsustainable. But we do need to be careful what we mean by sustainable. It is not a return to the conditions prior to the onset of the crisis in 2007. The unsustainable features for some institutions included: an excessive reliance on unstable funding sources, which could be wholesale or volatile retail deposits; dependence on capital instruments that do not bear losses in a going concern state; purchasing assets originated by others, where the incentives of the originator are to sell the assets quickly rather than longer-term viability; and excessive reliance on secured funding which encumbers too many good quality assets to the detriment of unsecured creditors.

What then does sustainability look like for building societies? First, it needs to recognise the inherent constraint in being a mutual on raising outside loss absorbing capital. A mutual structure does not naturally lend itself to the introduction of outside equity-like capital. That is a fact of life, and the solution is not to substitute less good quality capital. It creates a greater constraint on raising new capital as part of a recovery plan if problems arise, and this means – as can be seen – that the standing levels of capital in societies are higher as insurance against the greater inflexibility of capital raising.

I appreciate that, notwithstanding the inherent constraint, societies are keen to explore the possibility to issue a Core Tier 1 instrument which is compatible with the new Basel 3 and European CRD4 requirements. For our part, the authorities cannot, and should not, compromise on the definition and quality of capital. We have seen the harm that this can do. But, equally we must help to find good capital structures that meet our objectives. This process is currently at an early stage of negotiation, so the outcome is by no means certain. The European Commission are due to adopt the CRD4 Directive – which in layman's terms means publish a starting draft text – by the end of this summer (but note such timing predictions can turn out to be a term of art). It is at this point that the terms proposed will be properly in the public domain. I cannot forecast how long it will then take to get agreement on the CRD4 Directive, though it is set to be implemented by the start of 2013. We are working closely with the Government on the design and agreement of an appropriate capital instrument for mutuals. It must be able to absorb losses (i.e. be written down) prior to liquidation of the issuer. Of course, I do have to say that to what extent there is a market for such instruments, and at what price, is not something that the authorities can legislate.

It is however very important not to get carried away with the prospect of a new capital instrument. The building society model means that you will naturally be more dependent on retained earnings as the source of loss bearing capital. This puts an emphasis on managing costs as a means to create retained earnings, and retain a larger share of those earnings to build capital than has been the case since the mid 1990s. A feature of a number of the successful societies has been strong and effective cost management which has improved returns. This is not incompatible with the mutual ethos in my view, though it does need to be consistent with the fair treatment of customers, both savers and borrowers. There may be unexploited opportunities for societies to work together to reduce costs by sharing services and infrastructure for instance. I think this is an issue for you to determine not the authorities, though I would note that is happens in some other countries.

Turning to funding, I think it is safe to predict that the pressure on interest margins will not go away. In essence, we have seen a switch from pressure driven by the asset side of the balance sheet before the crisis broke (lending margins, as I described earlier) to the liability side of the balance sheet being the cause of pressure (funding costs). It is striking that over half of new household deposits in the UK have recently had a maturity greater than one year, compared with around 10% during the latter half of 2008. This is a natural response to very low interest rates as savers seek to earn additional return by lengthening the term of their deposits. And, even though absolute rates are low, the spread of household deposit rates relative to official interest rates has risen markedly. Competition for retail deposits is intense as banks and building societies compete to attract more stable funding. As authorities, we do watch carefully whether the assumptions that underpin the aggregated business plans of banks and building societies amount to an unrealistic expectation of retail deposit growth. I would say that it is a case of so far, so good. What we have seen over the last year is a very encouraging strengthening of funding by UK banks and building societies which has enabled substantial progress to be made in repaying the temporary support provided by the Bank of England and the Government, with the first phase of progress focussed on repayment of the SLS, with its earlier end-date.

Competition for funding, and the impact on the cost of funding has fed through to spreads on lending to households, where the spreads on new lending have increased markedly relative to the spreads on loans outstanding. We could debate at length whether this is a product of demand or supply side stories. More obviously, it is a product of maintaining margins, which is necessary to support and rebuild capital bases. Frankly, there is a very delicate balance to be struck here between the essential bedrock of a stable financial system and the necessary role of banks and building societies to support the public policy goal of ensuring access to housing on affordable terms. This is the historical role of building societies, and one that in my view will continue.

Let me end by making two final points on the future of building societies which in some ways hark back to the writer in the Building Societies Gazette of 1870. A sustainable sector requires good risk management systems, which enable management to understand the risks inherent in their businesses. Sadly, my involvement in resolving problems in banks and building societies over the last four years has left me with too many "war stories" where this was not the case. The FSA has been working with individual societies over the last couple of years or so to ensure that risk management systems and capabilities are appropriate for the chosen model of business and reflecting market conditions. To support this, the FSA published the Building Societies Sourcebook which sets out how a society can align its funding and credit risk appetite with its risk management capabilities. The reviews that societies have carried out themselves following the publication of the sourcebook of their business model, risk appetite and risk management capabilities have led in a number of cases to either a modification of lending risk appetite or to a strengthening of risk management to meet that appetite.

Finally, human capital is of course important. The author of the 1870 article advised avoiding crotchety men, and get a chief executive who can do compound interest calculations in his head. Perhaps the world has moved on a bit, though the first piece of advice strikes me as a universal truth. It is important that societies can attract and retain senior management and board members of the right calibre. There were undoubtedly failures of governance among the causes of the crisis. It is not for the FSA to determine how institutions should be run, but we do actively assess governance structures, including the effectiveness of boards. This is an important part of our role. Occasionally, we will have frank, but I hope not crotchety, messages about governance.

In conclusion, I hope that building societies will continue to play an important part in the fabric of our society. It is our job to ensure that they can do so within an environment where the financial system is stable. What that means for the number of societies in the future is not something that the authorities should dictate. We do not have a master plan to reduce or increase the number of societies. That said, mergers are part of your history. Frankly, having been involved in a number of mergers that arose out of problems with one of the parties, I have one wish for the future, namely that future mergers are a matter of your choice rather than collective necessity.

Thank you.

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