HOUSING FINANCE – THE BUILDING SOCIETY MODEL

THE BUILDING SOCIETIES ASSOCIATION

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INTRODUCTION

Over the past few years there has been increasing interest in the operation of national housing finance systems. Several reasons can be deduced for this change in attitude—

(a) A number of industrialised countries have run into major difficulties with their housing finance systems. The United States has experienced the worst problems with their specialist thrift institutions accumulating combined losses running into hundreds of billions of dollars. Volatile interest rates have also posed major problems for mortgage banks operating with fixed interest rates in some European countries.

(b) Developing countries have been striving to develop their housing finance systems, and there is now universal recognition that these have to be based on a private sector model, as government funding is not available.

(c) In the past year or so the command economies of Eastern Europe have begun the transformation to market based economies. This entails radical changes in housing and the rapid development of sophisticated housing finance systems.

The building society model from the United Kingdom has, not unnaturally, attracted considerable interest. Manifestly it has worked by financing a huge increase in owner-occupation with minimal government support, and in a manner which has preserved the financial stability of the specialist building societies, notwithstanding, at times, a hostile economic climate. The system has also adapted to a more competitive marketplace, and the building societies of today are very different institutions from those which existed even five years ago.

In brief, the British building society model has worked because it has had an operating environment which has been favourable without giving direct financial support. In particular, unreasonable restraints have not been placed on their operations, they have been free to pay and charge market interest rates, and they have had real security in respect of their mortgage lending.

It is both simplistic and patronising to believe that the British building society model can be transplanted to other countries. Where this has been attempted (including ambitious attempts to copy the rather complex and idiosyncratic British building society legislation) the result has been failure. Each country has to develop a housing finance system appropriate to its own particular circumstances. However, a country can do this only if it has the benefit of an informed debate, and an understanding of alternative systems in operation. This brief publication is aimed primarily at policy makers, and gives a very broad overview of the British building society model, discussing how it might be applicable to other countries.

Mark Boléat
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CHAPTER 1

THE DEVELOPMENT OF BUILDING SOCIETIES IN BRITAIN

1.1 As the name suggests, building societies originated, in the late 18th century, as co-operatives, small groups of people who clubbed together their financial and labour resources to build themselves homes. Societies gradually evolved from this simple beginning into permanent financial institutions, collecting savings and making loans for house-purchase. Until the last 20 years, the basic functions of building societies remained unchanged, notwithstanding a huge growth in the size of the industry and an increasing concentration of assets. More recently, building societies, in a more competitive marketplace, have had to diversify. The British model was copied in those countries where the British had a significant influence, in particular the USA and the English-speaking countries of the old Commonwealth.

ORIGIN

1.2 Britain went through an industrial revolution in the late 18th century, before most other countries. In every country industrialisation is accompanied by a drift from rural to urban areas, and, therefore, housing problems. Housing conditions in the towns in Britain in the late 18th century were appalling, and there was little that the ordinary worker could do to improve his housing.

1.3 Building societies were a response to this situation. The first known building society was established in Birmingham in 1775, and was followed by many others, predominantly in the Midlands and North of England. The societies existed to provide each member, and no one else, with a home. The members, generally skilled workers rather than manual labourers, numbered not more than 20 and paid an agreed sum weekly or fortnightly. When sufficient money had been accumulated land was bought and building commenced. A ballot was held to decide who occupied the first house and so on. Later, the practice of auctioning off the priority to the highest bidder was developed. Members continued to make regular payments until all members had been housed.

1.4 The early building societies could therefore be seen as precisely that, societies of people who built themselves homes. They were not really financial institutions and, indeed, to a large extent operated on fundamentally unsound lines, in that those who were allocated houses first benefited at the expense of others. Also, many building societies ran into financial difficulty, either because of misappropriation of funds, or because there was less enthusiasm on the part of those who had been housed to continue contributing.

THE DEVELOPMENT OF PERMANENT SOCIETIES

1.5 In the early part of the 19th century, building societies changed from being institutions which wound up when they had completed their task of housing their initial members to permanent institutions. This change did not occur suddenly, but rather was a result of gradual evolution. The societies found, not surprisingly, that they could speed up the production of houses by borrowing money, on which, of course, they had to pay interest. This required them to charge interest to those who had the benefit of the funds. The separation of investors and borrowers therefore began to develop. The new societies had the word "permanent" in their names to distinguish themselves from the old "terminating" societies, and even today two societies still retain the word "permanent" in their names. By the end of the 19th century the permanent societies were by far the most important group.

THE EMERGENCE OF REGULATION

1.6 Building societies developed as an individual response to housing conditions, and were not set up, or encouraged, by the government. The first legislation governing building societies did not occur until after 50 years after their foundation, when in 1836 the Regulation of Benefit Building Societies Act gave societies their official recognition and established a government official to register rules and to offer advice. The next major regulatory development was the establishment in 1870 of a Royal Commission on Friendly Societies, which included building societies within its terms of reference. The report of the Royal Commission made a number of recommendations, particularly with respect to the role of the government official (the Chief Registrar of Friendly Societies as he had become) and the powers of societies. The report

was followed in 1874 by the first comprehensive Building Societies Act, most of which remained in force until 1986. The main feature of the Act was to limit the power of building societies to build and own land to the purpose of conducting their business. They were not allowed to engage in speculative property development or, indeed, to build houses of any description. Despite this major change from the early days of the industry they retained the "building society" name. The Act also greatly strengthened the powers of the Chief Registrar over societies.

1.7 Following the failure of a major building society in the early 1890s, an 1894 Act further strengthened the powers of the Chief Registrar and prohibited some practices that were thought to be questionable, including second mortgages and balloting for mortgages. The next legislation was a fairly modest 1939 Act, which dealt with certain practices in relation to lending. This was followed by a 1960 Act which dealt, in particular, with the manner in which societies could invest their liquid funds and the nature and extent of their lending to corporate bodies. In 1962, there was a consolidating Act; that remained the legislation under which societies operated until the comprehensive Building Societies Act of 1986.

1.8 One can summarise the regulatory development of building societies, at least until the recent past, as follows —

(a) Societies were established without government support, and regulatory developments tended to follow practice rather than to lead it.

(b) Between 1874 and 1986, societies operated under virtually unchanged and restrictive legislation, which was more than adequate (until the early 1980s) for its purpose.

EVOLUTION IN THE 20th CENTURY

1.9 The point has already been made that until recently building societies had changed little in respect of their functions, but there was a huge growth in the industry and a considerable increase in concentration. The number of building societies declined from 2,286 in 1900 to 1,271 in 1920, 952 in 1940, 726 in 1960 and 273 in 1980. This decline occurred as the terminating building societies went out of business having completed their task, and as permanent societies merged. These trends naturally followed the evolution of the British economy. As people increasingly moved from their birthplace so institutions which served them, such as building societies, had to move with them. The first branches were established in the 1920s, and the number of branches then grew until the early 1980s.
The geographical spread of the operations of individual societies intensified competition, and, therefore, encouraged the trend for societies to get together by merger. Larger societies were seen to be able to offer in some respects a better service to their customers, through having a wider spread of branches which could service investors and, to a lesser extent, also assist home-owners and potential home-owners moving away from their home.

1.10 Until the 1960s the growth of building societies had taken place without attracting the interest of the media or government. Building societies had been regulated as a separate part of the financial system, and their operations were not considered like those of banks, even though they were performing basic banking functions of collecting savings and transforming the funds into loans. However, by the early 1960s the size of building societies had become too great to be ignored by politicians and regulators. The variable mortgage rate, a key feature of building society operations, attracted political attention in the early 1960s as interest rates became more volatile, and the government referred building society interest rates to the Prices and Incomes Board which had been established to regulate prices and incomes. In the 1970s a formal mechanism for consultation between building societies and government was developed in the hope, somewhat forlorn as it proved, that this could influence developments in the mortgage market.

RECENT DEVELOPMENTS

1.11 A major turning point for building societies came during the 1970s. A house-price explosion in 1972 and 1973 had been followed by an increase in mortgage rates to the then unprecedented level of 11%, and this bought the building societies to the centre of public, and therefore political, attention. The interventionist Labour Government of the late 1970s tried to influence housing market activity through building societies, albeit unsuccessfully. Commentators were, at this time, increasingly pointing to the illogicality of tightly restraining the ability of banks to make loans and take deposits in the name of monetary policy, while at the same time permitting the rapid growth of building societies, for whom these two activities were their only functions. Academic concern was given strong support when an official Royal Commission, headed by former Prime Minister Harold Wilson, reported on the subject in 1980.

1.12 In 1979 a Conservative Government came to power, dedicated to removing administrative controls and encouraging competition. The banks were freed from balance sheet controls under which they operated, and for the first time this allowed them to compete in the mortgage market

with building societies on equal terms, whereas previously societies had faced virtually no competition. This in turn contributed to a breakdown of the collective arrangements, or cartel, by which societies had set interest rates. This coincided with rapid developments in financial markets generally, encouraged in particular by technological developments, which had made it easier for an increasing number of institutions, including small ones, to offer sophisticated money transmission and other banking products. Building societies found it difficult to compete with banks because they had a legislative framework that permitted them to do little other than make loans and accept investments. Both government and building societies recognised that this framework would not be adequate, and in the 1980s consultations began on the format of new legislation.

1.13 This led to the Building Societies Act 1986, which greatly increased the powers of building societies, allowing them, for example, to offer a fairly full range of financial services, and to make unsecured loans. However, the Act did not go far enough, and within a year or two there was further deregulation, such that building societies were empowered to offer the full range of retail financial and housing services. At the same time societies had been taking advantage of the development of the capital and money markets to raise an increasing proportion of their funds on those markets when relative interest rates justified it.

1.14 Armed with their new powers, building societies challenged the banks in the mainstream retail banking market, the current account market, and they also aggressively moved into other areas, including credit cards, estate agency and the sale of life insurance, concentrating in particular on exploiting their existing customer base. By the early 1990s, the distinction between banks and building societies to the retail customer had disappeared, and, indeed, one large building society had converted from building society to banking status with its customers being scarcely affected at all.

DEVELOPMENT OUTSIDE THE UK

1.15 The British building society model was followed by a number of English-speaking countries during the 19th century. In the USA, what is now known as the thrift industry had its origins in Frankford, Pennsylvania, in 1831 when the Oxford Provident Building Association of Philadelphia County, modelled on the British terminating building society, was formed. The concept rapidly spread to other states, and in 1848 the first steps towards establishing permanent associations were taken. As their functions, like those of British building societies, changed from financing house construction to lending to people to enable them to buy houses, so they changed their names to savings and loan associations, by which name they were known until the 1980s, since when the terms "savings association" or "thrift" have become more common.

1.16 In Canada, building societies operated in the middle of the 19th century in much the same way as the British terminating societies. In 1859 the Building Societies Act gave legal status to permanent societies in Canada. By the late 19th century Canadian building societies had developed into sophisticated financial intermediaries, but within a few years they had virtually disappeared as separate entities as a result of an 1897 Act which removed the legal distinction between societies and other loan companies.

1.17 The Irish Republic has a building society industry very similar in concept to that in Britain, and this reflects the fact that the two countries were unified until 1921. However, the societies which operate in the Republic of Ireland are independent institutions (at least independent of British building societies; some have strong links with other Irish financial institutions) and they do not lend outside the country.

1.18 In Australia, the first building societies were established in the mid-19th century, and the industry grew much as in Britain, although the real take-off did not become significant until the mid-1960s, with the advent of mortgage insurance. South Africa and New Zealand also developed building societies on the British model.

1.19 More recently a number of the "new Commonwealth" countries have established institutions called building societies, although many of them have not operated like building societies in practice. Malaysia, for example, has two building societies, there are a number in the various countries of Sub-Saharan Africa, and the industry is particularly strong in Jamaica. However, a number of these societies, while their legislation is modelled on the British system, have, in fact, raised a significant proportion of their funds from the capital markets, and, in some cases, have also lent a significant proportion of their funds other than for house purchase.

CHAPTER 2

RAISING OF FUNDS

2.1 The British building society model is a very simple one. Funds are raised largely from retail investors at variable rates of interest and are lent to those purchasing homes, also at variable rates.

COLLECTION OF SAVINGS

2.2 Until recently building societies attracted all of their funds, and even now they attract 80% of their funds, from the retail savings market. That is, they seek to attract the savings of individuals. There is a popular misconception that the building society system involves attracting the savings of those people who intend subsequently to borrow for house purchase. This is not, and has never been, the case. The people with substantial liquid savings in any economy are the elderly. In advanced industrialised economies this is particularly true. Elderly people are likely to have paid off mortgage loans some time previously, to have retired with incomes at their peak, yet with living costs comparatively low as children have left home, and increasingly to retire with the benefit of a lump sum from their pension scheme, and, also, the proceeds of maturing insurance policies. As owner-occupation has increased so elderly people have also experienced huge increases in the capital value of their homes, and they have inherited money from their parents.

2.3 The bulk of their funds which building societies attract, and hold, are therefore not small amounts from large numbers of savers, but, rather, large amounts from comparatively small numbers of savers. Table 2A below shows the distribution of savings balances with societies by age of investor.

TABLE 2A INVESTMENT IN BUILDING SOCIETIES BY AGE, FEBRUARY-MARCH 1989

Age Range	Number of Investors Million	% of Total	Mean Investment £	Amount Invested £m	% of Total
16-19	2.0	7	500	1,000	—
20-24	3.0	11	2,000	6,000	3
25-34	6.0	20	3,200	19,200	11
35-54	10.0	33	4,400	44,000	28
55-64	4.0	13	9,500	38,000	24
65+	5.0	16	11,300	56,500	36
Total	30.0	100	5,200	156,000	100

Note: The figures for mean investments and numbers of investors have been rounded, figures for amounts invested have been calculated from the crude figures, and then rounded. Similarly, the percentages have been calculated from the crude figures, then rounded. Because of rounding individual components do not necessarily sum exactly to the totals.

It will be seen that only 14% of funds were held by those under 35 while 60% were held by those over 54.

2.4 Table 2B shows savings balances by size of account.

TABLE 2B SHARE AND DEPOSIT BALANCES BY SIZE OF ACCOUNT END-DECEMBER 1991

Size of Account	Balances Held		Number of Accounts	
	£m	%	000s	%
Up to £100	429	0.2	23,007	42.4
Over £100 up to £500	2,113	1.2	8,480	15.6
Over £500 up to £1,000	3,090	1.7	4,305	7.9
Over £1,000 up to £2,000	6,120	3.4	4,302	7.9
Over £2,000 up to £5,000	20,110	11.3	6,333	11.7
Over £5,000 up to £10,000	22,393	12.6	3,196	5.9
Over £10,000 up to £20,000	33,949	19.1	2,437	4.5
Over £20,000 up to £30,000	23,928	13.4	968	1.8
Over £30,000 up to £50,000	27,470	15.4	726	1.3
Over £50,000	38,486	21.6	480	0.9
Total	178,088	100.0	54,233	100.0

Notes: 1. The figures are based on returns provided by seven societies accounting for 75% of share and deposit balances at the end of December 1991.
2. The figures exclude SAYE accounts.
3. Many investors have more than one account and the figures for numbers of accounts should not be taken to indicate the number of investors.

The table shows that about 70% of the retail money invested in building societies was in the 8% of accounts containing balances in excess of £10,000.

2.5 The previous two tables usefully illustrate that the savings which building societies hold are not savings out of income but rather are large capital sums. Nearly half of the savings are held by people buying their homes with mortgages and over a quarter by those who own outright. The capital sums which people put into their building society accounts come from a number of sources including the proceeds of house sales. It is fairly common for older people to move from a large house to a smaller one, thereby releasing equity which they invest in order to give them an income. The capital sums also include the proceeds of life insurance policies which often mature while people are in their 50s or 60s and also, increasingly, inheritances, which again are most likely to be received by people of around that age. Clearly there is something of a circular process at work and much of the money which building societies hold derives from the proceeds of house sales, either by the individuals concerned or because they are inheriting money which in turn largely derives from the capital value of houses. The key point is

that the somewhat old fashioned notion of a building society, that is of an institution raising funds from potential home owners to build up a fund to lend to those people to buy their homes, simply does not apply. The savings balances held in building societies are largely held in large sums by relatively old people who already own their homes.

2.6 The structure of the savings balances has changed markedly over the last 20 years. Traditionally, building societies raised almost all of their funds by means of ordinary share accounts, or paid-up share accounts or passbook account as they were sometimes called. Money could be paid into ordinary share accounts at any time in cash, by cheque or by standing order from a bank, and withdrawals could be made without notice in cash or by cheque issued by the building society. Transactions were recorded in a passbook. Until the mid-1970s, nearly 90% of the funds which societies held were in this form of account. The other main form of saving account was regular savings whereby people paid in a set amount to an account each month in exchange for a slightly higher rate of interest. It should also be noted that, at this time, the building societies collectively agreed the rates of interest which they would pay on these and also the rate which they would charge on mortgage loans.

2.7 Subsequently, there has been a marked change in the capital structure of societies. This is illustrated in Table 2C below.

TABLE 2C SHARE AND DEPOSIT BALANCES BY TYPE OF ACCOUNT

End Period	Ordinary Accounts	Instant and Short Notice Accounts	Term Accounts	Regular Accounts	Other	Total
	%	%	%	%	%	%
1974	87.2		5.6	3.8	3.5	100
1977	83.2		9.4	3.4	3.9	100
1980	79.0		14.7	3.5	2.8	100
1983	45.1	26.3	23.4	2.9	2.6	100
1986	15.9	69.5	12.1	1.2	1.3	100
1989	7.6	83.4	7.0	1.1	1.0	100
1990	6.7	81.4	9.8	1.0	1.2	100
1991	5.8	82.4	6.6	1.0	3.9	100

Source: The Building Societies Association.

2.8 The first major innovation was the introduction, in 1973, of term shares. At this time societies were facing an outflow of funds because competitive interest rates were very high. Many responded by offering term shares which offered a fairly substantial guaranteed differential, perhaps 1 or 1½%, over the ordinary share rate, in return for the investor agreeing to leave his investment untouched for a specified period, typically two years. By 1983 term accounts had increased rapidly to comprise 23.4% of total savings balances. The nature of term accounts had also changed significantly. Terms were lengthened from two years to three, four and eventually five years. They also became more flexible, in particular by allowing a withdrawal facility in exchange for an interest rate penalty. Now most term shares offer immediate withdrawals with a penalty or withdrawals without a penalty after 60 or 90 days' notice.

2.9 Term accounts became blurred into a new form of account, that is an instant or short notice account. These began in 1980 when societies offered a higher rate of interest than on ordinary shares in exchange either for a minimum deposit, often as low as £500, and/or a short withdrawal period, often seven days. Many societies now offer such accounts on instant access, and the only thing that really distinguishes them from ordinary share accounts is perhaps a minimum balance and also the fact that those holding ordinary shares have not bothered to transfer their funds. A more detailed breakdown of accounts as at the end of 1991 shows that 32.2% of funds were in seven days, or instant access, accounts, 12.1% were in one month accounts and 48.1% were in longer notice accounts, generally three months. Even on many accounts where funds are nominally at three months' notice investors often enjoy instant access as long as some minimum amount remains in the account.

2.10 The most recent innovation has been the offering by societies of money transmission facilities. Again this is not something which happened overnight but rather was a gradual evolution. As computers became more powerful, so during the 1970s and the 1980s societies were able to put their branches on-line to head offices and with the aid of counter top terminals, branch staff had direct access to the mainframe computer with details of each account. This facilitated societies allowing larger withdrawals by cash or by cheque and many people effectively used building societies as banks. That is, they kept their savings in the building society, obtained their cash needs from a building society, had their salaries paid into a building society and on the few occasions when they needed cheques they would obtain those cheques directly from the building society, made out to whomever they wished to pay.

2.11 By the mid-1980s a number of building societies were developing more explicit current account services. Societies were then installing automated teller machines in shared networks (initially the largest society had its own network and there were two shared networks; all three networks have now merged). Several societies then launched cheque book accounts, initially using clearing banks to process the cheques. Compared with banks, which had a cost structure that was increasingly inappropriate to current market

conditions, building societies offered very attractive current accounts paying interest on credit balances and often with no charges for transactions. By 1990 building societies were competing with banks across the whole range of current account services, but at the same time the banks were competing vigorously for saving balances.

2.12 Before leaving the building societies' role in the saving market, it is perhaps helpful to put this in a slightly wider context. Building societies hold 13% of the financial assets of the personal sector. Equity in life insurance and pension funds accounts for 52% but, of course, this does not compete directly with building societies as much of it is contractual or compulsory. Banks account for a similar proportion of personal sector balances, although only because the second largest building society, the Abbey National, converted to a bank in 1989. In the banking sector a much higher proportion of balances is in the form of current accounts rather than saving balances. Both building societies and banks compete with the government's own national savings, which offers national savings certificates in particular, which have tax benefits. There is also competition with the stockmarket and unit trusts, especially at times when share prices are rising. Generally, however, building societies regard the competition as being with banks and national savings. Table 2D shows personal sector liquid assets at the end of 1988 and 1991, the change between the three years being caused largely by the conversion of the Abbey National from the building society to the banking sector.

TABLE 2D PERSONAL SECTOR LIQUID ASSETS, END-1988 AND 1991

	End-1988		End-1991	
	£m	%	£m	%
National savings certificates and bonds	27,168	9.6	27,602	7.3
National savings deposits	9,134	3.2	10,049	2.6
Bank deposits	97,141	34.3	165,461	43.6
Building society deposits	149,567	52.8	175,887	46.3
Other	370	0.1	432	0.1
Total	283,380	100.0	379,430	100.0

Source: *Financial Statistics* Table 9.5.

METHODS OF COLLECTING SAVINGS

2.13 The methods by which building societies attract savings have changed over the years in line with the changes in the types of savings which they have attracted. Traditionally, building societies obtained their business through branch offices. Indeed, branches were essential when building societies raised a significant portion of their funds in cash over the counter, and similarly when people made withdrawals in cash. Also, until the early 1980s building societies collectively fixed interest rates between themselves. They did so with a fairly generous operating margin. This both facilitated the expansion of branches by societies and also directly encouraged it, because as there could not be competition on interest rates, there was competition on service. Accordingly, the number of branches expanded rapidly. In 1967 societies had 1,542 branches; during the 1970s the figure increased by around 10% a year, such that by 1982 there were 6,480 branches. For reasons which will be explained subsequently, the increase in the number of branches has since levelled off; since 1987 branch closures have exceeded new openings.

2.14 In addition to obtaining business through branches, building societies also have had some 20,000 agents. Typically these have been estate agents, insurance brokers or solicitors, who have operated a limited collection and paying out service in those areas where building societies did not themselves have branches. The agents were paid a combination of a fee and commission based on their turnover.

2.15 As markets have evolved and become more competitive, and as technology has facilitated money transmission services, so the methods by which building societies have attracted business have changed. As the cartel broke down during the 1980s and building societies were free to react to market pressures as they wished, so it became more attractive to use advertising to bring in savings. The costs of advertising and running a postal service are much less than the costs of running a branch service, and a number of societies deliberately aim for large stable balances rather than smaller balances with substantial turnover. This has, of course, been reflected in the different rates of interest paid on the various types of account.

2.16 In the early 1980s building societies began installing automated teller machines (ATMs). By the end of 1990 there were 2,000, all of which are now joined in a single network, which also has access to ATMs of other institutions. In many respects ATMs have revolutionised the way building societies handle their saving accounts. They have enabled even the smallest building society to provide cash and to accept deposits anywhere in the country (and indeed outside Britain as well). They provide in many cases a 24-hour service and are quicker than dealing with a branch. The fact that building societies also provide cheque book accounts has, again, reduced the need for branches.

2.17 The economics of branches have therefore changed considerably. Many building society customers never use them at all, perhaps having their salaries paid into their accounts automatically and using cheque books and ATMs for their money transmission facilities. Branches have therefore had

to become selling points designed to attract new business, either mainstream building society business or related business, such as insurance services.

TAXATION OF BUILDING SOCIETY INTEREST

2.18 Until recently building societies were subject to special tax arrangements in respect of the interest which they paid to investors. These were not intended to give building societies a competitive advantage, but simply were different. However, since 1985, building societies and banks have been subject to the same regime for the taxation of interest.

2.19 From the 19th century building societies were subject to special income tax arrangements the centrepiece of which was "the composite rate". This contrasted with the method of taxing bank interest, which was that interest was paid gross and investors had to declare to the Inland Revenue the interest they had earned, which was then taxed at their marginal tax rate. In the case of building societies, the composite rate arrangements provided a mechanism by which, instead of each individual investor being taxed, building societies collectively were taxed at a rate equal to that required to raise as much basic rate tax as would be raised if each investor were separately assessed. Those investors liable to the higher rates of tax were then separately assessed at those higher rates. In other words, if the basic rate of tax was 30%, and 80% of building society interest went to taxpayers, then the composite rate would be set at 80% of 30%, that is 24%. Those investors liable to the higher rates of tax then had to pay the higher rates on top of this, but those investors not liable to tax could not claim a refund. There was effectively a subsidy from non-tax payers to tax payers.

2.20 The system was controversial, with banks and others alleging that it gave building societies a competitive advantage by enabling them to pay higher rates than otherwise would have been the case because they were deducting tax at the composite rate, not the basic rate. Others pointed to the unfairness of the system, in that it penalised non-tax payers who, by definition, had little income.

2.21 The main merit of the composite rate arrangement was that it was simple for building societies which only had to pay one lump sum in tax each year, for the Inland Revenue which did not need to collect tax from the individual investors and for the vast majority of individual investors whose tax liability was discharged, and who as far as they were concerned were receiving interest tax-free. The scheme was in fact extended to banks from 1985, therefore removing any argument as to whether or not it gave a competitive advantage.

2.22 From 1990, the government changed the tax system, such that wives were taxed separately from their husbands. Previously, the investment income of a wife was aggregated with that of her husband for tax purposes. The separate taxation provisions brought in sharp focus the inequity of the composite rate of tax. It was clear that many married women in particular would want to receive interest gross because they were not liable for tax. However, there was no mechanism for paying interest gross, unless investors went outside the United Kingdom or invested in otherwise not very attractive national savings instruments. The government responded by abolishing the special tax arrangements from April 1991. Instead, banks and building societies would pay interest net of the basic rate of tax which could be reclaimed by non-tax payers. A mechanism was also introduced to allow non-tax payers to certify that they would not be paying tax, thereby enabling them to receive their interest gross from their bank or building society.

2.23 The key point is that building societies have not enjoyed any artificial advantage through special tax arrangements. Since 1985 they have been subject to the same tax arrangements as banks, and previous to that they had different arrangements which gave them some advantages and some disadvantages. There is no question of the government allowing building societies to have favourable tax arrangements.

WHOLESALE FUNDING

2.24 This chapter has so far concentrated on the attraction by building society of retail funds, and that is their traditional and basic method of operation. The chapter has illustrated how building societies have adapted to changing market conditions both in respect of the type of retail funds which they attract and how they attract them. However, building societies have not had a blinkered view that they should raise all of their money from the retail market regardless of circumstances. As financial markets changed in the early 1980s so wholesale funding became an attractive option and building societies have exploited this.

2.25 When building societies collectively set their interest rates, they frequently did so at rates which were out of line with current market interest rates. It was not uncommon, for example, for the mortgage rate to be perhaps two percentage points above or below money market rates of interest. This meant that it was not sensible for building societies to raise their funds on the capital markets as there was no guarantee that they could cover the costs

through the mortgage rate. As the cartel broke down in the early 1980s so the mortgage rate developed a more stable relationship with the money market rates, generally being above it, perhaps averaging about one percentage point, and never being more than one percentage point below it. This made it more attractive for building societies to raise funds on the wholesale markets.

2.26 The first wholesale funds were raised in 1980 through negotiable bonds. In 1983, tax rules governing the payment of interest by building societies were changed, such that societies could issue certificates of deposit (CDs). A CD is a receipt, issued by a bank or other financial institution, which is negotiable without endorsement, that is, it can be bought or sold without reference to the issuer. A CD has a fixed maturity, usually three or six months, and a fixed rate of interest. On maturity of the certificate the issuer repays the deposit with interest to the person who presents it for payment. CDs are held by institutional investors such as banks, discount houses, insurance companies and building societies. By the end of 1984 all the large building societies had issued CDs and they have remained in the market ever since.

2.27 From 1983 building societies were also enabled to pay interest gross on time deposits. Broadly speaking, these are the same as certificates of deposit except they are not transferable. They are particularly attractive to smaller building societies which are not able to issue CDs.

2.28 Another wholesale instrument is syndicated bank loans. They became attractive to issue from 1983 when there was a modest change in regulations which had previously required a building society to deduct bank loans from its total liquid funds for the purpose of meeting regulatory requirements. Bank loans have been used particularly by smaller societies.

2.29 From 1985 building societies were able to issue Eurobonds; the large ones immediately entered this market and have used it consistently ever since. Obviously this is a market open only to the largest building societies.

2.30 Table 2E illustrates how building societies have being making increasing use of wholesale funds by showing the net increase in wholesale funds in relation to the total increase in funds and also wholesale funds outstanding as a proportion of the total. It will be seen that in recent years wholesale funds have accounted for about a third of the total increase in funds. The proportion has shown a substantial variation dependent on conditions in the financial markets. When money market rates of interest have been comparatively low in relation to retail rates, then societies have, of course, made more use of wholesale funds. This explains the position in particular in 1986, 1989 and 1990. Conversely, when retail rates are comparatively low, building societies draw more heavily on retail funds, as in 1987 and 1991.

TABLE 2E BUILDING SOCIETIES WHOLESALE FUNDING

Year	Net Increase in Wholesale Funds in Year		Wholesale Funds Outstanding	
	£m	As % of Total Increase in Funds	£m	As % of Total Funds
1983	1,635	13	1,951	2.4
1984	2,228	14	4,184	4.4
1985	3,063	19	7,296	6.5
1986	6,527	34	13,796	10.5
1987	3,297	19	18,391	12.4
1988	5,865	22	24,225	13.9
1989	8,143	32	27,728	16.3
1990	9,697	35	37,425	18.9
1991	6,856	28	43,803	14.7

Source: *Financial Statistics*.

2.31 In 1991, of the increase in wholesale funds societies attracted, about 4% were certificates of deposit, 48% were time deposits and 19% were Eurobonds.

CHAPTER 3

LENDING FOR HOUSE PURCHASE

3.1 Building societies lend to individuals buying their own homes rather than to those building houses. Before lending they check the value of the property and the capacity of the borrower to repay the loan. They take out insurance to cover the risk of loss on the loans they make. A major feature of mortgage loans in Britain is the variable rate of interest, and this, among other things, requires careful management of the loans.

FINANCING CONSTRUCTION

3.2 In many countries much of the activity of housing finance institutions is in financing the construction of new houses. This may be either by providing finance to developers or by financing individuals who are having their own homes built or, particularly in middle income and third world countries, who are building their own homes. This activity is very different from lending to people to buy existing homes, and building societies have played little part in it.

3.3 In Britain some 90% of the homes which are bought each year are existing homes. Very few people have their own homes built to order; still fewer play any part in building their own homes. Most housing in Britain is constructed on what is called a speculative basis, that is a developer will buy land and build housing on it without having a definite purchaser. As the house nears completion, or after it has been completed, it is then marketed. This is naturally a risky business for the developer; he has no certainty of selling houses which he has completed. In a very active market, houses can be sold for substantially more than the developer could reasonably have expected, while in a quiet or depressed market, developers may have difficulty in selling any house. The house building industry in Britain has therefore shown marked fluctuations with the level of construction and house building profits varying considerably.

3.4 It follows that lending to house builders is risky. The developer can repay a loan only if he sells a completed house, whereas individual home buyers generally have no intention of selling homes which they have bought. If the home buyer defaults on his loan then the house has value and can be sold. If a developer defaults then he may be leaving a half-completed house or group of houses which may have a value substantially less than the outstanding loan. Construction finance is therefore regarded as a wholly separate business from lending to house buyers. It carries a higher rate of interest, and most of the lending is not by the specialist building societies but rather by banks which treat a loan to a developer in the same way as any other business loan.

LOANS TO HOUSE BUYERS

3.5 In order to understand the house purchase process in Britain, it is necessary to understand the housing market. There is only a modest market rental sector in the United Kingdom. This means that most households wish to, or rather need to, become owner-occupiers at a very early age, at which time they have not had the opportunity to accumulate a significant down-payment. The alternative is social housing, provided either by local authorities or housing associations. While this still accounts for about 25% of the housing stock, this housing is available only to those who can demonstrate some need and is not likely to be available, for example, to single people or to young couples with no children. Typically in Britain, many people first become owner-occupiers when they are still single, purchasing a modest flat. Some people become owner-occupiers when they first acquire a partner, whether by marriage or less formally. A first home is likely to be lived in only for a few years before there is a move up-market to a bigger house; there may be a third move up-market at a time when borrowers are in their thirties. Subsequently, any moves are likely to be job related rather than income or family related, but as people get older so there might be a move to smaller accommodation, partly to free capital for spending on other purposes and partly because of the difficulties of looking after a large house in old age.

3.6 There is therefore a thriving market in secondhand houses; 90% of all lending by mortgage lending institutions in Britain is on the security of existing dwellings, rather than to enable people to buy new homes. People will wish to purchase their first house at a very early age when they have little savings and will expect to be able to move at any time. The mortgage market has had to accommodate this housing market.

3.7 People in Britain who wish to buy houses generally do so through an estate agent; the agent acts on behalf of the vendor and charges no fee to those seeking to purchase. People are well aware of how much money they can borrow and generally

do not start looking for a mortgage loan until after they have found the house they want. This represents a marked change on the position of, say, ten years ago. Then, building societies could never fully meet mortgage demand, and they gave preference in granting loans to those who had been investors with them. This reflected the old fashioned mutual concept of a building society. As the mortgage market became more competitive so building societies dropped this requirement and now will consider loan applications on their merits, from whomever they might come. Normally, a building society would expect to be able to give an immediate response to a loan application; that is, on the basis of information provided by the potential borrower, a society could immediately indicate that it would or would not be prepared to grant a loan. When a formal application is received then the building society will institute a number of checking procedures. These checks relate both to the house and to the individual.

3.8 As far as the house is concerned, the normal practice of building societies and other mortgage lenders is to commission a valuation of the house; it must be stressed that it is a valuation, not a full structural survey. Valuations can be carried out fairly quickly and are simply designed to give an indication to the lender that the property is worth roughly a certain amount and is therefore good security for a loan of the amount requested. In the case of new houses, there is additional protection because almost all new houses in Britain are built under the National House Building Council warranty scheme, which means that the house is guaranteed against major structural defects for ten years.

3.9 Checking the income of the borrower is more complex. The lender will ask for details of income and will verify these directly with an employer. Enquiries will also be made about past rent payments and any previous mortgage account. Building societies use credit reference agencies to check that the mortgage applicant is who he says he is and also that there have been no court judgments for debt against him. Generally, although not always, the building society will wish to interview first-time buyers to ensure that they fully understand the commitment that they are taking on.

3.10 Building societies, therefore, lend on the security of the income of the individual and also the value of the property itself. However, they do not regard that as adequate security. Where a mortgage loan is for more than 75% or 80% of the value of the property, then the building society or other lender will take out an insurance policy on the top slice of the loan. The premium for this policy has to be paid by the borrower but it is generally added to the loan. A number of general insurance companies provide this insurance cover; unlike in other countries, for example the USA, Australia and Canada, there is no special mortgage insurer. The government also plays no role in the mortgage insurance market. Currently the premiums which relate to the amount of the loan insured vary from 3.5% for loans of between 80% and 90% of valuation (that is the premium of 3.5% of the amount of the loan over 80%), 4.5% for loans of between 91% and 95%, and 7% for loans in excess of 95%.

3.11 Mortgage insurance gives the building societies valuable additional protection. If the borrower defaults, the lender will take possession of and sell the house, using the proceeds to pay off the loan. However, if the proceeds are insufficient, then the insurance company will meet the difference, with the building society only suffering a loss if the house has fallen in value so much that the proceeds do not cover the uninsured 75% or 80% of the loan.

3.12 The security of mortgage lending in Britain is enhanced in a number of other ways. The value of houses in Britain has risen steadily over the years and in anything other than a very short period has show a significant increase. This means that if the borrower defaults then there is likely to be sufficient equity to repay the loan. The rise in house prices also reduces the likelihood of borrower default as they are aware that they have equity available and in some cases can use that equity to borrow additional amounts or even to capitalise interest if they had short term difficulty in repaying their loan. However, the early 1990s marked a change from this pattern with significant falls in nominal house prices leading to substantial bad debt provisions for lenders.

3.13 The social security system in Britain is generous towards those who suddenly find themselves unable to repay their mortgage loan. If a borrower loses his job then, provided he has savings below a certain amount, he is entitled to "income support" to meet the interest on his mortgage. Half of the interest will be met for the first 16 weeks and the whole of the interest thereafter, including interest on any capitalised interest due in the 16-week period for which only half of interest has been paid. This provides very valuable additional security for building societies especially in parts of the country suddenly subject to a big increase in unemployment. Without income support a number of borrowers would be unable to keep up loan repayments and if mortgage lenders took their properties in possession they might have difficulty selling them because of a depressed market.

3.14 Finally, mortgage lenders in Britain do genuinely lend on the security of property. The

terms of the mortgage contract are that if the borrower does not meet the loan repayments then the lender can take possession of the house and sell it so as to recover its loan, any surplus being paid to the borrower. In many countries lenders have difficulty in enforcing their rights under the mortgage deed. This is not the case in the United Kingdom. However, lenders cannot obtain possession of the house unless they have a court order to do so, and the courts will consider carefully the merits of any case put before them. The court will give a court order provided it is satisfied that the borrower not only cannot repay the loan at present but is unlikely to be in a position to do so. Frequently the court will give what is called a suspended possession order, which is an order giving possession to the lender but suspending it provided the borrower makes certain repayments. If the borrower does not do so, then the possession order is executed.

TYPES OF LOAN

3.15 Until fairly recently building societies provided most of their mortgage loans on the annuity or repayment basis, that is a monthly payment was calculated which would be sufficient to repay the loan over its life. Initially, of course, most of the repayments would be interest but over time the proportion of capital repayments increased.

3.16 Over the last ten years or so endowment linked loans have become more common and now account for some 80% of all new mortgage lending. Under this system the borrower pays interest only on his mortgage loan; simultaneously he makes contributions to a life insurance policy with the same maturity period as the loan. The life policy is usually on what is known as a low-start basis, that is the sum assured is not sufficient to repay the loan although the life insurance element part of the contract means that in the event of the death of the borrower the loan will be repaid in full. Bonuses are added to the life insurance policy over its term and normally the proceeds are more than sufficient to repay the whole loan. For the borrower, endowment-linked loans are attractive because they provide the life cover which borrowers would otherwise have to pay for separately, and also the monthly repayments on an endowment loan are little different from those on a repayment loan. For the lender, they help to simplify administration of loans and also they provide an opportunity to earn valuable commission from the sale of life insurance policies. The lender also has additional security in that in the event of the death of the borrower the proceeds of the policy are first used to discharge the loan (in legal terms the insurance policy is "assigned" to the lender).

3.17 More recently there have been a number of innovations in loan types. Life insurance policies no longer carry major tax advantages. There are other savings instruments which are more tax advantageous, in particular personal pension plans and personal equity plans. (In the latter arrangement, £6,000 a year can be invested in equities with the dividends and capital gains being tax-free.) A number of lenders, therefore, offer interest-only loans with the repayments being provided for by a personal equity plan or personal pension plan. Unlike endowment-linked loans, there is generally no formal assignment between the savings instrument and the mortgage but this does not seem to have caused any problems.

3.18 In response to a very competitive mortgage market and rapidly rising interest rates in the late 1980s, lenders have offered other variations, including divorcing the rate of interest charged on the loan from the rate of interest according to which payments are calculated. These schemes allow borrowers to make much lower initial payments than would otherwise be the case. They can work quite well in times of rising incomes and inflation but can be dangerous in more difficult market conditions.

VARIABLE INTEREST RATES

3.19 Building societies operate almost entirely on the basis of variable interest rates. The previous chapter has pointed out how building societies raise most of their funds from individuals on a short-term basis. This means that societies must keep the rate of interest they pay to their depositors at a competitive level. If they do not do so then not only will they not attract new savings but they will lose existing savings. If building societies are to operate in a viable way, then clearly they must vary the rate of interest which they charge on their mortgage loans in the same way they vary the rate of interest which they pay on their investment balances.

3.20 As with their savings product, building societies have made modest adaptation to the terms of their mortgage loans to take account of changing market conditions. Until the early 1970s interest rates in Britain were relatively stable. Building societies had mortgage deeds which provided for three months' notice to be given of any increase. As there were increases only occasionally this did not cause them any problems. In the 1970s interest rates began to come more volatile. Building societies found themselves having to change the rate of interest to their investors at short notice, but they were unable to recoup any extra interest from their borrowers until the end of a three months' notice period. Accordingly, notice periods were reduced to one month and then finally to no notice.

Building societies now have provisions in their mortgage contracts which enable them to vary the rate of interest on existing loans by giving notice in a press advertisement.

3.21 Obviously if rates of interest fluctuate markedly then this can put considerable pressures on the budgets of households. Recently, for example, between the spring of 1988 and the beginning of 1990, the general level of mortgage interest rates increased from 9.5% to 15.4%. Building societies have developed a number of ways of minimising the impact on borrowers.

3.22 Traditionally, with the annuity loan, building societies could lengthen the term, thereby reducing repayments. However, this has only a limited effect and can do little if interest rates are at a very high level. More importantly, most mortgage loans now are on an interest only basis and therefore when the mortgage rate increases the higher repayments must be met in full. Nevertheless, in cases of hardship, building societies will accept an interest payment that is lower than the rate being charged on the account for a limited period of time.

3.23 To try to give more stability to borrowers, many building societies have introduced annual review systems. Under this system a repayment is fixed for one year at a time on the basis of the interest rate then in force. While interest rates may change during the year the monthly payments will not. If interest rates rise then the debt will increase, while if interest rates fall the debt will reduce. At the end of the year a new repayment is calculated on the new debt outstanding and at the then prevailing interest rate. This system works reasonably well when interest rates fluctuate but if interest rates rise or fall several times in the same direction during a year it can lead to some consumer resistance, either because people feel they are not getting the reductions they are entitled to or because several increases are implemented at the same time.

3.24 Over the past 20 years building society mortgage interest rates have been very competitive with other interest rates in the economy. This is partly because they are based on short-term interest rates, and short-term rates tend to be lower than long-term rates. However, since the late 1980s there has been, in technical terms, an inverse yield curve with long-term rates being less than short-term rates. Building societies and other mortgage lenders responded to this by raising from the wholesale markets tranches of funds at a fixed rate of interest, for say, three years, and then on-lending those funds also at a fixed rate for three years. At the end of that three-year period either a new fixed rate will apply or the loan can go on to the normal variable rate basis. This product has been very successful but only because of the particular market circumstance in which it was introduced.

3.25 Building societies do not generally lend at fixed rates of interest for longer than about five years. There are, of course, strong arguments for having fixed rates for longer periods. However, it is impossible to operate a housing finance system on the basis of long-term fixed rates loans if borrowers are to be allowed to redeem at any time. It would be safe to lend for, say, 25 years at a fixed rate of interest only if, similarly, the funds were borrowed on a matched 25-year basis. If borrowers were, however, able to redeem without notice and with no penalty after, say, five years because interest rates had fallen, then the building society would be left to fund the higher interest rates on the funds raised to finance that loan. In some countries, for example Denmark, the mortgage market does work in this way, but only at the expense of preventing borrowers from redeeming unless they compensate the lender for any change in interest rates.

3.26 Because building societies operate almost the whole of their business on a variable rate basis, they minimise the risk to them and this enables them to operate on a lower margin than would otherwise be the case. All borrowers therefore benefit to some extent from the system because it keeps the margin, and therefore mortgage rates, down.

MANAGEMENT OF MORTGAGES

3.27 A mortgage loan is unlike most other goods or services, in that the institution which provides it cannot be certain of getting its money back for many years, and then only if it manages the product correctly. Building societies devote considerable resources to the management of their existing mortgage loans. Most loans are repaid through bankers' orders although some borrowers still make monthly cash payments. The building society will carefully monitor the pattern of repayments and if one or two repayments are missed then a letter is sent immediately to the borrower. Often, of course, repayments may be missed for purely technical reasons without the borrower having any difficulty in meeting repayments. If a borrower indicates that for some reason he cannot meet his repayments or if there is no response to letters, then this will be followed up quickly by a personal visit. The intention is to help the borrower re-arrange his finances, if necessary through some re-arrangement of the mortgage, so as to ensure that in the long term the loan can be repaid. Ultimately, if it is clear that a loan cannot be repaid then the building society will seek a court order for possession of the property and, as has been indicated earlier, provided it is clear that the

borrower will not be able to meet the repayments they will get that court order.

SECONDARY MORTGAGE MARKET

3.28 In the USA there is a very significant secondary mortgage market by which loans or securities backed by mortgage loans are traded. The United Kingdom has only a small such market. This has developed over the last few years as a result of the activities of a number of new centralised lending institutions which raise their funds entirely on the wholesale market and which obtain their loan business through introductions from intermediaries. These new lenders, together with some existing lenders, have securitised loans by selling them to specially created companies which, in turn, issue securities backed by the particular pool of loans. The pool needs what is called credit enhancement, which is given by various insurances including often insurance of the entire mortgage pool. Partly because the secondary market is still relatively small, the cost of securitisation remains quite high. Mortgage backed securities carry a rate of interest that is related to money market rates of interest, generally about 30 to 50 basis points higher. The cost of a deal can easily amount to the same over its life.

3.29 Most banks and building societies, the mainstream mortgage lenders in Britain, have not yet securitised any of their loans. For them the funds raised are more expensive than those they could raise in the financial markets and they do not have such a capital shortage that they are unable to hold all the loans they can originate on their balance sheets. There is, however, no philosophical objection to securitising mortgage loans. This has not yet been an efficient method for portfolio lenders in Britain to do business.

CHAPTER 4

THE BUILDING SOCIETY INDUSTRY TODAY

NUMBER OF SOCIETIES

4.1 Chapter 1 explained the factors leading to the decline in the number of societies from 2,286 in 1900 to 273 in 1980. The decline has continued largely as a result of mergers between societies. In some cases small societies have been taken over by larger units when, for various reasons, often related to management succession, they have felt that the interests of their members would be better served by amalgamating with a stronger organisation. In other cases, two strong societies have got together to form an even stronger society, in some cases at national level and in other cases at regional or local level.

4.2 The number of societies declined from 273 at the end of 1980 to 167 at the end of 1985 and 110 at the end of 1991.

4.3 Table 3A shows the distribution of societies by asset size at the end of 1990.

TABLE 3A DISTRIBUTION OF SOCIETIES BY ASSET SIZE, END-1991

Asset Range	No of Societies	Percentage of Total	Percentage of Assets
Over £25,000 m	2	2	36.9
£10,000-£25,000 m	6	5	37.7
£3,000-£10,000 m	5	5	11.5
£1,000- £3,000 m	12	11	8.8
£600- £1,000 m	6	5	2.0
£150- £600 m	22	20	2.4
Under £150 m	57	52	0.9
Total	110	100	100.0

Source: The Building Societies Association.

4.4 Table 3B lists the largest 20 building societies at the end of 1991, giving details of their base, assets and branches.

4.5 The five largest building societies operate throughout the whole country and are truly national societies. However, it will be noted that four of them have names indicating a geographical location reflecting their place of origin. The next eight societies in the list can also be regarded as national societies having branches throughout the country but their coverage in some areas is relatively modest. The remaining societies in the largest 20 and a number of other societies operate on a regional basis, their name generally indicating their base or area of operation.

4.6 In addition to national and regional societies there are also local societies which operate in a fairly small geographical area only, generally a single town. Many local societies, however, do raise funds from investors outside their locality, by post, and may also seek mortgage business from other parts of the country.

TABLE 3B LARGEST 20 BUILDING SOCIETIES, END-1991

Year End (31.12.91 unless otherwise stated)	Rank	Society	Base	Assets £m	Branches
31.1.92	1	Halifax	Halifax	58,710	750
4.4.91	2	Nationwide	London	31,125	777
	3	Alliance & Leicester	Brighton/ Leicester	20,479	411
	4	Woolwich	Bexleyheath	20,165	551
30.9.91	5	Leeds Permanent	Leeds	16,211	424
	6	Cheltenham & Gloucester	Gloucester	14,789	210
	7	Bradford & Bingley	Bingley	11,910	291
	8	National & Provincial	Bradford	10,708	315
	9	Britannia	Leek	8,524	246
	10	Bristol & West	Bristol	7,141	168
	11	Northern Rock	Newcastle	4,415	119
	12	Yorkshire	Bradford	4,185	134
	13	Birmingham Midshires	Wolverhampton	3,745	121
	14	Skipton	Skipton	2,717	60
	15	Portman	Bournemouth	2,594	97
	16	Coventry	Coventry	2,369	66
	17	Chelsea	Cheltenham	2,277	58
	18	Leeds & Holbeck	Leeds	2,236	77
	19	Town & Country	Clacton	2,192	78
	20	Derbyshire	Derby	1,351	59

Source: The Building Societies Association.

BRANCHES AND STAFF

4.7 The number of building society branches increased rapidly in the 1960s and 1970s. Branches were the principal means by which building societies both attracted new customers and undertook business with their existing customers. Branches have been located in areas of maximum pedestrian traffic which has generally meant shopping areas in the main town centres and suburbs.

4.8 The rate of branch expansion began to slow down in the mid-1980s. This reflected a very changed market position. Until the early 1980s building societies had dominated the savings and mortgage markets and had set interest rates collectively. This concentrated competition into non-price areas, particularly branching. As building societies lost their dominant position, so the artificial attractiveness of branching as a distribution mechanism diminished.

4.9 A related factor was the advent of automated teller machines which gave existing customers a more convenient method of access to funds than visiting a branch.

4.10 Between 1984 and the end of 1988 there was only a modest increase in the number of branches from 6,816 to 6,912. However, during this period a number of societies increased their branch networks while others actually reduced them by selling branches which were surplus to their requirements. Mergers also had the effect of reducing the number of branches. Excluding the Abbey National (which converted from a building society to a bank in 1989), the number of branches fell from 6,236 at the end of 1989 to 5,921 at the end of 1991.

4.11 Table 3C shows details of staff employed by building societies at the end of 1990.

TABLE 3C BUILDING SOCIETY STAFF, END-1990

	Full-Time	Part-Time	Total
Branches	37,664	13,253	50,917
Chief Offices	23,590	1,875	25,465
Total	61,254	15,128	76,382

Source: The Building Societies Commission.

4.12 It will be seen that building societies in total had 76,382 staff at the end of 1990. 20% of these were part-time staff. Societies have made particular use of part-time staff in their branch offices to accommodate the variable traffic flow through branches during the course of the day.

4.13 There are 2.4 branch staff for every employee at chief offices. Over recent years there has been an increase in the ratio of head office to branch office staff reflecting largely computerisation and the centralisation of some services.

4.14 The average building society branch employs a little under ten staff but the variation is substantial from just two or three staff in a sub-branch to over 100 in some of the big city centre branches.

ACCOUNTS

4.15 Table 3D shows the assets and liabilities of building societies at the end of 1991.

TABLE 3D ASSETS AND LIABILITIES, END-1991

Liabilities	£m	%	Assets	£m	%
Retail funds and deposits	181,380	74·4	Mortgages	196,938	80·7
Non-retail	45,269	18·6	Other commercial assets	3,942	1·6
Other loans and liabilities	3,220	1·3	Cash and investments	39,511	16·2
Subordinated debt	2,358	1·0	Fixed assets	2,866	1·2
Subscribed capital	314	0·1	Other assets	712	0·3
Reserves	11,428	4·7			
Total	243,968	100.0	Total	243,968	100.0

Source: The Building Societies Association.

4.16 The table shows that over 70% of building society liabilities were in the forms of retail funds and deposits, largely shares held by members. Non-retail funds have been accounting for an increasing proportion of funding in recent years, as was illustrated in Chapter 2. Mortgage loans account for over 80% of the total assets of building societies. This is notwithstanding significant diversification in recent years into areas such as credit cards and consumer loans.

4.17 The operation of building societies is perhaps illustrated a little more clearly by a simplified income and expenditure account, which is shown in Table 3E.

TABLE 3E INCOME AND EXPENDITURE, 1991

	£m	£ per £100 Mean Assets
Income		
Mortgage interest	24,098	10.46
Investment and bank interest	4,719	2.05
Commission	600	0.26
Other	−779	−0.34
Total	28,638	12.38
Expenditure		
Management expenses	2,584	1.12
Interest paid (including tax)	24,033	10.43
Corporation tax	665	0.29
Total	27,282	11.84
Extraordinary items	27	0.01
Total profit	1,330	0.58

Source: The Building Societies Association.

This table illustrates the importance of interest in building society operations. Mortgage interest together with investment and bank interest account for well over 90% of the income of societies, and expenditure is largely explained by interest paid to depositors, together with tax paid on that interest. Management expenses are relatively low in relation to mean assets.

CONSTITUTION AND REGULATION

4.18 Building societies are governed by a single act of parliament which deals with their constitution, powers and supervision. The current legislation is the Building Societies Act 1986, together with secondary legislation made under that act.

4.19 The Act provides that building societies have a mutual constitution. There is a specific requirement that at least 50% of the funds of a society should be raised from members, and also 75% of commercial assets must be in the form of first mortgage loans to owner-occupiers of residential property, and such borrowers are also

members. The Act lays down items which must be covered in the rules of a society and makes provision for such matters as the election of directors, and the rights of members.

4.20 In theory, the members of each building society play a significant part in the affairs of that society. For example, they elect the directors, and also must approve the Memorandum of Powers under which a society operates. In practice, however, building societies work rather differently. In practice, most building societies adopt a common Memorandum of Powers, giving them access to all of the powers which building societies are permitted to undertake. Most societies also adopt a set of model rules prepared by The Building Societies Association in conjunction with the Building Societies Commission. While directors have to be elected by members, in practice the names of potential new directors are put forward by existing directors. In this respect they are little different from public limited companies.

4.21 The mutual concept does give some problems in theory, although not in practice. The tight legal framework, together with supervision by the Building Societies Commission, ensures that building societies are run for the benefit of their members, and cannot be exploited by management or directors. It is also important to note here that building societies are long established organisations, each society having its own characteristics and tradition. In such circumstances continuity in management, and on the board of directors, can be ensured. It would be a very different matter to try to set up new building societies of a significant size given the constitution which societies have. Also, of course, long established organisations have had the opportunity to build up reserves which form its capital. A new organisation cannot do the same.

4.22 Under the Building Societies Act 1986, a Building Societies Commission was established, although this was based on the previous regulator, the Registry of Friendly Societies. The Commission is a separate government department responsible to the Treasury. The Bank of England, which regulates banks in the United Kingdom, has no responsibility for building societies, although, in practice, the Commission and the Bank work closely together.

4.23 The Commission is given responsibility under the 1986 Act for administering the Act and for supervising building societies. The Commission's supervisory function is particularly important. It exercises this through requiring societies to make returns covering a number of variables including income and expenditure, profitability, arrears, capital and so on. Each society has a supervisor allocated to it with whom close contact is maintained. Once a year there is a formal annual review meeting between representatives of the Commission and the chairman and other board members of the society.

4.24 The Building Societies Commission issues a series of prudential notes covering matters such as capital adequacy, liquidity, systems and so on, which, in practice, comprise part of the supervisory framework with which societies must comply.

4.25 The Commission also has an important responsibility to be the "sponsoring department" for building societies. It has a duty to recommend to the Treasury changes in the Act if it considers these are necessary in order to maintain the viability of societies.

4.26 In practice, it has been very helpful for societies to have their own dedicated supervisor. The Commission has become expert in supervising societies and because it understands how they operate and how their business is developing it has been able to secure the necessary changes to building society legislation in order to ensure that societies have been able to operate within a viable framework.

MARKET POSITION

4.27 Building societies occupy an important position in the markets for personal sector liquid assets and house purchase loans. This is illustrated in Tables 3F and 3G.

TABLE 3F PERSONAL SECTOR LIQUID ASSETS, END-1991

Asset	£m	%
Deposits with building societies	175,887	46·3
Deposits with banks	165,461	43·6
National Savings	37,651	9.9
Other	432	0·1
Total	379,431	100.0

Source: *Financial Statistics* Table 9.5.

TABLE 3G LOANS FOR HOUSE PURCHASE, END-1991

Institution	£m	%
Building societies	197,139	61.5
Banks	90,376	28.2
Miscellaneous financial institutions	25,939	8.1
Insurance companies and pension funds	4,329	1.5
Other	3,024	0.9
Total	320,807	100.0

Source: *Financial Statistics* Table 9.4.

4.24 These tables understate the role played by the institutions which traditionally have been regarded as building societies. In 1989, the second largest building society, the Abbey National, converted to banking status and is now included within the banks for statistical purposes. The Abbey

National alone accounted for about 6% of personal sector deposits and 10% of mortgage lending.

4.25 Even with the Abbey National counted as a bank it will be seen that deposits with building societies exceeded deposits with the banking sector. National Savings occupies a relatively modest role.

4.26 In the mortgage market building societies, even without the Abbey National, still account for 60% of outstanding loans. The banks are the other major lenders.

REPRESENTATION

4.27 The building society industry comprises 90 individual institutions, each independent from each other and from other institutions. The building societies need to have a collective voice so as to ensure that regulations governing their operations are appropriate and also to facilitate the exchange of non-commercial information, in particular statistics. In Britain this function is performed by The Building Societies Association, a trade body established as long ago as 1869. All but one or two active building societies belong to the Association, which operates from London with a staff of 50. The Association performs two basic functions. Firstly, it acts as the representative voice for building societies, representing their interests to government, parliament, the media and other trade bodies. The Association is frequently asked to comment on government proposals and to explain the policies and practices of building societies. The second major function of the Association, connected with the first, is to provide a technical service to members. The Association provides explanations of all legislation and regulatory developments of relevance to building societies and it provides a statistical and technical service to members as well.

4.28 For many years The Building Societies Association not only was the representative body for building societies but effectively it was the representative body for the mortgage lending industry generally given societies' dominance of this market. As the mortgage market became more competitive in the early 1980s, and given the conversion of the Abbey National from a building society to a bank, so a wider representative body became necessary. The Association took the initiative in establishing the Council of Mortgage Lenders, which came into being in August 1989. This comprises building societies and almost all other mortgage lenders, including banks, centralised lenders and insurance companies. The Association handed over its housing and mortgage work to the Council. The secretariat of the Association also services the Council.

CHAPTER 5

WHY HAS THE MODEL WORKED?

5.1 The building society model has worked in the United Kingdom for a variety of reasons, most of which are accidental rather than the deliberate intention of government policy or, indeed, of building societies themselves. Nevertheless, the experience of building societies is valuable in showing the sort of framework which will facilitate the development of an effective housing finance system. The success of building societies relies on a favourable (although not artificially so) regulatory regime and the method of operation of societies which has combined efficiency and simplicity.

LACK OF GOVERNMENT COMPETITION

5.2 In many countries, in particular developing countries, the savings market is dominated by governmental or quasi-governmental organisations, often, if not invariably, operating with competitive advantages, for example a government guarantee of the institutions, or lower capital requirements than those applying to private sector institutions. This has not been the case in the United Kingdom.

5.3 As in other countries, a savings bank sector developed in the mid-19th century but, unlike in other countries, its growth was comparatively modest. It was very much part of the public sector, run on bureaucratic administrative lines rather than commercial lines. All of the funds raised by a network of savings banks were handed over to the government. The savings banks undertook no loan business at all. At the end of 1981, savings banks were only one-tenth of the size of building societies. From the beginning of 1982, savings banks were transferred to the banking sector and gradually were transformed into a single bank, the TSB Bank, which now operates as a commercial bank in the same way as other banks. However, it remains comparatively small compared with the big commercial banks and the largest building societies.

5.4 National Savings has provided a greater element of competition to building societies. Traditionally, National Savings, as in other countries, has been aimed at small investors. However, during the 1970s in particular, National Savings was used as a method of funding the public sector borrowing requirement and was also partly used to counteract the effects of very high marginal tax rates. National Savings certificates, which can be held in limited amounts only, have been tax-free and thus have been particularly attractive to higher rate taxpayers. Since the mid-1980s, the government has recognised that using National Savings in this way has distorted the markets. The government began to cut sharply the higher rates of tax, which reduced the need to use an instrument such as National Savings to help people avoid paying the highest rates. The total amount invested in National Savings was, as a result, stagnant since 1987, while building societies between 1982 and 1991 continued to grow rapidly. However, over the last two years the government has again begun to make extensive use of National Savings.

EXEMPTION FROM MONETARY AND CREDIT CONTROLS

5.5 Building societies have undoubtedly benefited, at least until recently, by not being regarded as banks. Traditional economic theory has regarded the banks as having a special place in the financial system, capable of creating credit. In the 1960s and 1970s it was fashionable for governments to attempt to influence the economy by influencing the supply of money directly, that is either by influencing the level of bank deposits or the level of bank lending. Both instruments were used in the United Kingdom. At times banks were subject to limits in the increase in their loan balances and, at other times, they were subject to a restriction on the growth of their interest bearing deposits. Building societies, because they were not banks and were, at this time, substantially smaller than the banks, were exempt from these controls and, indeed, no one ever considered seriously whether they should be applied to societies.

5.6 The result was that banks became less competitive for both deposits and loan business. They lost loan business for large companies to American banks in particular and they were unable to take mortgage lending business from the building societies. The banks even adopted policies such as closing their branches on Saturday mornings and early in the afternoon because there was no advantage to them in increasing their deposit base.

5.7 Building societies obviously flourished in this environment. They were subject to no restrictions yet were operating in large and rapidly growing markets for mortgage loans and personal deposits. The market position was such that building societies were never able to meet fully mortgage demand and, encouraged by the government, societies got together to fix interest rates, generally below a market clearing level. This ensured that all

building societies could operate with satisfactory profitability and, at the same time, that there were no strong commercial pressures on societies. Competition tended to develop in a non-price way.

5.8 The illogicality of government policy began to be recognised in Britain, and in other countries, in the early 1970s. The policy of imposing controls on the banks was seen to have inhibited competition in the banking sector while, at the same time, transferring business to building societies. The very size and growth of building societies meant that their role in influencing economic variables was increasingly recognised and that, therefore, it was futile to operate monetary policy while ignoring some of the major participants in the market.

5.9 Nevertheless, it is the case that this very favourable environment helped building societies build an entrenched position in the retail markets, and, even when freed from controls at the end of the 1970s and in the early 1980s, the banks found it very difficult to regain the business which they had lost.

SIMPLE AND ATTRACTIVE PRODUCTS

5.10 By the mid-1970s building societies were in an almost unique position. They were huge and rapidly growing institutions. However, they operated on simple lines. They did not offer a wide range of banking products, confining themselves to retail savings products and mortgage loans. This, of course, was largely a result of their legislation more than any specific intention of societies. However, in retrospect, the restrictive legislation probably served societies well. It helped to prevent them from diversifying into areas where other institutions subsequently lost a great deal of money. It enabled them to concentrate on the retail sector, in which they became expert. Branches were carefully designed to be attractive to people and, because only personal business was conducted, customers found them more convenient than bank branches. In banks, people often have to wait in a queue behind, for example, businessmen paying in substantial amounts of cash or large numbers of cheques.

5.11 Both making loans for house purchase and being a home for savings are popular services whereas other banking services, for example current accounts and unsecured loans, can easily be less than popular. The restriction of building societies to a narrow range of popular products, therefore, led them to become much more popular institutions in the eyes of the public than the banks and this, in turn, helped them gain additional business.

5.12 Perhaps societies were fortunate that they had a very entrenched position in the retail markets before the retail markets themselves became competitive. There is no doubt that by the mid-1980s large financial institutions could not survive by offering interest without money transmission any more than they could survive by offering money transmission without interest. Building societies were well placed to take advantage of new technology to add money transmission to their traditional range of savings products and to do so in an efficient and competitive way.

5.13 Even though building societies have diversified substantially over the past few years, they have done so generally within a very limited range, concentrating on providing financial products to individuals. Few societies have moved into the commercial market and in some cases where they have moved (albeit relatively modestly) in this direction the result has been very costly with substantial bad debts.

5.14 Building societies have exemplified the advantages of specialisation in a market where specialisation is appropriate. It is increasingly difficult to draw lines when one is providing financial services; often the provision of one service leads to the need to provide another. This is certainly the case with corporate business. Any institution purporting to provide a banking service to a company must, of necessity, also be willing to provide trade finance and unsecured loans, otherwise it risks losing the whole of the business. Where small savings banks in other countries have ventured into the small business market they have found it necessary either to expand directly their services or to do so through central giro organisations, for example as happens in Germany. Building societies, by a mixture of luck and judgment, have drawn the line in a place where the market allows them to draw the line, that is the provision of retail financial services to individuals.

FAVOURABLE HOUSING ENVIRONMENT

5.15 Societies have also benefited from operating in a favourable housing environment, although that environment is not one which is recommended to other countries as a model. Building societies' basic product is the mortgage loan used to finance house purchase. It follows that, to operate successfully, societies need a thriving market for owner-occupied housing. There has been such a market in the United Kingdom.

5.16 At the turn of the century it is estimated that about 90% of all homes in the United Kingdom were rented with most of the remainder being owned outright by their occupiers. Rent controls were imposed in Britain for the first time in 1914 and were maintained with varying degrees of severity until the late 1980s. Security of tenure

provisions also prevented landlords from coming to any agreement with a tenant which enabled them to take possession. There was also a general atmosphere of distrust towards private landlords and the subject was always one of political controversy. In such circumstances, it is not surprising that the private rental sector began a steep and unending decline such that today well under 10% of all housing units in the United Kingdom are rented from private landlords.

5.17 Two tenures grew at the expense of private renting. One was owner-occupation and the other was renting from local authorities. By the end of the 1970s a third of the housing stock in the United Kingdom was owned by local authorities, but by this time the inadequacies of bureaucratically controlled rented housing were also becoming recognised. By 1980 owner-occupation had risen rapidly to account for over 50% of all housing units and building societies had played their part in funding that increase.

5.18 Beginning in 1979 the government introduced a policy of selling off local authority housing to sitting tenants; a quarter of the stock outstanding at the beginning of 1980 has now been sold, largely financed by building societies. Accordingly, the proportion of houses that are owner-occupied has risen by about one percentage point a year and now stands at 68%.

5.19 Housing has also been very favourably treated by the tax system. Housing has been exempt from Capital Gains Tax and interest on mortgage loans has qualified for tax relief although this has been increasingly restricted to the extent that it is now largely irrelevant in many parts of the country. Housing has, therefore, been seen as an excellent investment, outperforming almost all other investments.

5.20 The standard advice given to young couples, at least until recently, was that they should seek to buy the most expensive house possible with the largest mortgage which they could afford. The stock of outstanding mortgages has risen by an average of 18% a year, reflecting the extremely favourable market environment.

5.21 The owner-occupied market has been very attractive in other respects. House prices, because of the market conditions referred to earlier, have risen steadily and generally above the rate of inflation. The house transfer system in Britain is extremely efficient with costs being much lower than in other countries. In England and Wales, an efficient land registry system ensures the smooth transfer of title and there are equally adequate arrangements in Scotland.

5.22 Lenders have enjoyed not only the security of rising house prices and borrowers' incomes but, where necessary, they have been able to realise their security. If a borrower defaults on his mortgage loan then the lender is entitled, with a court order, which is not unreasonably withheld, to obtain possession, sell the property and pay off its loan, returning any additional amount to the borrower. Many borrowers also benefit by having access to state benefit if they are unemployed and this state benefit includes an amount sufficient to pay the whole of their mortgage interest.

5.23 Mortgage lending has, therefore, been both very safe and profitable for building societies. Mortgage loans typically have carried only a very modest margin over the cost of funds, and the rates of interest on mortgage loans have correspondingly been substantially below other rates of interest. This has further contributed to the high demand for mortgage finance.

5.24 Finally, it is fair to comment that the building society system works and continues to thrive because it has become established. In the period since 1945 in particular, building societies have gradually increased their share of outstanding savings and mortgage loan business and have come to be accepted as the place where ordinary people obtain their loans to purchase their homes and deposit their savings. The large societies are household names and almost every family has at least one, if not more, building society account. Accounts are often opened in the names of children at a very young age and even among five-year-olds the market penetration of building societies is around 40%.

5.25 Societies developed this very entrenched position for the reasons explained earlier in this chapter. They were fortunate to operate in a favoured market and were not subject to the same constraints on their operations as their natural competitors, the banks and the savings banks. When the market situation changed, as it has done over the past ten years, the very entrenched position of building societies has been sufficient to ensure that they have maintained their pre-eminent position. It has proved difficult for the commercial banks to regain the business they had lost and foreign institutions have not found it easy to penetrate the UK market, notwithstanding the absence of any regulatory or legal obstacles to them so doing.

CHAPTER 6

WHAT ARE THE OTHER HOUSING FINANCE SYSTEMS?

6.1 The housing finance system in Britain predominantly uses retail deposits to fund variable rate mortgage loans. It is helpful to examine briefly the other housing finance systems and to contrast them with the "building society system".

THE CONTRACTUAL SYSTEM

6.2 A variation of the building society system is one where individuals contract to save a certain amount and when they have saved that amount they are entitled to a loan. Both the savings and the loan usually carry an interest rate below market rates and often there is entitlement to a government financed bonus or tax benefit.

6.3 The contractual system is best established in Germany through the Bausparkassen. These institutions, most of which are linked to other financial institutions (some are actually departments of the central giro institutions of the savings banks), have an extremely well entrenched role in the German housing finance system. The system has evolved in response to the characteristics of the German housing and savings markets.

6.4 In Germany, housing is much more expensive than in the United Kingdom, and there is a thriving rental sector. It is unusual for people to own houses while they are in their twenties, and most first-time buyers are in their late thirties. It follows that people have the opportunity to save a greater deposit than is the case in the United Kingdom and also, because house prices are so high, they have a need to save a greater deposit. The contractual system, therefore, works well.

6.5 The normal contractual savings period is seven years and at the end of that period the borrower is typically entitled to a loan equal to twice the amount he has saved. The savings and the loan are both at slightly below a market rate of interest but there is entitlement to a government premium or tax benefit.

6.6 The Bausparkasse system cannot provide more than a fraction of the total finance which the homebuyer requires, typically 20% and certainly no more than 35%. The system, therefore, has to be used in tandem with other systems. In Germany, typically the house purchaser will have a combination of a savings bank loan, financed in much the same way as a building society loan, a long-term mortgage bank loan at a fixed rate of interest, and a Bausparkasse contract. In some cases the Bausparkasse contract is taken out only when the house is purchased, and the contract can be seen as a method of repaying the loan rather than as a method of borrowing.

6.7 To the outsider, the German system may look cumbersome but in practice a full package is offered to homebuyers by one of the institutions concerned, very often the savings bank, co-operative bank or commercial bank with which the individual concerned has his banking business.

6.8 A very similar system operates in Austria, where there are four independent Bausparkassen, but each one is linked to one of the major banking groups.

6.9 A variation of the Bausparkasse system operates in France through the Epagne Logement system. The basic difference between this and the Bausparkasse system is that rather than special institutions offering the contractual arrangements they are offered by any bank which wishes to participate in the scheme. The Crédit Agricole, the network of the agricultural co-operative banks, is the market leader. As in Germany, the Epagne Logement system needs to be combined with other loans in order to produce a sufficiently large package to finance house purchase.

6.10 In no other industrialised country does the contractual system apply, and although it has been attempted in some developing countries the impact has been modest. Although the principle is sound there are a number of inherent problems with the system, the main one of which being that it can raise only a proportion of the funds which homebuyers require. Depending on how the system is structured it is likely that it also requires a continued infusion of new customers in order to meet the obligations to existing ones; alternatively, it requires customers to take out savings contracts who do not then want loans.

ROLL-OVER LOANS

6.11 Another slight variation on the savings bank system is the granting of a series of connected short-term loans. A borrower may, for example, be able to take out a 25-year loan but with the rate of interest fixed for five years at a time. This loan can then be funded by deposits raised on five-year terms. The system operated in Canada with quite considerable success for many years. It gave

the borrower certainty for a five-year period as to what his interest rate and, therefore, what his repayments would be. If interest rates rose gradually over the five-year period then the borrower could actually afford, without too much difficulty, the higher rates when the loan was renewed because his income would have increased in that period, and lenders were also protected because house prices would similarly have risen.

6.12 However, the system came to grief in the 1970s and 1980s as interest rates oscillated violently. People found that, purely by chance, they were having to redeem their loans when interest rates were substantially higher than they had been only a few months earlier. Lenders responded by shortening the repayment term and by offering variable rates on the British pattern.

6.13 Paradoxically, Britain has moved towards the Canadian system. In the late 1980s and the early 1990s, for a considerable time short-term interest rates were substantially higher than long-term interest rates. Lenders were able to borrow tranches of funds for two, three or four years and lend them out at fixed rates for the same period at a rate substantially below the going rate on variable rate loans. These loans have been very attractive but, unlike in Canada, have normally been transformed into variable loans at the end of the period.

THE MORTGAGE BANK SYSTEM

6.14 The complete opposite to the building society or savings bank system is the mortgage bank system, which operates predominantly in the continental European countries. Under this system, mortgage lending institutions lend at fixed rates of interest for between ten and 20 years. They fund their activities not by raising deposits from individuals but rather by issuing bonds on the capital markets. These bonds may be purchased by banks, insurance companies, pension funds and even individuals. This can be seen as a double intermediation system. With the savings bank system people invest money in savings banks or building societies which then lend back to people. With the mortgage bank system people invest money in building societies or savings banks which lend it, generally by purchasing bonds, to mortgage banks, which then lend to homebuyers, often operating through the savings banks or building societies as agents, because they have no retail outlets themselves.

6.15 The mortgage bank system has a number of distinct advantages. Because it is not dependent on branch networks, administrative costs are very low compared with building societies or savings banks. Fixed rates also have an advantage; the borrower knows what rate he will be paying for the whole life of the loan.

6.16 However, the system also has disadvantages, especially when interest rates fluctuate markedly. When interest rates decline borrowers may wish to pay off high rate mortgage loans, refinancing them with cheaper loans. In countries where this has been allowed to happen, for example the United States (although there, the mortgage loans were funded by retail deposits) and France, it has put the financial institutions in financial difficulty as they have been guilty of the cardinal banking sin of borrowing short and lending long. Where premature redemption of loans has not been allowed, as in Denmark, then a rise in interest rates can have a disastrous effect on the housing market as individuals wait for rates to fall before seeking to enter the market. There is also a degree of inequity in that borrowers living next to each other may find that they can be paying vastly different mortgage rates simply because of the accident of timing of the house purchase.

6.17 The mortgage bank system is particularly strong in Germany, although it is frequently used with the Bausparkasse system and the savings bank system, and it has predominated in Italy and the Scandinavian countries. In countries where it has been the dominant form of housing finance this has often reflected a regulatory regime which has either limited banks in their ability to make long-term loans (as in Italy) or has reserved the right to make long-term bond issues of a specific type to mortgage bank (as in Germany and Sweden). In some countries, including Sweden, there has been an obligation on the part of certain financial institutions to purchase bonds issued by the mortgage banks.

6.18 With the financial deregulation which has taken place throughout the world some of the well established mortgage bank systems have changed radically. Where banks have been free to make long-term loans themselves then the mortgage banks have suffered a loss of market share and have had to adapt their method of doing business including, in some cases, by seeking to become deposit-taking bodies.

CONCLUSION

6.19 An examination of the experience of other countries cannot show any right or wrong way to make mortgage loans. Each country's system has developed in response to the particular market, regulatory and other circumstances of the country. This is as true of the British system as of any other. It has worked well in the British context. It might not have worked well in other countries.

6.20 However, it is reasonable to say that the savings bank system, working with variable rates of interest, has stood the test of time better than other systems. The American system of funding long-term mortgage loans with short-term deposits has been a disaster. Rigid mortgage bank systems have presented major problems, either for the financial institutions themselves or for their borrowers, where interest rates have fluctuated markedly. Where interest rates have been relatively stable, and perhaps Germany is the best example here, then it has made little difference which housing finance system has been used as effectively they are all much the same in a stable interest rate environment.

6.21 The key question facing policy makers is not whether interest rates should be fixed or variable or how mortgage loans should be funded but rather what mechanism is most appropriate given the likely macro-economic conditions in the country concerned. If interest rates are going to fluctuate markedly then a system which uses variable mortgage rates is most likely to protect the institutions concerned, but only at the expense of transferring risk to the borrowers. In a free mortgage market it is likely that the savings banks system will predominate but where mortgage banks and the mortgage bank system are well entrenched then there is no reason to suspect that those institutions will not be able to continue taking a significant share of the market.

CHAPTER 7

APPLICABILITY OF THE BUILDING SOCIETY MODEL IN OTHER COUNTRIES

7.1 This chapter considers the applicability of the building society model of housing finance in developing countries and in the former command economies of Central and Eastern Europe. While the characteristics of the third world and former command economies differ radically, the nature of the problems which have to be faced in developing housing finance systems are similar.

FORMER COMMAND ECONOMIES

7.2 Over the past four years there has been a dramatic political transformation in the countries in Eastern Europe. Communist governments have largely been removed and all of the countries are seeking to move fairly quickly from a command economy to a free market economy. However, in making such a move the countries must start from where they are and not from where they would like to be.

7.3 While some of the Eastern European countries have been relatively successful in the industrial field they have not developed either housing or financial systems that are recognisable in western terms. Housing markets have operated on a non-market basis. A significant proportion of the housing stock has been built by the state or by quasi-state bodies. Rents have been extremely low, frequently not even covering the costs of collecting the rents, day-to-day management and maintenance. Housing has been allocated by a bureaucratic system with local communist party organisations having significant influence. In some countries there has been a strong owner-occupation sector, particularly in rural areas. However, even the owner-occupation sector has been closely regulated. In Hungary, for example, owner-occupied units could be sold only to someone with the approval of the state and at a price determined by the state. Where loans to finance house purchase have been available, these have been at very low interest rates, generally 1% or 2%. Most of the East European countries do not have efficient land title systems, nor generally is it possible for a lender to take possession of the property in the case of default of the borrower. In most countries there has been a single monopoly lender, generally a state savings bank in one form or another.

7.4 The banking industry has been similarly regulated and operated on a non-market basis. There has been only a small number of banks with virtually no competition between them. Public savings have predominantly been invested in state savings banks and the proceeds have been handed over to the government. Normal bank underwriting criteria have not been used but rather the banks have been regarded as an extension of the state.

DEVELOPING COUNTRIES

7.5 While the former command economies have unsatisfactory housing and banking systems, in the case of many developing countries the problem is that there are no systems. The vast majority of third world countries have had to cope with the major problem of a rural to urban drift with substantial squatter and slum settlements being developed on the outskirts of the major cities. Informal mechanisms have predominated both in respect of the construction of housing and its financing. A high proportion of people live in dwellings which do not exist officially. Land is subdivided illegally and land is occupied without due authorisation. Much construction is on a self-help basis. Even where substantial units are built often it is the informal system which both does the building and provides the finance. In none of the poorer third world countries do financial institutions fund more than 10% of construction activity; rather the funding comes from drawing on savings, friends and informal mechanisms such as rotating credit societies.

7.6 The former command economies and third world countries share one problem, that is inefficient land title systems and the inability of mortgage lenders to obtain possession if the borrower defaults. India and Egypt are among the countries where, in practice, it is impossible for lenders to take possession. There are a number of responses which lenders have adopted to deal with this problem. In India, for example, it is normal to require two or three guarantors before a loan can be made and lenders have no hesitation in calling on these guarantees if the borrower defaults.

BENEFITS OF THE BUILDING SOCIETY MODEL

7.7 Given the market position in the former command economies and third world countries, what are the benefits of the building society model?

Perhaps the first benefit, and indeed the essential foundation stone on which a financial system can be built, is that there is an abundance of evidence that people will save for house purchase. Even people on very low incomes are willing to make major sacrifices in order to become home-owners. An expansion of home-ownership can, therefore, be seen as a method of deepening financial markets.

7.8 The building society model also shows the benefits of a specialist system concentrating on the retail markets. The experience in a number of countries has been that where housing finance institutions have been able to undertake other banking activities then they have found it easier to do so rather than concentrate on what is often the complex business of giving loans to finance house purchase. Where, however, an institution is specialist in this field it can take advantage of the specialism through economies of scale and can even use its expertise to help the development of the housing finance market generally. The work of the Housing Development Finance Corporation in India is a good example here, although, significantly, this institution raises most of its funds from the capital markets rather than from the retail financial markets.

7.9 The simplicity of building societies should also be attractive. People can see that the money which they invest in the society is actually used to fund house purchase, perhaps for their own friends and relatives or people in the area in which they live. Building society type institutions are seen to be a "good thing" and do not suffer from the remoteness which is characteristic of banks.

THE REQUIRED FRAMEWORK

7.10 What then is the required framework for an efficient housing finance system based on the building society model?

7.11 The first and most important is that there must be an adequate land tenure system. This must include an efficient system for determining the ownership of property and for ownership to be transferred smoothly and efficiently. In very few third world or Eastern European countries does such a system exist other than on paper. One can find examples, particular in African countries such as Kenya, of houses being unsold simply because of a failure of the land tenure system.

7.12 Related to this, lenders must have the right to take possession of a property where the borrower has defaulted. It is misguided consumer protection to prevent this happening. If lenders cannot take possession then effectively they do not have the loan secured on property but rather an unsecured loan. Their reaction will either be to charge a higher rate of interest or to require additional security or a combination of the two. Whatever route is chosen the end result is that the cost of the house purchase is substantially higher and some people are excluded totally from the market. This is not to suggest that lending institutions should be able to evict people at their whim. In Britain, the system works well even though the lending institution has to obtain a court order. There is an inevitable time lag between a lender seeking a court order and a court order being enforced, but generally this is no more than six months and that is something that lenders can live with. What they cannot accommodate is a delay of years or even, as is the case in some countries, the practical impossibility of taking possession, which is likely to lead borrowers to be reluctant to meet their mortgage repayments knowing that there is no particular advantage for them so doing.

7.13 As far as the institutions are concerned, it is important to have a sound prudential framework. Other things being equal, this is best controlled by the central bank rather than a specialist regulatory body, although where these exist and operate successfully there seems no need to alter the arrangements. There must be adequate capital adequacy standards set for deposit-taking institutions and checks kept on their systems of control and their management. In the third world countries experience suggests that it is a mistake to establish too many competing deposit-taking institutions (as has happened in Kenya). It has to be recognised that there are limited savings which can be tapped, limited management expertise to run the institutions and limited regulatory expertise. Three or four healthy institutions are far more likely to create a viable housing finance system than 20 or 30 institutions, the collapse of one or more of which can easily adversely affect those which should be thriving. While government has a duty to provide a sound prudential framework it should not otherwise intervene in the operation of deposit-taking institutions. It is particularly important that it should not impose either credit or interest rate controls. Limits on interest rates which can be charged are often imposed with the best of motives but can have very damaging results. They create an artificial demand for loans and restrict the supply and, at worse, can seriously threaten the viability of the financial institutions themselves. Similarly credit controls, either negative, that is preventing lending on certain terms or to certain people, or directional, that is requiring institutions to invest in certain assets, simply serve to distort the market. They prevent institutions from operating competitively and will inhibit a building society from raising deposits if it is clear to depositors that the funds so raised are being used for purposes which were not intended.

7.14 It is equally important that there should be no strong artificial competition from government backed organisations. A building society type institution cannot operate successfully if it has to compete with government offering tax free savings accounts with 100% security. Governments must recognise their role as enablers and not attempt either to be significant lenders or depositors, something which they can do successfully only if they operate on a market basis and, if they operate on a market basis, there is no need for them to operate at all as the market will produce the necessary institutions.

7.15 Having made these positive points it is necessary to add two important caveats which have little to do with housing or financial markets. Political stability is very important in a housing market. People purchase housing as a long-term investment decision and repaying their mortgage loans will account for a significant proportion of their income for many years. If there is uncertainty, for example, a fear that government might take actions which could reduce house prices or increase loan interest rates, inevitably there is a danger that people will be deterred from house purchase. If people fear that their savings will be seized or used for the wrong purposes then they will be deterred from investing in building society type institutions. A stable political framework is essential if there is to be a stable housing finance system.

7.16 Similarly, economic stability is important. If inflation is running at 20-30% or more and interest rates are similarly at a high level then it is impossible to create an effective housing finance system. One can certainly create elements of the system and use devices such as dual index mortgages or index linking but these are always second best options. Similarly, while the variable rate mortgage is undoubtedly an important instrument it cannot accommodate huge swings in interest rates any more than the mortgage bank system can accommodate it without jeopardising the health of the institutions concerned.

7.17 It is probably no exaggeration to say that if the government of a third world or Eastern European country can create political stability and relative economic stability, and if it introduces an appropriate land tenure system which allows mortgage lenders to take possession and a sound prudential framework for financial institutions, then providing it does not itself artificially compete with the private sector then savings bank or building society type institutions will quickly emerge and will play a major role in the housing finance market. It does not require the government to take direct measures to achieve this end but rather to avoid taking measures which prevent it happening and to create the right framework in which a viable system can develop and ultimately thrive.

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