A stable source of funds for UK building societies

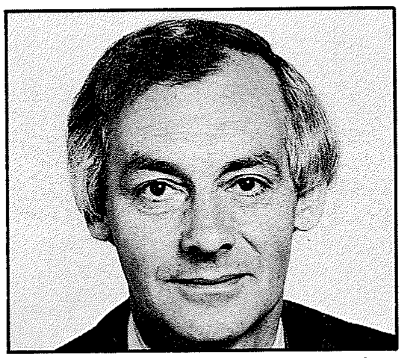
Eurobond markets are making a valuable contribution to societies' inflow, as Brian Phillips explains

BUILDING societies were originally formed in the latter part of the 18th century by individuals who joined together to subscribe to a fund in order to build or buy houses for themselves. The activities of these terminating societies were limited in that once all the members were housed, the society was disbanded.

Terminating societies were gradually replaced by permanent societies which not only raised money by issuing shares but also accepted deposits from people who were looking for a return on their investment rather than the opportunity to purchase property.

Following these early developments societies steadily increased their activities by encouraging both savings and home ownership, but it was the 1970s which saw the demand for mortgage loans increasing sharply as inflation pushed up house prices and more and more people sought to become home owners. Between 1970 and 1980 the number of borrowers increased from 3.7 million to 5.4 million, the number of societies' branches from 2,000 to 5,700 and the number of share accounts from 10 million to 30 million.

The demand for mortgage loans continued to exceed the supply despite the steps taken by societies during the 1970s to attract additional funds. First, term shares paying premium rates of interest for a fixed period were introduced to attract longer-term investments.



Subsequently, accounts paying higher rates but subject to a period of notice prior to withdrawal were launched. Although subsequent changes allowed premature withdrawals from fixed period investments and reductions in notice periods on other accounts, sufficient funds could not be attracted at reasonable interest rates. Societies therefore began to turn to the wholesale markets to increase their funding.

First, in 1980 funds were raised through syndicated bank loans, closely followed by the issue of building society bonds. In 1983 societies issued Certificates of Deposit for the first time, and started accepting Time Deposits. Following the recent issues of Eurobonds wholesale funds now represent 6.5% of total liabilities.

Regulatory reform allowing Eurobond market to be used

UK taxation laws changed in 1984 to allow companies to pay interest gross on Eurobonds and The Building Societies Association made representations for similar powers to be extended to building societies. Subsequently in the 1985 Budget, the Chancellor of the Exchequer announced that building societies would be allowed to pay interest gross on quoted Eurobonds to non-UK resident holders after 5 April 1986.

As a result, following the publication of the 1985 Finance Bill, societies were able quickly to launch their first Eurobond issues in September 1985. The only pre-requisite was that the first interest payment should be due after 5 April 1986.

The interest on quoted Eurobonds would normally be subject to UK income tax by direct assessment on the recipient non-resident holder of the bonds. However, as with other gross interest payments to non-residents, a UK Inland Revenue Extra-Statutory concession (No. B13) effectively means that no action is taken to pursue such tax liability in most circumstances, so long as the beneficial owner of the interest is not resident in the UK and has no assessable branch or agency in the UK. An example of an exception to this is where the tax can be recovered by a set-off on a claim to relief in respect of taxed income from other UK sources.

The legislation allowing building societies to utilise the Eurobond market for their funding is, therefore, a fiscal measure. In addition, however, and once again following representations by the BSA and backed by favourable legal opinion, the Registry of Friendly Societies issued a guidance note on 5 March 1986 stating that a sterling fixed rate bond issue swapped into floating rate would be permissible. Societies have since made several issues when "windows" in the market have opened to make such issues favourable.

Building Society Eurosterling Issues

Date	Society	Initial Amount £m	Term Years	Lead Bank
1985				
September	Halifax	150	7	Morgan Grenfell
	Nationwide	200	10	Credit Suisse First Boston
	Abbey National	150	15	Samuel Montagu
	Bristol & West	100	7	County Bank
October	Britannia	75	8	Hambros
	Alliance & Leicester	150	8	Warburgs
November	Woolwich	200	5	Hambros
December	Anglia	100	8	Morgan Guaranty
1986				
January	Halifax	200	10	Morgan Grenfell
February	National & Provincial	200	10	Goldman Sachs
March	Leeds Permanent	50	5	Baring Bros (swap)
	Halifax	50		Morgan Grenfell (swap)
	Nationwide	75	7	Credit Suisse First Boston (swap)
	Bradford & Bingley	100	10	Credit Suisse First Boston
	Alliance & Leicester	60	5	Warburgs (swap)
	Leeds Permanent	200	10	Baring Bros
April	Halifax	200	8	Morgan Grenfell
May	Leeds Permanent	50	7	Baring Bros (swap)
June	Alliance & Leicester	50	7	Salomon Brothers
	Abbey National	200	7	Samuel Montagu
	Britannia	25	7	Hambros
	Nationwide	250	10	Baring Bros
	Alliance & Leicester	300	8	Morgan Guaranty

Why societies are using the Eurobond market

There are a number of reasons why societies have entered the Eurobond maket, the main one being to provide access to a new and very much wider source of funds than has been possible through the domestic retail and wholesale markets. This attraction will increase if societies are permitted to tap the foreign currency markets following the building societies' legislation recently enacted by Parliament.

Any funds raised in a foreign currency may readily be converted through the swap mechanism into variable sterling interest rates and the final cost could be below the London Interbank Offered Rate (LIBOR). In this way funds can be raised from a worldwide spread of investors ranging from large institutions to wealthy individuals who find the Eurobond market attractive.

Another attraction of the Eurobond market to building societies is the life of the loans — varying between five and 10 years — which is a good match for mortgages which have an average life of seven years when account is taken of early redemptions. Eurobonds have therefore led to an improvement in building society capital structures in addition to reducing the administrative costs associated with shorter-term funding.

The variable interest rates — after swaps in the case of fixed rate issues, which are usually linked to three month LIBOR — are also an attraction. These fit in well with the variable interest rate nature of societies' balance sheets and mortgage lending policies. This avoids a high level of interest rate exposure without the need to seek cover in the futures market or through other interest rate exposure management tools.

Furthermore, the ability of societies to raise large sums at short notice through the market is particularly attractive to societies seeking to respond quickly to the increased demand for mortgages that so often occurs when UK interest rates fall sharply.

Building societies entered the Euromarket for the first time in October 1985, with four societies raising £600 million between them from the issue of Floating Rate Notes. First was the Halifax on 2 September 1985, with a £150 million issue, followed by Nationwide three days later with the largest-ever issue of £200 million. Abbey National was close behind with £150 million, as was Bristol and West with £100 million.

Societies generally adopted the procedure of appointing a "lead bank" to manage the issue, organise other banks which would agree to participate with the help of one or more co-lead managers and advise generally on the issue, particularly on terms. For the first few societies this was a challenging task as British building societies needed to be "sold" to investors who were largely unaware of societies' existence and certainly unaware of their financial structure.

Undoubtedly, the London branches of the major overseas institutions helped in this task and the European and Far East Roadshows in which most of the leading building societies have participated have maintained investors' interest. So successful was the initial marketing campaign that the three largest societies paid an interest rate of only 1/16% over LIBOR. They paid 40 basis points to the lead managers to cover issue expenses and the commissions payable to other institutions for the inevitable risks between launch and issue, as no underwriting fees as such were paid.

On settlement day the societies received the cash and then were reliant on the lead managers, co-lead managers and other institutions to continue to support their issues in the secondary market — further issues on the same or similar terms would otherwise be impossible.

Following the initial issues in October most of the other leading societies entered the market by June 1986 as shown by the table. The five fixed rate issues listed in the table (Swap) have enabled societies to raised £285 million at interest rates close to or below LIBOR. This has increased the total funds raised in the Eurobond market to £3.1 billion.

With the prospect of foreign currency borrowings next year, the Eurobond markets look set to continue to provide a cost-effective means of securing stable funds for the UK housing market in the future ■.

Brian Phillips joined Nationwide Building Society from Local Government in 1967. He has served on a number of BSA committees and, in 1980, chaired a committee on marketable securities.